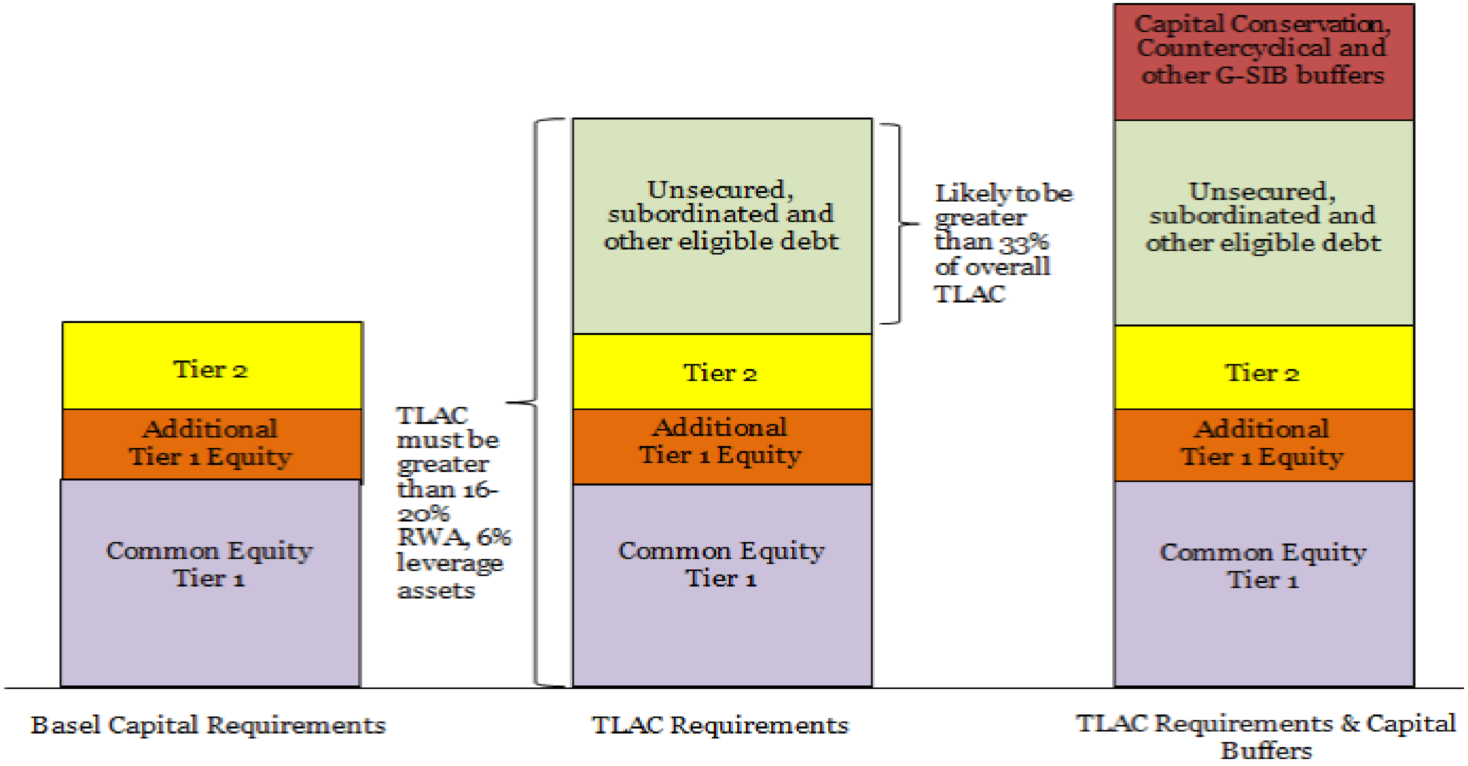
The FSB Final TLAC Principles and the Federal Reserve Board's LTD, TLAC and Clean Holding Company Proposal

December 2015

Objective of TLAC

- Where does TLAC fit in?
  - For Basel purposes, a bank must satisfy the minimum regulatory capital requirements
  - In addition to the minimum regulatory capital requirements, banks are subject to the capital conservation buffer and any applicable counter-cyclical capital buffer
  - In addition to that, G-SIBs must have “buffer” capital or a G-SIB “surcharge”
  - **Finally**, G-SIBs must meet TLAC requirements
    - TLAC is intended to prevent a bank failure
    - TLAC would be relied upon to provide additional loss absorbency and facilitate resolution

Where does TLAC fit in?



The Financial Stability Board Principles

A timeline

- Financial Stability Board Proposal for Comment was issued in November 2014
- Comment period closed in February 2015
- FSB conducted a quantitative impact study (QIS) in which it collected information from G-SIBs
- The final TLAC principles were released on November 9, 2015.

The FSB Principles-overview

- Designed to facilitate orderly resolution of G-SIBs
  - 30 banks globally
  - Includes 8 US banks
- Calibration of minimum TLAC from January 1, 2019 of 16% of risk weighted assets (RWAs) rising to 18% from January 1, 2022 and from January 1, 2019, 6% of the Basel III leverage ratio denominator and from January 1, 2022, rising to 6.75% of the Basel III leverage ratio denominator
  - Phased in requirements for GSIBs headquartered in emerging markets
  - Tier 1 and Tier 2 Capital is “eligible”
  - Other eligible TLAC that is not regulatory capital
- Additional TLAC may be required for individual G-SIBs based on risk factors
- Two elements: Risk-weighted TLAC ratio and a TLAC leverage ratio

Regulatory capital instruments

- TLAC and regulatory capital instruments
  - The sum of a G-SIB's resolution entity's (1) T1 and T2 regulatory capital instruments that are in the form of debt, plus (2) other eligible TLAC that is not regulatory capital, is equal to or greater than 33% of the G-SIB's minimum TLAC requirement
  - Regulatory capital instruments may count toward minimum TLAC requirement, subject to certain conditions:
    - CET1 regulatory capital instruments used to satisfy minimum TLAC requirement cannot also be used to satisfy capital buffers
    - Non-CET1 regulatory capital instruments must be issued under the laws of a jurisdiction in which resolution tools, statutory write-down or conversion powers are effective
    - Non-CET1 regulatory capital instruments issued by subsidiaries of the resolution entity, that are located in a different jurisdiction from the resolution entity, must be capable of being written down or converted to equity at the point of non-viability of the subsidiary without the subsidiary having to enter into a resolution proceeding

Regulatory capital instruments (cont'd)

- Regulatory capital instruments issued from entities forming part of a material subgroup may count toward minimum TLAC only to the extent that home and host country authorities agree conversion to equity would not result in a change-of-control

TLAC Eligibility Criteria

- TLAC Eligibility Criteria:
  - External TLAC must be issued and maintained by resolution entities (except, in some circumstances, regulatory capital issued by wholly and directly-owned funding entity will be eligible)
  - Paid-in
  - Unsecured
  - Not subject to netting
  - Perpetual or minimum remaining contractual maturity of one year (for any security with a redemption feature, first redemption date would be effective maturity date; “maturing” instruments would need to be replaced with new TLAC-eligible instruments)
  - Subject to certain limited exceptions, not funded directly by the resolution entity or a related party of the resolution entity
- Eligible TLAC must contain a contractual trigger or be subject to a statutory mechanism which permits the resolution authority to write down or convert to equity

TLAC Eligibility Criteria (cont'd)

- Excludes
  - Insured deposits, sight deposits and deposits with original maturity of less than 1 year
  - Liabilities funded by the resolution entity or a related party (possible exception for parent-funded TLAC in some circumstances where a multiple point of entry resolution strategy applies)
  - Liabilities arising from derivatives or debt instruments with derivative-linked features—e.g., structured notes
  - Non-contractual liabilities, such as tax liabilities
  - Preferred liabilities
  - Other liabilities that cannot be written down or converted to equity by resolution authorities without giving rise to material risk of successful legal challenge/valid compensation claim

TLAC Eligibility

- Priority: in order to ensure that TLAC instruments absorb losses prior to liabilities excluded from TLAC, TLAC eligible instruments generally must be:
  - Contractually subordinated;
  - Statutorily subordinated; or
  - Structurally subordinated
- Redemption: eligible external TLAC instruments cannot be redeemed without supervisory approval, unless G-SIB would still be in compliance with TLAC requirements thereafter
- Deductions: a G-SIB must deduct from TLAC any holdings of third-party G-SIB TLAC instruments (to avoid contagion risk)

TLAC Eligibility (cont'd)

- Liabilities that are not TLAC eligible may still remain subject to potential bail-in under the European BRRD

TLAC Eligibility (cont'd)

- Treatment of debt issued by subsidiaries:
  - Prior to January 1, 2022, debt liabilities issued by a wholly and directly owned funding entity of the resolution entity may count for external TLAC purposes, provided that:
    - The issuance is consistent with paragraph 65 of the Basel III framework (requires a finance company issuance), including that the assets of the funding entity must meet the eligibility criteria for TLAC instruments;
    - There is substantial legal certainty that the TLAC will absorb losses at the resolution entity in its resolution; and
    - Home and host authorities agreed on issuance through funding entity.
  - Term sheet also provides for a phase-out from eligible TLAC of regulatory capital instruments issued from subsidiaries within the resolution group and held by third parties, except where the instrument constitutes CET1.

Internal TLAC

- Resolution entity must have “External TLAC” as discussed
- Material sub-groups in jurisdictions outside of bank’s home country must have “Internal TLAC”
  - Each material sub-group must have 75-90% of the external TLAC that would be required of the material sub-group, if it were a resolution group
  - For this purpose, a “material sub-group” is one whose members are incorporated in the same jurisdiction (other than the jurisdiction of the resolution entity) and are not themselves resolution entities, do not form part of another material sub-group of the resolution group and that: (i) has more than 5% of consolidated RWAs of the G-SIB group; (2) generates more than 5% of total operating income of the G-SIB group; (3) has total leverage exposures that are more than 5% of the G-SIB group’s total leverage exposure; or (4) has been identified as material to the firm’s critical functions

Internal TLAC (cont'd)

- Internal TLAC:
  - Loss-absorbing capacity at material subsidiaries of a resolution entity, which subsidiaries are incorporated outside of the resolution entity's home country intended to facilitate resolution within the host country
  - Minimum size of internal TLAC: each material sub-group must maintain internal TLAC of 75% to 90% of the external minimum TLAC that would apply to the material sub-group if it were a resolution group, as calculated by the host country. In addition to the minimum, the host country could impose a firm-specific requirement as well.
  - Internal TLAC should be pre-positioned on-balance sheet at the material sub-groups; internal TLAC that is not pre-positioned should be readily available
  - Substitution: home/host countries may agree jointly to substitute on-balance sheet internal TLAC with TLAC in the form of collateralized guarantees subject to certain conditions
  - Eligibility Criteria: criteria for internal TLAC and for external TLAC are the same

Implementation of FSB Principles

How will FSB principles be implemented?

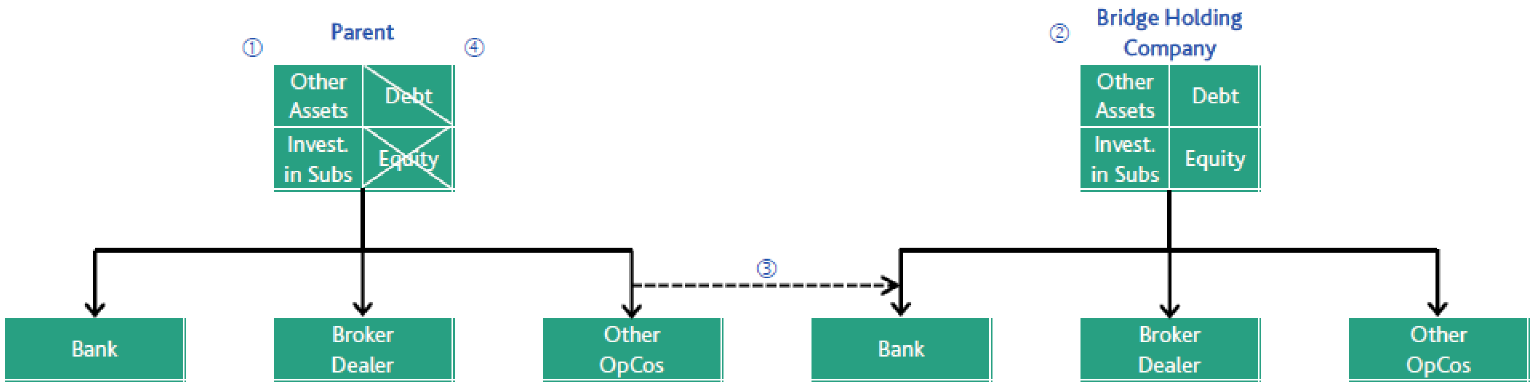
- Each jurisdiction must enact regulations that implement the principles
- In Europe, the BRRD establishes a minimum required eligible liabilities (MREL) requirement (applies more broadly than the FSB principles)
- Differences exist between MREL and TLAC:
  - MREL applies from January 1 2016
  - MREL applies to all European banks, not just GSIBs
  - MREL levels are decided by each national resolution authority on a case-by-case basis for their banks
  - MREL eligibility requirements differ in some respects from TLAC (e.g. no requirement for MREL subordination to excluded liabilities)

Implementation of FSB Principles (cont'd)

  - MREL levels set by reference to own funds and liabilities i.e. non-risk-weighted
- Reconciliation likely to be achieved by level of discretion given to national resolution authorities, by requirements to have regard to issues such as the risk of exclusion from bail-in of otherwise eligible liabilities and express ability in draft final RTS of EBA for resolution authorities to consider RWA-based capital requirements and leverage ratio requirements in setting MREL as a percentage of own funds and liabilities

FRB Proposal

Single point of entry resolution



Source: Moody's Investors Service, Federal Deposit Insurance Corporation

FRB proposal

- The FRB released its proposal on October 30, 2015 which would establish for covered BHCs and covered IHCs an external TLAC requirement in the case of covered BHCs (and an internal TLAC requirement in the case of covered IHCs), a related TLAC buffer, a minimum long-term debt requirement for covered BHCs (and a minimum internal long-term debt requirement for covered IHCs), and a "clean holding company" requirement
- Premised on the view that TLAC alone is not sufficient to facilitate SPOE resolution
- As a result, the FRB approach differs from the FSB approach
- In addition, to avoid contagion risk, the FRB proposal also would penalize banks generally for holding unsecured debt of a covered BHC

FRB proposal (cont'd)

- U.S. covered BHCs must maintain:
  - Outstanding eligible external long-term debt equal to the greater of: (i) 6% of RWAs, plus the applicable G-SIB buffer, and (ii) 4.5% of total leverage exposure, plus
  - Outstanding eligible external TLAC equal to the greater of: (i) 18% of RWAs (when fully phased-in), and (ii) 9.5% of total leverage exposure
  - An external TLAC buffer

External long-term debt

- **What is eligible external long-term debt?**
  - Debt securities issued directly by the covered BHC that:
  - Are unsecured
  - Are "plain vanilla"
  - Are governed by U.S. law
  - Have a remaining maturity of over one year
- *Eligible external long-term debt with a maturity of less than two years would be subject to a 50% haircut*
- **What is "plain vanilla" debt?**
  - The debt cannot contain an embedded derivative, have a credit sensitive feature, contain any contractual conversion or exchange features, or include acceleration rights, other than on payment defaults
  - No structured notes

External TLAC

- **What is eligible external TLAC?**
  - The sum of (1) common equity Tier 1 capital and AT1 capital issued by the covered BHC, and (2) eligible external LTD
- **What is the amount of the external TLAC buffer?**
  - An external TLAC buffer is <u>added</u> on top of the 18% risk-based capital component of the external TLAC requirement, which can be met only with common equity Tier 1 capital
  - Equals the sum of 2.5%, any applicable countercyclical capital buffer, and the G-SIB surcharge calculated under Method 1
- **What is the consequence of failing to meet the external TLAC buffer requirement?**
  - Restrictions on distributions and discretionary bonuses (similar to CCB)

IHCs of Foreign G-SIBs

- A covered IHC would be subject to an internal LTD and an internal TLAC requirement
- FBOs with consolidated global assets of $50 billion or more and consolidated U.S. assets of $10 billion or more must establish an IHC
- The following are G-SIBs with an IHC requirement (based on FSB's 11/2015 G-SIB list):
  - HSBC
  - BNP
  - Mitsubishi
  - Deutsche
  - Barclays
  - RBS
  - Mizuho
  - SocGen
  - Santander
  - UBS
  - Credit Suisse

IHCs of Foreign G-SIBs (cont'd)

- **What is the internal LTD requirement?**
  - Internal LTD will at least equal the greater of (i) 7% of RWAs, (ii) for covered IHCs subject to the Supplementary Leverage Ratio, 3% of total leverage exposure, and (iii) 4% of average total consolidated assets
- **What is the internal TLAC requirement?**
  - The internal TLAC requirement depends on whether the foreign G-SIB parent of the covered IHC will undergo SPOE or Multiple Point of Entry (MPOE) resolution
  - For SPOE, IHC would be required to keep outstanding eligible internal TLAC at least equal to the greater of: (i) 16% of RWAs (when fully phased in), (ii) for covered IHCs subject to the SLR, 6% of total leverage exposure, and (iii) 8% of average total consolidated assets
  - For MPOE, IHC would be required to keep outstanding eligible internal TLAC at least equal to the greater of: (i) 18% of the RWAs (when fully phased in), (ii) for covered IHCs subject to the SLR, 6.75% of total leverage exposure, and (iii) 9% of average total consolidated assets

Eligible internal LTD

- **What are the requirements for eligible internal LTD?**
  - Same general requirements as those applicable to eligible external LTD
  - In addition, eligible internal LTD:
    - Is required to be held by foreign parent
    - Must be contractually subordinated to the covered IHC’s third-party liabilities
    - Be required to contain contractual provisions pursuant to which the FRB could cancel the internal LTD or convert it into equity on a going-concern basis (without entering resolution) upon the occurrence of certain conditions

Eligible internal TLAC

- **What is the required amount of internal TLAC?**
  - Eligible internal TLAC equals the sum of (i) common equity Tier 1 capital and AT1 capital issued by the covered IHC to its foreign parent, 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 on top of the 16 or 18% risk-based capital component that could be met solely with common equity Tier 1 capital in an amount equal to the sum of 2.5% and any applicable countercyclical capital buffer (equal to the existing capital conversation buffer now applicable to IHCs under the capital rules)

Foreign banks

- Foreign (non-U.S.) banks that are G-SIBs and that are required to establish IHCs will need to focus on both the FSB and the FRB requirements
  - Depending on their organizational structure and how these FBOs have been funding themselves in the United States, compliance with both the FSB and the FRB requirements will create added complexity
- It is possible that other jurisdictions will apply the final FSB TLAC requirements to their domestic systemically important banks (D-SIBs) (entities that are not G-SIBs); there already are proposals to this effect in Canada, for example and in Europe the MREL provisions apply to all European banks.

Clean Holding Company

- **What is the clean holding company requirement?**
  - The proposal sets out a “clean holding company” requirement, which has two parts:
  - First, a covered BHC would be prohibited from
    - Engaging in short-term borrowings,
    - Entering into QFCs,
    - Issuing guarantees of subsidiary liabilities that could create cross-default, set-off or netting rights for creditors of the subsidiary
  - Second, 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% of the value of its eligible external TLAC
  - The clean holding company requirement applicable to IHCs differs from the requirement applicable to U.S. G-SIBs as it does not provide for the 5% bucket of non-contingent liabilities

Regulatory capital deduction

- Banks, savings and loans, and similar entities with total assets of more than $1 billion would suffer from a regulatory capital deduction for any investments in unsecured debt issued by covered BHCs (including eligible external LTD) in excess of certain thresholds

Timing

- As proposed, covered BHCs would be required to comply with the external LTD and TLAC requirements by January 1, 2019, but the RWA component of the external TLAC requirement would be phased in with an initial 16% requirement applicable as of January 1, 2019, and the final 18% requirement applicable as of January 1, 2022. The clean holding company requirement would be applicable as of January 1, 2019.
- Covered IHCs would be subject to similar effective dates and phase-ins.
- The regulatory capital deduction would become effective as of January 1, 2019.

Issues arising under FRB Proposal

Issues arising under FRB proposal

- During the comment period, we would anticipate that market participants will likely consider whether to seek guidance on certain issues, such as:
  - Structured notes
  - Covenants contained in senior note indentures
  - Survivor's option provisions
  - Guarantees

Structured note definition

- A "structured note" is a debt instrument that:
  - Has a principal amount, redemption amount, or stated maturity that is subject to reduction based on the performance of any asset, entity, index, or embedded derivative or similar embedded feature;
  - Has an embedded derivative or similar embedded feature that is linked to one or more equity securities, commodities, assets, or entities;
  - Does not specify a minimum principal amount due upon acceleration or early termination; or
  - Is not classified as debt under U.S. generally accepted accounting principles.

Structured note definition (cont'd)

- Definition clearly applies to both principal-protected and non-principal protected structured notes.
- **However, the draft Notice states that**: "The proposed definition of a structured note is not intended to include non-dollar-denominated instruments or instruments whose interest payments are linked to an interest rate index (for example, a floating-rate note linked to the federal funds rate or to LIBOR) that satisfy the proposed requirements in all other respects."
- The Proposal defines structured notes so as to avoid capturing debt instruments that pay interest based on the performance of a single index but to otherwise capture all debt instruments that have a principal amount, redemption amount, or stated maturity, that is subject to reduction based on the performance of any asset, entity, index, or embedded derivative or similar embedded feature.

Structured notes

- Rate-linked notes are not excluded
- Although these particular requirements would not apply to structured notes issued by a subsidiary of the BHC that benefits from a parent guarantee, the “clean holding company” requirements would appear to limit this
  - Therefore, the nature of the guarantee would be critical

Structured notes (cont'd)

- For rates, it may be useful to obtain clarity regarding the "benchmarks"
- The language references LIBOR and Fed Funds as examples
- Objective is to ensure that rates are readily available, "benchmark" type rates
- For a different purpose (23A/B, transactions with affiliates provisions), the FRB references securities that have a "ready market"; "prices that are quoted routinely"—these concepts could be applicable to the reference rates

Structured notes (cont'd)

- These requirements are applicable only at the BHC level, so, they would not be applicable to: structured bank notes or to market-linked CDs
  - Bank notes: there may be a concern about relying on structured bank notes if the minimum denominations are high
  - Market-linked CDs: pricing may be a factor

Covenants

- Indentures for most G-SIB issuers would be considered "covenant lite"
- Covenants are limited to fundamental matters, such as maintaining corporate existence, remaining financial holding company or bank holding company, maintaining a trustee and paying agent, etc., but do not include any affirmative or negative covenants
- However, most indentures currently contain a provision that requires acceleration of payment obligations where breaches of covenants are not cured within a specified time period, usually 90 days
- Under the proposed FRB regulations, the acceleration upon unremedied covenant breach would render a security not eligible as LTD/TLAC; however, it is unlikely that the banking agencies were focused on this fundamental covenants or that these fundamental covenants would be seen as impediments to a resolution

Survivor's option

- Many G-SIBs issue "retail debt" securities or "baby bonds" that contain a survivor's option (also called a successor's option) that permits acceleration of payment upon the bond holder's passing
- Usually, the issuer imposes a limit on the amount of debt that will be subject to the survivor's option feature
- This type of feature is viewed as retail friendly
- Under the proposed FRB regulations, this type of provision would appear to violate the prohibition against payment acceleration clauses

Next Steps

Preparing to comply

- Covered U.S. G-SIBs and covered IHCs will want to take stock of their outstanding debt securities in order to assess which securities meet the eligibility criteria, which requires:
  - Going back to the indentures (or similar agreements) governing the terms of outstanding debt securities in order to review the applicable default provisions
    - Inquiry would be made as to U.S. issuances, as well as all international offerings
    - Was any debt issued with additional relevant or unusual terms? Supplemental indentures?
  - Identifying which instruments qualify as “structured notes” (as defined in the FRB proposal), or that otherwise would not qualify as eligible debt securities, such as those with certain acceleration provisions

Preparing to comply (cont'd)

- Identifying outstanding debt securities that benefit from a BHC guarantee and reviewing the terms of all such guarantees
- Reviewing governing law for the outstanding debt securities: are securities governed by U.S. law?
- Reviewing maturities, as well as put/call features that would affect effective maturities

Preparing to comply (cont'd)

- Amendments
  - On a go forward basis, should the issuer put in place new indentures (for debt securities to be issued in the future)?
  - Can the issuer amend the terms of outstanding notes and issued guarantees? With or without holder consent?
  - Is a liability management exercise required?
    - FRB notice contemplates replacing "near eligible" debt with eligible debt
    - This could be accomplished through consent solicitations and exchange offers
      - What price would debtholders seek?
- Consider the "cap" for certain liabilities that do not meet the criteria for "clean holding companies"
  - How will a G-SIB use this "cap"?
  - Assessing liabilities that are not consistent with the clean holding company requirement also will require significant time and effort

Preparing to comply (cont'd)

- FBOs subject to the IHC requirement likely are already well along the way in formulating their IHC compliance plan
- Now, they will have to consider the requirements that would be applicable to their IHCs, and how these differ from the requirements to which the foreign parent will be subject to as a result of the FSB TLAC requirement
  - Is foreign bank a SPOE or MPOE institution?
  - Will the IHC be a "resolution entity"?
  - Which securities qualify for FSB's "internal TLAC" requirement but not for FRB's "internal TLAC" requirement?

Other structuring thoughts

- Market participants also likely will want to consider new possible approaches to issuance of non-TLAC eligible securities, whether through:
  - other issuers within the same group, such as subsidiaries (with or without a guarantee), or
  - third-party issuance (or “repackaging”) vehicles to which BHC sells a plain vanilla note