Banking and Finance Law Daily Wrap Up, TOP STORY—Fed's proposed rules would cushion large BHC and GSIB bankruptcies, (Nov. 2, 2015)

Banking and Finance Law Daily Wrap Up

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The Federal Reserve Board has issued a proposed rule that is intended to safeguard the financial stability of the United States by: enhancing the resolvability of covered bank holding companies (BHCs) under the U.S. Bankruptcy Code; enhancing the resolvability of covered BHCs under Title II of the Dodd-Frank Act; enhancing the resolvability of foreign global systemically important banking organization (GSIB) parents of covered intermediate holding companies (IHCs) under their home jurisdiction resolution regimes; and further increasing the resiliency of covered BHCs and covered IHCs. Comments on the proposal are due by Feb. 1, 2016.

Specifically, the proposed rule, which was approved by the Fed at its Oct. 30, 2015, open meeting, would:

(1) require covered BHCs to 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;
(2) require covered IHCs to 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;
(3) impose restrictions on the operations of covered BHCs and covered IHCs to be known as "clean holding company requirements"; and
(4) impose regulatory deductions for investments in the unsecured debt of covered BHCs.

External LTD and TLAC. The proposal's external LTD and TLAC requirements would apply to all top-tier U.S. bank holding companies identified by the Fed as GSIBs. Currently, the following eight firms would be subject to the proposal: 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.

To meet the external TLAC requirement, covered BHCs would be required to maintain outstanding eligible external TLAC equal to the greater of: 18 percent of risk-weighted assets (RWAs) and 9.5 percent of total leverage exposure.

The external LTD requirement would be met if a covered BHC maintains outstanding eligible external LTD equal to the greater of: 6 percent of RWAs, plus the applicable GSIB capital surcharge, and 4.5 percent of total leverage exposure.

Finally, 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 Fed's GSIB surcharge rule.

In a memorandum to the Fed, the agency's staff noted that six of the eight covered BHCs would currently have external TLAC shortfalls. The memorandum added that 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. The Fed staff estimated that the aggregate increased funding cost for the covered BHCs would range from approximately $680 million to $1.5 billion annually.

Internal LTD and TLAC. Covered IHCs, which are controlled by foreign GSIBs, would meet the internal LTD if they keep outstanding an amount of eligible internal LTD with an aggregate principal amount that is at least

equal to the greater of: 7 percent of RWAs; for covered IHCs that are subject to the Fed's Supplementary Leverage Ratio rule, 3 percent of total leverage exposure; and 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 a single point of entry strategy or a multiple point of entry 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 Fed indicating that the covered IHC is a non-resolution entity covered IHC.

Finally, 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 Fed 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.

Clean holding companies. The proposal's clean holding company requirements would apply to both covered BHCs and IHCs and is intended to facilitate a single point of entry resolution by restricting the operations of those entities that could pose obstacles to orderly resolution.

To meet this objective, certain holding company liabilities would be prohibited, such as short-term debt issued to third parties; derivatives and other qualified financial contracts with external counterparties; and certain guarantees of subsidiary liabilities or other arrangements that create disruptive default, set-off, or netting rights for subsidiaries' creditors. In addition, certain holding company liabilities would be subject to a cap of 5 percent of the value of the covered BHC's eligible external TLAC. This cap would apply to 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.

Regulatory capital deductions. The final component of the Fed's proposal would seek 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. This would be achieved by requiring 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.

During the meeting, Fed Chair Janet L. Yellen noted that the proposal "combined with our other work to improve the resolvability of systemic banking firms, would substantially reduce the risk to taxpayers and the threat to financial stability stemming from the failure of these firms. Accordingly, the proposal is another important step in addressing the 'too big to fail' problem."

Fed Governor Daniel K. Tarullo echoed Yellen's sentiment that the proposed regulation will be another important step in solving the too-big-to-fail problem. Commenting on the internal LTD requirement, Tarullo noted that "the proposal will enhance prospects for orderly resolution of the foreign banks by their home jurisdiction authorities. But if, for any reason, that resolution is unsuccessful, the internal long-term debt will be available to U.S. authorities for orderly resolution and recapitalization of the IHCs."

Governor Lael Brainard stated that the proposal "puts in place the critical remaining plank to ensure that even the largest and most complex banking institutions in America can fail without posing unacceptable risks to financial stability, by requiring them to hold a cushion of long-term debt sufficient to fully recapitalize their important operating subsidiaries in the event of bankruptcy."

Finally, Martin J. Gruenberg, Chairman of the Federal Deposit Insurance Corporation noted, "The long-term debt requirement would make sure that capital resources from private creditors would be available to facilitate this process. I look forward to continuing to work with the Federal Reserve to promote resolvability of systemically important financial firms."

Companies: Bank of America Corporation; Citigroup Inc.; Goldman Sachs Group, Inc.; JP Morgan Chase & Co.; Morgan Stanley; State Street Corporation; The Bank of New York Mellon Corporation; Wells Fargo & Company

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