October 20, 2020

MEMORANDUM TO: Board of Directors

FROM: Doreen R. Eberley, Director
Division of Risk Management Supervision

SUBJECT: Final Rule: Regulatory Capital Treatment for Investments in Certain Unsecured Debt Instruments of Global Systemically Important U.S. Bank Holding Companies, Certain Intermediate Holding Companies, and Global Systemically Important Foreign Banking Organizations; Total-Loss Absorbing Capacity Requirements

Summary: Staff is presenting for approval of the Federal Deposit Insurance Corporation ("FDIC") Board of Directors ("FDIC Board") a request to adopt and publish the attached interagency final rule ("final rule"), which would require deduction from an advanced approaches banking organization's regulatory capital for certain investments in unsecured debt instruments issued by foreign or U.S. global systemically important banking organizations ("GSIBs") for the purposes of meeting minimum total loss absorbing capacity ("TLAC") requirements and, where applicable, long-term debt requirements, or for investments in unsecured debt instruments issued by GSIBs that are *pari passu* or subordinated to such debt instruments (collectively, "covered debt instruments"). Under the final rule, an advanced approaches banking organization must treat covered debt instruments as investments in tier 2 capital instruments for purposes of applying the deduction from regulatory capital in the capital rule. Such investments are currently not subject to deduction from regulatory capital. The final rule aims to reduce both interconnectedness within the financial system and systemic risk and is substantially consistent with the interagency notice of proposed rulemaking ("proposed rule" or

Concur:

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"proposal") issued in April 2019 jointly by the FDIC, Board of Governors of the Federal Reserve System ("FRB"), and the Office of the Comptroller of the Currency (collectively, the "agencies").

The final rule would allow advanced approaches banking organizations to exclude from deduction limited amounts of investments in covered debt instruments. The agencies separately are proposing changes to regulatory reporting to effectuate the regulatory capital treatment for covered debt instruments held by advanced approaches banking organizations. As part of the same Federal Register Notice, the FRB is adopting changes to its TLAC rules to clarify requirements and correct drafting errors.

Recommendation: Staff requests that the FDIC Board approve the final rule and authorize its publication in the *Federal Register* with an effective date of April 1, 2021.

Discussion:

I. Background

In December 2016, the FRB issued a final rule requiring the largest domestic and foreign banking organizations operating in the United States to maintain a minimum amount of TLAC, consisting of tier 1 capital and certain long-term debt ("LTD") instruments ("TLAC Rule"). The objective of the TLAC Rule is to enhance financial stability by reducing the impact of the failure of certain large and systemically important banking organizations by requiring such organizations to have sufficient loss-absorbing capacity on both a going-concern and a gone-concern basis. The TLAC Rule applies to a U.S. top-tier bank holding company identified under the FRB's rules as a global systemically important bank holding company ("covered BHC") or a top-tier U.S. intermediate holding company subsidiary of a global systemically important foreign banking organization ("foreign GSIB") with $50 billion or more in U.S. non-branch assets

("covered IHC") (collectively, "covered banking organizations"). The TLAC and LTD requirements set forth in the TLAC Rule became effective as of January 1, 2019.

Instruments issued by covered banking organizations to comply with the TLAC Rule's requirements that do not qualify as regulatory capital currently are not subject to deduction in the capital rule. Rather, exposures to such instruments are subject to leverage and risk-based capital charges, which provide a more favorable capital treatment relative to a deduction from capital. The final rule would recognize the risks posed by such investments and reduce the potential contagion risk stemming from the failure of a covered BHC, covered IHC, or foreign GSIB by incorporating these exposures into the capital rule's deduction framework. This approach serves to dis-incentivize advanced approaches banking organizations from investing in the instruments issued to comply with TLAC and LTD requirements.

Consistent with the proposed rule, the final rule would continue to apply only to advanced approaches banking organizations.[1] As explained in the proposed rule, the systemic risk associated with banking organizations' investments in covered debt instruments is greatest for the banking organizations covered by the proposal. The final rule states that the agencies acknowledge the possibility of potential systemic risks associated with other banking organizations' investments in covered debt instruments and will continue to evaluate whether additional steps are warranted to address such risks.

II. Overview of Notice of Proposed Rulemaking and Summary of Comments

In April 2019, the agencies issued the proposed rule to amend the agencies' capital rules to address the risk-based capital treatment of an advanced approaches banking organization's

[1] As a result of the Interagency Tailoring Rule, an advanced approaches banking organization is now a U.S. GSIB, a subsidiary depository institution of a U.S. GSIB, and any other U.S. banking organization with $700 billion or more in total consolidated assets or $75 billion or more in cross-jurisdictional activity. *See* 84 FR 59230 (November 1, 2019).

investments in LTD instruments and unsecured debt instruments issued by covered banking organizations for the purposes of meeting minimum TLAC requirements and, where applicable, LTD requirements, other than those instruments that qualify as tier 2 capital. The proposed rule would also have amended the risk-based capital treatment of advanced approaches banking organizations' investments in unsecured debt instruments issued by GSIBs that are *pari passu* or subordinated to such debt instruments, other than those instruments that qualify as tier 2 capital. The proposed rule collectively referred to these instruments as covered debt instruments.

Under the proposed rule, an investment in a covered debt instrument by an advanced approaches banking organization would have been treated as an investment in a tier 2 capital instrument and therefore would have been subject to the deductions treatments under section __.22 of the capital rule.[2] The capital deductions required under the proposed rule would have affected all capital ratios that apply to advanced approaches banking organizations—that is, the risk-based capital ratios that include "standardized total risk weighted assets" in the denominator and the risk-based capital ratios that include "advanced approaches total risk-weighted assets" in the denominator, as well as the tier 1 leverage and supplementary leverage ratios, all under subpart B of the capital rule.[3]

The proposal also would have allowed advanced approaches banking organizations to exclude from deduction investments in covered debt instruments, subject to certain qualifying and measurement criteria, up to five percent of the sum of advanced approaches banking organization's common equity tier 1 capital elements minus all deductions from and adjustments

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[2] 12 CFR part 3, subpart B (OCC); 12 CFR part 217, subpart B (FRB); and 12 CFR part 324, subpart B (FDIC).

[3] For advanced approaches banking organizations that are GSIBs, the proposed deduction also would apply for purposes of the enhanced supplementary leverage ratio.

to common equity tier 1 capital elements required under section __.22(a) through __.22(c)(3), net of associated deferred tax liabilities ("DTLs") ("five percent exclusion"). In the case of a U.S. GSIB, such investments must be "excluded covered debt instruments," which were defined in the proposal as covered debt instruments held for 30 business days or less and held for the purpose of short-term resale or with the intent of benefiting from actual or expected short-term price movements, or to lock in arbitrage profits.

Collectively, the agencies received ten public comment letters from trade associations, public interest groups, private individuals, and other interested parties. As further detailed below, commenters generally supported the overarching goal of the proposal to reduce interconnectedness by creating an incentive for advanced approaches banking organizations to limit their exposure to GSIBs. However, commenters also expressed certain general concerns with the proposal and noted specific concerns with certain technical aspects of it.

As discussed further below, after considering the public comments received on the proposal, the final rule would be substantially consistent with the proposed rule with certain modifications in response to comments.

III. Final Rule

A. Amendments to Definitions

The final rule would add or amend certain definitions in section __.2 of the capital rule to implement the proposed deduction approach.

1. Definition of "Covered Debt Instrument" for Covered BHC and Covered IHC Issuance

Under the final rule, a "covered debt instrument" would be defined to include an unsecured debt instrument that is:

(1) issued by a covered BHC and that is an "eligible debt security" for purposes of the TLAC Rule,[4] or that is *pari passu* or subordinated to any "eligible debt security" issued by the covered BHC; or

(2) issued by a covered IHC and that is an "eligible Covered IHC debt security" for purposes of the TLAC Rule,[5] or that is *pari passu* or subordinated to any "eligible Covered IHC debt security" issued by the covered IHC.

Some commenters requested that *pari passu* or subordinated unsecured debt instruments be excluded from the definition of "covered debt instrument." Staff of the agencies believe it is important to treat unsecured debt instruments that are *pari passu* or subordinated to TLAC-eligible debt instruments as "covered debt instruments," given that these liabilities will incur losses ahead of or proportionally with TLAC-eligible debt. Excluding these *pari passu* and subordinated instruments from the regulatory deduction treatment would understate the degree of risk of these investments.

2. Definition of "Covered Debt Instrument" for Foreign GSIB Issuance

Under the final rule, a "covered debt instrument" also would include any unsecured debt instrument issued by a foreign GSIB or any of its subsidiaries, other than its covered IHC, 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

[4] *See* 12 CFR 252.61.
[5] *See* 12 CFR 252.161.

subsidiaries in connection with a resolution, receivership, insolvency or similar proceeding of the issuer or any of its subsidiaries ("foreign TLAC-eligible debt"). Further, covered debt instruments would also include any debt instrument that is *pari passu* or subordinated to any foreign TLAC-eligible debt, other than an unsecured debt instrument that is included in the regulatory capital of the issuer.

For purposes of the definition of covered debt instrument, 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 the foreign TLAC-eligible debt is eligible under that special resolution regime to be written down or converted into equity or any other capital instrument, then an instrument is *pari passu* or subordinated to foreign TLAC-eligible debt if that instrument is eligible to be written down or converted into equity or another capital instrument under that special resolution regime ahead of or proportionally with any foreign TLAC-eligible debt.

In response to commenters' concerns that the scope of the definition of covered debt instrument is overly broad and that it is not practical for banking organizations to determine whether a given instrument is *pari passu* or subordinated to foreign TLAC-eligible debt, the final rule would revise the proposed rule's definition of covered debt instruments issued by foreign GSIBs and their subsidiaries, other than covered IHCs, in two ways. First, the final rule would provide that an instrument is a covered debt instrument if it 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 to recapitalize the issuer or any of its subsidiaries in connection with a resolution, receivership, insolvency, or similar proceeding. The proposal's definition would not have explicitly considered whether the instrument is eligible for use to comply with such a law or

regulation. Second, the final rule would clarify whether an unsecured debt instrument is *pari passu* or subordinated to foreign TLAC-eligible debt for purposes of the final rule as described above. These revisions to the proposed rule would reflect the Financial Stability Board's TLAC term sheet's focus on having instruments and liabilities that should be readily available for bail-in.[6]

B. Investments in Covered Banking Organization's Own Covered Debt Instruments and Reciprocal Cross Holdings

The final rule would adopt the proposal's proposed amendment of section __.22(c)(3) of the capital rule to require advanced approaches banking organizations to deduct from tier 2 capital any investment in a covered debt instrument that is held reciprocally with another financial institution. A non-GSIB advanced approaches banking organization is not subject to the TLAC Rule and therefore would be required to effectuate all deductions related to an investment in a covered debt instrument from its own tier 2 capital. In order to not provide a less stringent standard for GSIBs, the final rule would require any advanced approaches banking organization to deduct from its tier 2 capital investments in its own covered debt instruments, as applicable, and any investment in a covered debt instrument that is held reciprocally with another financial institution.

Commenters asked that the final rule include a separate deduction threshold for market making activities in own covered debt instruments capped at five percent of a covered BHC's or an advanced approaches covered IHC's own common equity tier 1 capital. Commenters stated that such a threshold is necessary to better facilitate deep and liquid markets for TLAC-eligible

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[6] *See* Financial Stability Board, Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution - Total Loss-absorbing Capacity (TLAC) Term Sheet, 3 (November 9, 2015), https://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf.

debt instruments. Staff of the agencies are concerned that finalizing the rule with a separate threshold for investments in own covered debt instruments could create additional balance sheet capacity for covered BHCs and advanced approaches covered IHCs, as applicable, to increase their investments in covered debt instruments issued by other GSIBs. Such an approach would not align with the proposal's goal of reducing interconnectedness and systemic risk among large and internationally active banking organizations. Therefore, the final rule would not implement this suggested change.

C. Significant and Non-Significant Investments in Covered Debt Instruments

The agencies received no comments on the proposal's requirement for an advanced approaches banking organization with an investment in a covered debt instrument issued by an unconsolidated financial institution to deduct the investment from tier 2 capital, in accordance with the corresponding deduction approach, if the advanced approaches banking organization has a significant investment in the capital of the unconsolidated financial institution. The final rule would adopt this aspect of the proposal as proposed.

Consistent with the proposal, the final rule also would require an advanced approaches banking organization to deduct from regulatory capital the amount by which the aggregate amount of non-significant investments in the capital of unconsolidated financial institutions exceeds 10 percent of the sum of the banking organization's common equity tier 1 capital elements minus all deductions from and adjustments to common equity tier 1 capital elements required under section __.22(a) through __.22(c)(3), net of associated DTLs ("10 percent threshold for non-significant investments"). Any investment in a covered debt instrument subject to deduction would be deducted according to the corresponding deduction approach in the capital rule.

To help support a deep and liquid market for covered debt instruments, the proposal would have included limited exclusions from the 10 percent threshold for non-significant investments's deduction approach. Specifically, for an advanced approaches banking organization that is not a U.S. GSIB banking organization, such a banking organization would have the option to exclude from the 10 percent threshold for non-significant investments deduction, covered debt instruments up to five percent of its common equity tier 1 capital, measured on a gross long basis.[7] No comments were received on this provision of the proposal and the final rule would implement this five-percent exclusion for non-U.S. GSIB banking organizations as proposed.

Under the proposal, U.S. GSIB banking organizations could have excluded from the aggregate amount of non-significant investments in the capital of unconsolidated financial institutions limited amounts of market making exposures ("excluded covered debt instruments") up to an aggregate amount, measured on a gross long basis, equal to or less than five percent of its own common equity tier 1 capital (market making exclusion). If the aggregate amount of excluded covered debt instruments were more than five percent of the common equity tier 1 capital of the U.S. GSIB banking organization, the excess over five percent would have been subject to deduction from tier 2 capital on a gross long basis. In addition, if an excluded covered debt instrument were held for more than 30 business days or ceased to be held in connection with

[7] Under section __.22(h) of the capital rule, gross long basis generally means that an exposure amount or investment cannot be reduced by offsetting short positions. Net long basis generally means that an exposure amount can be reduced by offsetting short positions subject to limiting conditions in the capital rule. An exposure amount measured on a gross long basis is greater and therefore more likely to result in a deduction relative to an exposure measured on a net long basis.

market making activities, the excluded covered debt instrument would have been subject to deduction from tier 2 capital on a gross long basis.

Some commenters asserted that the agencies should eliminate the 30-business-day requirement in the market making exclusion because it would make the proposed market making exclusion unavailable for many market making activities that support the depth and liquidity of the markets for TLAC-eligible debt, in particular synthetic exposures from derivatives used in market making activities. As an alternative, the commenters suggested the agencies use the regulatory framework implementing the Volcker Rule to identify which positions in covered debt instruments are held for market making purposes and eliminate the 30-business-day requirement.

Staff of the agencies believe that removing the 30-business-day requirement would only be appropriate for market making in the form of synthetic exposures as defined in the agencies' capital rule. Accordingly, the final rule would reflect this change. Synthetic market making exposures, such as derivatives, may frequently be held for more than 30 business days. Removing the 30-business-day requirement for synthetic exposures would, relative to the proposal, better align with the proposal's goal of supporting deep and liquid markets for covered debt instruments by allowing synthetic exposures arising from market making activities to be included in the market making exclusion, subject to limits. However, staff of the agencies continue to believe that the 30-business-day requirement is an appropriate metric to identify market making positions in "direct" investments in covered debt instruments (i.e., holding the instrument on the banking organization's balance sheet) and "indirect" investments in covered debt instruments (i.e., exposure to the instrument through investment funds). Direct investments in covered debt instruments held in connection with market making should turn over regularly and the agencies seek to dis-incentivize long-term direct and indirect exposures to covered debt

instruments, given the risk of write-down or conversion to equity of such instruments. Therefore, the final rule would retain the 30-business-day requirement for "direct" and "indirect" investments in excluded covered debt instruments.

After consideration of comments, the agencies also have revised the rule to use the Volcker Rule exemption for market making activities to identify excluded covered debt instruments for purposes of qualifying for the final rule's market making exclusion. Relative to the proposal, this change should decrease compliance burden by allowing banking organizations to use a single methodology for identifying market making activities, rather than two similar, but non-identical regulatory standards.[8]

In addition, the preamble to the final rule would provide that the agencies intend to monitor advanced approaches banking organizations' holdings of covered debt instruments in the form 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. Further, to better understand advanced approaches banking organizations' risk from exposures to the capital of unconsolidated financial institutions, the agencies may issue an information collection proposal to collect quarterly data on advanced approaches banking organizations' non-significant investments in the capital of unconsolidated financial institutions and excluded covered debt instruments, as applicable.

Some commenters stated that finalizing the exclusions for covered debt instruments based on a net long position measurement basis would allow advanced approaches banking organizations to better support the depth and liquidity of market making in TLAC-eligible debt instruments, because such market making activities are typically well hedged and a "net long

[8] *See* 12 CFR 44.4 (OCC); 12 CFR 248.4 (FRB); 12 CFR 351.4(FDIC).

position” would allow more positions to qualify for the exclusions. The final rule would maintain measurement of the exclusions for covered debt instruments based on the gross long position. Staff of the agencies are concerned that moving to a “net long position” measurement could undermine the agencies’ goal of reducing interconnectedness among large and internationally active banking organizations as it would allow such banking organizations to accumulate exposure to covered debt instruments significantly beyond the threshold envisioned in the proposal. Further, advanced approaches banking organizations are able to assign hedged covered debt instrument exposures to the 10 percent threshold for non-significant investments on a net long basis.

D. Corresponding Deduction Approach

The proposal would have amended the corresponding deduction approach in section __.22(c)(2) of the capital rule to specify that an investment in a covered debt instrument by an advanced approaches banking organization would have been subject to the corresponding deduction approach, with the covered debt instrument treated as a tier 2 capital instrument. Some commenters asked the agencies to treat investments in covered debt instruments as common equity tier 1 capital instruments, or, as applicable, allow deductions under the corresponding deduction approach from own TLAC-eligible debt instruments. Staff of the agencies believe that requiring a deduction of a covered debt instrument from tier 2 capital should serve as a sufficiently prudent and simple approach that dis-incentivizes advanced approaches banking organizations’ investments in such instruments and thereby would support the objectives of reducing both interconnectedness within the financial system and systemic risk.

Accordingly, the final rule would implement the proposed amendments to the corresponding deduction approach in section __.22(c)(2) of the capital rule.

E. Net Long Position Calculation

Some commenters recommended that the capital rule should be modified to not require short positions to be in the "same instrument" as the gross long position when calculating the net long position. Instead, commenters recommended that the final rule allow recognized short positions to be in any instrument that is *pari passu* or subordinated to the gross long position's instrument. These commenters recommended that this change should also apply to calculating the net long position of investments in covered debt instruments in the final rule.

The agencies have consistently maintained that recognition of short positions under the net long position calculation are required to be in the "same instrument" as a matter of prudent risk management and hedging practices. To recognize short positions in other than the "same instrument" would potentially undermine the effectiveness of risk mitigating hedges. Accordingly, the final rule would adopt the calculation of the net long position as proposed.

IV. Technical Amendment, Transition Period, and Proposed Changes to Regulatory Reporting

The proposal did not contemplate providing a transition period for implementation of the final rule by advanced approaches banking organizations. Large and internationally active banking organizations should be deeply knowledgeable of the securities exposures on their own balance sheets, if only for the purposes of prudent risk management. Therefore, the final rule would not provide a transition period and would become effective on April 1, 2021.

The final rule would make certain technical amendments to section __.10 of the capital rule to more clearly differentiate between requirements applicable to advanced approaches banking organizations and those applicable to Category III banking organizations. These technical amendments do not amend any substantive requirements applicable to banking organizations.

Separately, the FRB is proposing changes to regulatory reporting to require covered BHCs and covered IHCs to publicly disclose their LTD and TLAC issuances in a standardized manner.

Conclusion:

FDIC staff requests that the FDIC Board approve the attached final rule and authorize its publication in the *Federal Register* with an effective date of April 1, 2021.

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