Understanding TLAC

The Federal Reserve's final bank capital rules have been hailed as the end of too big to fail

The Federal Reserve Board's final rules regarding total loss absorbing capacity (TLAC) requirements for global systemically important banks (G-Sibs) in the US will require levels of capital and other loss-absorbing capacity that should put the final nail in the coffin of too big to fail. [See '*Rewriting history - A retrospective analysis of now-defunct Continental's fate under the current financial regulatory regime shows that the US commercial lender would likely not have needed a federal bailout*' in IFLR's December/January 2017 issue]. Originally designed simply to absorb losses, the advent of risk-based capital also used capital requirements to shape a bank's balance sheet. With the Federal Reserve's final TLAC rules, capital and related loss-absorbing instruments not only absorb losses and shape the balance sheet of the existing bank holding company, they also become tools to be deployed to help restructure a failed institution while maintaining market confidence and minimising systemic disruption. This article outlines the elements of the Federal Reserve's final TLAC rule and the ways in which these serve to accomplish specific objectives.

Going versus gone capital

Before the financial crisis, capital rules were generally premised on the notion that an appropriate amount of capital, referred to as going concern capital, would induce market confidence. To the extent that banks maintain robust levels of high quality, or tier 1 capital, depositors have faith in the strength of the banking system. Traditionally, tier 2 capital was envisioned as capital that could absorb losses in the event of a failure and, in the US, be used to protect the deposit insurance fund and insured depositors. It was viewed as gone concern capital. However, during the financial crisis, whether because of a lack of harmonised rules relating to the types of instruments that qualified for tier 1 capital treatment or investor (and rating agency) scepticism regarding the absorbency of various capital instruments, these principles proved insufficient to maintain investor confidence and forestall bank failures. The Basel III rules, which streamlined the capital rules, imposed significantly higher capital requirements, and established prescriptive criteria for the types of instruments that qualify as tier 1 and tier 2 capital, addressed many of the perceived shortcomings.

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The requirement to maintain specified amounts of TLAC effectively adds a layer to gone concern capital. TLAC is intended to absorb losses after an institution has failed. By doing so, TLAC addresses the too big to fail issue and also helps avoid the need for future taxpayer injections to bail out failed institutions. TLAC is different from traditional gone concern capital, though, because it also serves the purpose of facilitating an orderly resolution of the failed institution and the recapitalisation of the new holding company for the failed bank holding company's operating subsidiaries as we discuss below.

TLAC requirement

Pursuant to the Federal Reserve's rules released in December, the bank holding companies (BHCs) of US G-Sibs, which are referred to as covered BHCs, as well as top-tier US intermediate holding companies (IHCs) of foreign G-Sibs, referred to as covered IHCs, are required to maintain a minimum amount of loss-absorbing instruments, including capital and a minimum amount of unsecured long-term debt (LTD). While consistent with the final TLAC principles outlined by the Financial Stability Board (FSB), the Federal Reserve's final TLAC rules create a total of loss absorbing debt and equity instruments at the top tier holding company that the market should recognise as loss absorbing and price accordingly. This is the total TLAC number - the sum of tier 1 capital issued directly by the covered BHC and the amount of eligible external LTD - together with the G-Sib surcharge and applicable regulatory capital buffers. The final rules set the TLAC requirement at not less than the greater of: 18% of the covered BHC's total risk-weighted assets (RWAs), and 7.5% of the covered BHC's total leverage exposure. This brings the loss-absorbing capacity requirement to levels not seen generally since the 19th century and before the creation of the Federal Reserve System, deposit insurance, and modern tools of bank supervision.

Eligible external LTD

The Federal Reserve's rules, unlike the FSB final principles, establish a distinct eligible LTD requirement. This debt component is designed to allow the resolution authority, be it the Federal Deposit Insurance Corporation (FDIC) or a bankruptcy proceeding, to recapitalise a new bridge holding company as part of the single point of entry (SPOE) resolution approach. Indeed, the required debt level is designed to refill the capital needs of the bridge holding company, going so far as to allow for shrinkage of the holding company during the resolution process. The SPOE approach involves a single resolution proceeding taking place at the bank holding company-level. To the extent that losses have arisen at the subsidiaries of the bank holding company, there needs to be an effective mechanism to transfer the losses to the holding company being resolved. Losses arising at subsidiaries would be transferred to the parent company being resolved. As a result, there needs to be sufficient loss-absorbing capacity available at the holding company level for the subsidiaries to be kept solvent and operational. A bridge financial company, which would be the new holding company for the operating subsidiaries, would be capitalised by the bail-in of the eligible external LTD of the failed BHC.

Under the Federal Reserve final rules, all covered BHCs must maintain outstanding eligible external LTD in an amount not less than the greater of: 6% (plus the applicable G-Sib surcharge) of total RWAs; and a minimum ratio of common equity tier 1 capital to RWAs of 4.5% (total leverage exposure). There is no automatic bail-in of the eligible long-term debt under US law, so the conversion would need to be achieved through an offer of equity to the debt holders *in lieu* of a claim against a receivership estate with little or no value. The equity component of the TLAC requirement is used to pass losses on to common shareholders of the failed BHC.

Plain vanilla debt

The Federal Reserve's LTD requirements value speedy valuation and simplicity over cost of issuance. Therefore, for example, all but the simplest of structured notes are excluded from eligible long-term debt. The eligible long-term debt requirement must be met by plain vanilla debt, which is paid-in, issued directly by the covered BHC, is unsecured, governed by US law and has a maturity greater than one year from the issuance date. Eligible external LTD instruments are prohibited from being structured notes, having a credit-sensitive feature, including a contractual provision for conversion into or exchange for equity in the covered BHC, or including a provision that gives the holder a contractual right to accelerate payment (other than a right that is exercisable on one or more dates specified in the instrument, in the event of a covered BHC's insolvency, or the covered BHC's failure to make a payment on the instrument when due that continues for 30 days or more). However, the final rules permit eligible external LTD to be subject to payment default event acceleration rights. An acceleration clause relating to a failure to pay principal or interest must include a cure period of at least 30 days.

Grandfather provision

There are some accommodations made in the final rules to enable US G-Sibs to meet the new requirements without having to raise extraordinary amounts of new LTD. The final rules provide a grandfather provision for certain outstanding LTD of covered BHCs issued prior to December 31 2016, which will count towards the external LTD and external TLAC requirements. The grandfathered LTD is not subject to the limitations on acceleration and the requirement to be governed by US law that will apply to eligible debt securities. Given the grandfather provision, the rules apply as of January 1 2019.

Facilitating SPOE

The Federal Reserve's final rules represent an effort to use capital and debt instruments to achieve another specific purpose – the preservation of the operations and transactions of a large financial holding company, while imposing losses on the equity investors who invested in the risks and rewards of the company's business model and presumably, through the board of directors had some say in how the company was run. The rules include a clean holding company requirement, the intent of which is to simplify the SPOE resolution process and maintain stability.

As part of the SPOE resolution, the assets of the failed BHC, including ownership interests in, and intercompany loans to, the BHC's operating subsidiaries, and of these operating subsidiaries would be transferred to the bridge financial company established by the FDIC. As discussed above, the bridge financial company would be capitalised first by the bail-in of outstanding LTD of the failed BHC. The bridge financial company would continue certain key operations of the entity and thereby serve to minimise systemic disruption. The FDIC would replace the officers and directors of the BHC and appoint a new board of directors from among a pre-qualified pool of candidates. The FDIC would require that the bridge financial company enter into an operating agreement that, among other things, would address the preparation of a business plan for the bridge financial company intended to maximise recoveries and avoid fire sales of assets, a capital and liquidity plan, retention of accounting and valuation experts, and a restructuring plan. The FDIC would retain control over certain important actions of the bridge financial company, such as the issuance of any securities, asset sales, asset transfers and mergers, dividend or other distributions of capital, adoption of compensation plans, and appointment of valuation experts and other professionals.

Clean holding company provisions

A covered BHC is prohibited from engaging in transactions that could make orderly resolution more difficult or that may increase systemic risk. The final rules prohibit a covered BHC from:

- maintaining third-party debt instruments with an original maturity of less than one year;
- entering into qualified financial contracts (*ie* securities contracts, commodity contracts, forward contracts, repurchase agreements, or swaps) with a third party;
- entering into a contract that permits offset of a claim against the covered holding company against an amount owed by the holder to a subsidiary;
- issuing certain guarantees of the covered holding company's subsidiaries' liabilities if the liabilities provide default rights against the subsidiary based on the resolution of the covered holding company, excluding a limited exemption; and
- entering into, or otherwise benefitting from, any agreement that provides for its liabilities to be guaranteed by any of its subsidiaries.

This means that market transactions are effectively pushed down to the subsidiaries of a bank holding company, and the subsidiaries, with their ongoing businesses, be transferred to a bridge holding company intact.

The final rules also cap the amount of a covered BHC's third-party liabilities (excluding those related to eligible external TLAC and eligible external LTD) that can be *pari passu* with or junior to its eligible external LTD at 5% of the value of its eligible external TLAC. However, if a covered BHC chooses to contractually subordinate all of its LTD, there will be no cap on the amount of the covered BHC's non-contingent liabilities.

Conclusion

The structure of the rule and its components are inextricably tied to this model for domestic holding companies. A far simpler system would have just increased the capital levels and broadened the definitions of qualifying capital. The same thinking is reflected in the rules for foreign G-Sibs and their intermediate holding companies with an option for foreign holding companies and their regulators to replicate this model offshore - by using internal debt and equity to pass the losses up to the foreign holding company - or to permit a multiple point of entry approach allowing the intermediate holding company to be treated separately and accordingly - to issue external debt instead of relying entirely on internal debt and equity.

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