September 18, 2018

MEMORANDUM TO: Board of Directors

FROM: Doreen R. Eberley, Director

SUBJECT: Regulatory Capital Rule: Capital Treatment for Investments in Certain Unsecured Debt Instruments of Global Systemically Important U.S. Bank Holding Companies and Certain Intermediate Holding Companies, and Global Systemically Important Foreign Banking Organizations

Summary: In December 2016, the Board of Governors of the Federal Reserve System ("FRB") issued a final rule requiring the largest domestic and foreign banking organizations operating in the United States to maintain a minimum amount of total loss-absorbing capacity ("TLAC"), consisting of tier 1 capital and certain long-term debt ("LTD") instruments ("TLAC Rule"). Staff is seeking the approval of the Federal Deposit Insurance Corporation ("FDIC") Board of Directors ("FDIC Board") to publish the attached interagency notice of proposed rulemaking ("proposed rule" or "NPR") that would revise the regulatory capital rules of the FDIC, FRB, and the Office of the Comptroller of the Currency (OCC) (collectively, the "agencies") to address the regulatory capital treatment of advanced approaches banking organizations' investments in LTD instruments and unsecured debt instruments that are *pari passu* or subordinated to LTD instruments, other than those instruments that qualify as tier 2 capital, issued by: (1) a global systemically important bank holding company ("covered BHC"); or (2) a top-tier U.S. intermediate holding company subsidiary of a global systemically important foreign banking

Concur:

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organization ("foreign GSIB") with $50 billion or more in U.S. non-branch assets ("covered IHC"), and investments in similar instruments issued by foreign G-SIBs or their foreign subsidiaries (collectively, "covered debt instruments"). The proposed rule would not apply to non-advanced approaches banking organizations.

Under the proposed rule, an investment in a covered debt instrument by an advanced approaches banking organization generally would be treated as an investment in a tier 2 capital instrument. The existing deduction approaches under the capital rules would therefore apply to a banking organization's investments in covered debt instruments. For example, such an organization would be required to deduct from its regulatory capital an investment in its own covered debt instrument and reciprocal crossholdings of covered debt instruments with another banking organization. In addition, the existing corresponding deduction approach in the capital rules would apply to any required deduction by advanced approaches banking organizations of an investment in a covered debt instrument that exceeds certain thresholds.

The proposed rule includes exclusions from covered debt instruments that would allow advanced approaches banking organizations to hold limited amounts of, and conduct limited market making in, such instruments to help support a deep and liquid market for covered debt instruments. The agencies separately are proposing changes to regulatory reporting to effectuate the proposed regulatory capital treatment for covered debt instruments held by advanced approaches banking organizations.

Recommendation: Staff recommends that the FDIC Board approve the proposed rule and authorize its publication in the *Federal Register* with a 60-day public comment period.

Discussion:

I. Background

The objective of the TLAC Rule is to enhance financial stability by reducing the impact stemming from 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. To further this objective, the largest domestic and foreign banking organizations operating in the United States will be required to maintain a minimum amount of TLAC instruments, including a minimum amount of LTD instruments. The TLAC Rule applies to covered BHCs and covered IHCs because the failure or material financial distress of such banking organizations could substantially impair the functioning of the U.S. financial system. LTD instruments, which count in regulatory capital in limited amounts if they comply with certain eligibility criteria, are capable of absorbing losses in resolution. This is because the debt holders' claim on a company's assets may not receive full payment in a resolution, receivership, insolvency, or similar proceeding, which would increase the size of a company's assets relative to the size of its liabilities and thereby increase the company's equity. The TLAC and LTD requirements set forth in the TLAC Rule take effect on January 1, 2019.

The proposed rule would recognize the risks posed by investments in covered debt instruments and reduce the potential contagion risk stemming from the failure of a covered BHC, covered IHC, or foreign GSIB by creating an incentive for advanced approaches banking organizations to limit their exposure to these institutions.

While investments in covered debt instruments by non-advanced approaches banking organizations also can result in interconnectedness and pro-cyclicality within the financial system in times of stress, the proposed approach is complex and, as a result, would apply only to

advanced approaches banking organizations. The NPR will seek comment on the extent to which non-advanced approaches banking organizations have material holdings of covered debt instruments issued by covered BHCs, covered IHCs, and foreign GSIBs to facilitate the further consideration of how to address the risks associated with these holdings.

The NPR also notes that the agencies are in the process of considering the appropriate scope of "advanced approaches banking organizations" and may propose changes to the scope of this term in the near future. The NPR states that the agencies anticipate that the proposal would, at a minimum, continue to include U.S. GSIBs, and potentially other banking organizations.

II. The Proposed Rule

Under the proposed rule, an investment in a covered debt instrument by an advanced approaches banking organization generally would be treated as an investment in a tier 2 capital instrument and therefore would be subject to the deductions treatments described in section 22 of the capital rules.[1] The capital deductions required under the proposed rule would affect 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 rules.[2]

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[1] 12 CFR part 3 (OCC); 12 CFR part 217 (FRB); and 12 CFR part 324 (FDIC).

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

A. **Amendments to Definitions (Section 2 of the Capital Rules)**

Under the proposed rule, several new definitions would be added to the definitions section of the capital rules (section 2) to effectuate the capital deductions under the proposed rule. The term "covered debt instrument" would be added and defined to include an unsecured debt instrument that does not qualify as tier 2 capital and is: (1) issued by a covered BHC and that is an eligible debt security for purposes of the TLAC Rule, 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, or that is *pari passu* or subordinated to any eligible Covered IHC debt security issued by the covered IHC. Covered debt instrument also would include any unsecured debt that is not included in the regulatory capital of the issuer and is: (1) issued by a foreign GSIB or any of its subsidiaries, other than its covered IHC, for the purpose of absorbing losses or recapitalizing 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 (2) *pari passu* or subordinated to any unsecured debt instrument described above issued by the foreign GSIB or any of its subsidiaries.

The proposed rule would also add a definition to the capital rules for "excluded covered debt instrument" in order to identify covered debt instruments held for short-term trading purposes that would not be subject to deduction, if below a certain threshold. The definition and prudential treatment of excluded covered debt instruments and their deduction under the proposal are discussed in more detail in section II.C below.

An "investment in a covered debt instrument" would be added and defined as a net long position in a covered debt instrument, including direct, indirect, and synthetic exposures to such covered debt instrument. Investments in covered debt instruments would exclude underwriting

positions held for five business days or less. In addition, the proposed rule would amend the definitions of "indirect exposure" and "synthetic exposure" in the capital rules to add exposures to covered debt instruments.

B. Investment in Covered Banking Organization's Own Covered Debt Instruments and Reciprocal Cross Holdings (Sections 22(c)(1) and (3) of the Capital Rules)

The proposed rule would amend sections 22(c)(1) and (3) of the capital rules to require an advanced approaches FRB-regulated institution to deduct from its regulatory capital any investment in its own covered debt instruments in the same way that it would deduct its investment in its own capital instrument. Similarly, just as an advanced approaches banking organization is required under the capital rules to deduct from its regulatory capital any investment in the capital of other financial institutions it holds reciprocally (where such reciprocal cross holdings result from a formal or informal arrangement to swap, exchange, or otherwise intend to hold each other's capital instruments), the advanced approaches banking organization also would be required to deduct from its regulatory capital any reciprocal cross-holdings of covered debt instruments.

C. Significant and Non-Significant Investments in Covered Debt Instruments (Sections 22(c)(4) and (5) of the Capital Rules)

Under sections 22(c)(4) and (5) of the capital rules, a banking organization must deduct from regulatory capital certain investments in the capital of unconsolidated financial institutions. The calculation of the deduction depends on whether the banking organization has a "significant" or a "non-significant" investment in the unconsolidated financial institution, with "significant" defined as ownership of more than 10 percent of the common stock of the

unconsolidated financial institution.[3] Under section 22(c)(5) of the capital rules, if a banking organization has a significant investment in an unconsolidated financial institution, the banking organization must deduct from regulatory capital any investment in the capital of the unconsolidated financial institution that is not in the form of common stock.[4] Under section 22(c)(4) of the capital rules, if the banking organization has one or more "non-significant investments" in unconsolidated financial institutions, it must aggregate such investments and deduct from regulatory capital any amount that exceeds 10 percent of the banking organization's common equity tier 1 capital.[5]

1. Non-Significant Investments

The proposed rule would amend section 22(c)(4) of the capital rules to require an advanced approaches banking organization with a non-significant investment in a covered debt instrument to include such investment in the aggregate amount of non-significant investments in the capital of other unconsolidated financial institutions. As under the existing capital rule, the proposed rule would require a 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 advanced approaches banking organization's common equity tier 1 capital. Any investment in a covered debt instrument subject to deduction would be deducted according to the corresponding deduction approach described below in section II.D.

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[3] *See* 12 CFR 324.2.
[4] *See* 12 CFR 324.22(c)(5).
[5] *See* 12 CFR 324.2(c)(4).

The NPR includes limited exclusions from this approach. The specifics of the applicable exclusion would depend on whether a firm is a covered BHC or is a subsidiary of a GSIB. To help support a deep and liquid market for covered debt instruments, the proposed rule would allow advanced approaches banking organizations to hold limited amounts of, and conduct limited market making in, such instruments. The proposed rule would provide that an advanced approaches banking organization that is a covered BHC or is a subsidiary of a covered BHC or foreign GSIB ("advanced approaches GSIB banking organization") could designate an investment in a covered debt instrument as an "excluded covered debt instrument" if it holds the covered debt instrument for 30 business days or less 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. In this case, the advanced approaches GSIB banking organization could exclude each "excluded covered debt instrument" from the threshold calculation and potential deduction under section 22(c)(4) if the aggregate amount of excluded covered debt instruments is five percent or less of the common equity tier 1 capital of the advanced approaches GSIB banking organization. If the aggregate amount of excluded covered debt instruments is more than five percent of the common equity tier 1 capital of the advanced approaches GSIB banking organization, the excess over five percent would be subject to deduction from tier 2 capital. In addition, if a covered debt instrument ceases to qualify as an excluded covered debt instrument (i.e. it is held for more than the 30-day period or ceases to be 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), the covered debt instrument would be subject to deduction from tier 2 capital.

As for advanced approaches banking organizations that are not covered BHCs or subsidiaries of a covered BHC or foreign GSIB ("advanced approaches non-GSIB banking organizations"), the proposed rule would allow those organizations to exclude covered debt instruments from the threshold calculation and potential deduction under section 22(c)(4) if the aggregate amount of covered debt instruments is five percent or less of its common equity tier 1 capital. The excess over five percent, if any, would be included with other non-significant investments in the capital instruments of unconsolidated financial institutions as described above.

2. Significant Investments

The proposed rule would amend section 22(c)(5) of the capital rules to require 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.

D. Corresponding Deduction Approach (Section 22(c)(2) of the Capital Rules)

The NPR would amend the corresponding deduction approach in section 22(c)(2) of the capital rules to specify that an investment in a covered debt instrument by an advanced approaches banking organization would be subject to the corresponding deduction approach. 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.[6] If the banking organization does not have enough of the component of capital to give full effect to the deduction, the corresponding deduction

[6] *See* 12 CFR 324.22(c)(2).

approach provides that any amount of the investment that has not already been deducted would be deducted from the next, more subordinated component of capital.[7] If, for example, a banking organization has insufficient amounts of tier 2 capital and additional tier 1 capital to effect a required deduction, the banking organization would need to deduct from common equity tier 1 capital the amount of the investment that exceeds the tier 2 and additional tier 1 capital of the banking organization.[8]

E. **Net Long Position (Section 22(h) of the Capital Rules)**

The NPR would apply the same approach under the current capital rules regarding the calculation of deductions and the treatment of guarantees and indirect investments. Specifically, under the capital rules, the amount of a banking organization's investment in its own capital instrument or in the capital instrument of an unconsolidated financial institution is the banking organization's "net long position" in the capital instrument as calculated under section 22(h) of the capital rules. Under section 22(h), a banking organization may net certain gross short positions in a capital instrument against a gross long position in the instrument to determine the net long position that is potentially subject to deduction under section 22(c).

The proposal would modify section 22(h) of the capital rules such 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.

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[7] *See* 12 CFR 324.(c)(2) and (f) .
[8] *See* 12 CFR 324.22(f).

Consistent with the current capital rules, the calculation of a net long position would take into account direct investments in covered debt instruments as well as indirect exposures to covered debt instruments held through investment funds. However, for purposes of the five percent common equity tier 1 capital thresholds applicable to both advanced approaches GSIB banking organizations and advanced approaches non-GSIB banking organizations, investments in covered debt instruments are measured on a gross long basis.

With respect to a capital instrument held indirectly through an investment fund, a banking organization has three options under the capital rules to measure its gross long position.[9] The proposed rule would amend section 22(h)(2)(ii) of the capital rules to provide the same three options to determine the gross long position in a covered debt instrument held through an investment fund. The first option would be to use the entire carrying value of the investment in the fund. The second option would be, with prior supervisory approval, for the advanced approaches banking organization to use a conservative estimate of the amount of the investment in the covered debt instrument held through the fund. The third option would be to multiply the carrying value of the advanced approaches banking organization's investment in the fund by the exact percentage of the covered debt instrument held by the investment fund or by the highest stated prospectus limit for such an investment. Under each option, the amount of the gross long position may be reduced by the advanced approaches banking organization's qualifying short positions to reach the net long position.[10]

For purposes of any deduction required for an advanced approaches banking organization's investment in the capital of an unconsolidated financial institution, the amount of

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[9] *See* 12 CFR 324.22(h)(2).
[10] *See* 12 CFR 324.22(h)(1).

a covered debt instrument would include any contractual obligations the advanced approaches banking organization has to purchase such covered debt instruments.

F. Technical Amendment and Proposed Changes to Regulatory Reporting

The NPR would make a technical amendment to the definition of "investment in the capital of an unconsolidated financial institution" in the capital rules. The NPR also would propose changes to regulatory reporting to effectuate the proposed regulatory capital treatment for covered debt instruments held by advanced approaches banking organizations. 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 recommends that the FDIC Board approve the attached proposed rule and authorize its publication in the *Federal Register* with a 60-day public comment period.

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