Breaking Down the Proposed Rule to Bail In More Banks

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As part of the continuing financial regulatory reform efforts following the 2023 bank failures, the FDIC, the OCC, and the Federal Reserve issued a proposed rule that would generally require large banks and thrifts with total assets over $100 billion, as well as their holding companies, to issue and maintain outstanding a minimum amount of plain vanilla LTD that can be used to recapitalize these banking organizations in the event of their failure.

The federal banking agencies are attempting to improve the resolvability of these banking organizations, reduce costs to the FDIC's Deposit Insurance Fund, and mitigate financial stability and contagion risks by reducing the risk of loss to uninsured depositors. The proposed rule follows a general anti-tailoring trend, coming on the heels of a proposed capital rule. While distinct from the current Total Loss Absorbing Capacity (TLAC) rule that generally applies to Globally Systemically Important Banks (G-SIBs) and their Intermediate Holding Companies (IHCs), the proposed rule would borrow many TLAC concepts and further harmonize the treatment of all large banking organizations with over $100 billion in total assets. Together, these proposals appear to be ushering in a new era for the regulation of U.S. regional banks.

Key Takeaways

- Banks and their holding companies with more than $100 billion in total assets would have to issue eligible long-term debt (LTD) over a 3-year period. This requirement would be in addition to the proposed capital rule and other recent bank regulatory proposals. While distinct from TLAC rules that apply to the U.S. G-SIBs, these changes will add further compliance costs to affected banking organizations, including issuing eligible LTD, managing compliance programs, and certification requirements
- The agencies expect that banking organizations affected by the proposal rule would have to issue $70 billion in new debt. Although this proposed rule has yet to be finalized, we anticipate that some banking organizations will begin issuing LTD, both as a matter of sound planning and economic uncertainty, and in light of the proposed grandfathering provisions
- If an affected banking organization were to fail, the FDIC expects to use the eligible LTD requirements to limit the impact on the Deposit Insurance Fund, ensure that the entity is in a better position for the creation of bridge banks, if necessary, and resolve larger, more complex banking organizations without recourse to the systemic risk exception, which allows the FDIC to bypass the least-cost rule under federal law
- Banking organizations under $100 billion in total assets would not be subject to LTD requirements

Overview of the Proposed LTD Requirements

The proposed rule would generally require certain holding companies and insured depository institutions that have more than $100 billion in total assets to issue certain amounts of LTD that can be converted into equity to recapitalize these entities in the event of failure.

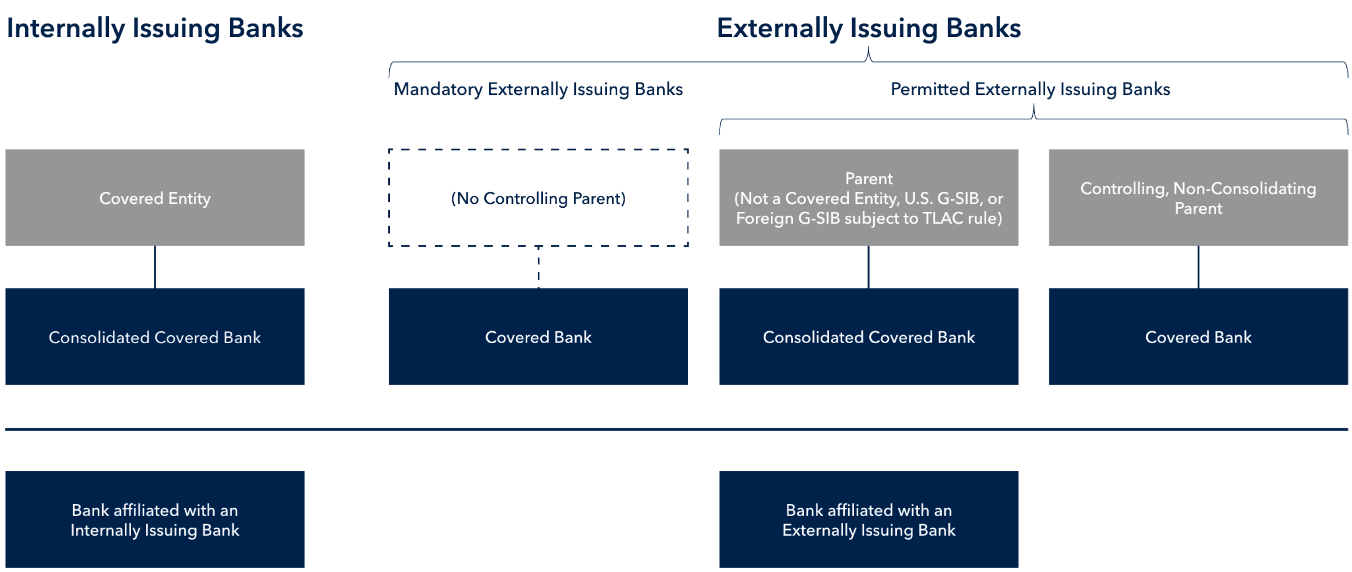
We refer to the first group as "Covered Entities," which includes bank holding companies (BHCs), savings and loan holding companies (SLHCs), and U.S. intermediate holding companies of foreign banking organizations (FBOs) that are not G-SIBs (Covered IHCs).

In addition, we refer to the second group as "Covered Banks," which includes insured depository institutions, such as national and state-chartered banks. The LTD requirement would also apply to insured depository institutions that are affiliated with a Covered Bank.

As we explain further below, eligible LTD, whether issued by a Covered Entity or Covered Bank, would generally need to contain certain characteristics to avoid complexity or frustrating the purpose of the proposed rule—that is, to recapitalize failed banking organizations so they or their business lines can be sold while preserving the value of the business over a time period that may exceed the typical "resolution weekend" that the FDIC often uses for smaller banks. Moreover, there are distinctions between eligible internal LTD, which is issued within a banking organization's holding company structure, and eligible external LTD, which is issued to the public (i.e., third-party investors).

Covered Entities and Covered Banks That Would Be Subject to the LTD Requirements

At a high level, Covered Banks would issue debt either internally or externally, depending on certain structure (i.e., control and accounting consolidation) considerations.



The above categories are broken down further in the table below. Whether a bank or holding company is a Covered Bank or Covered Entity depends on the amount of its total assets and whether a bank is affiliated with a Covered Bank.

<table>
<tr><th colspan="3">Covered Entities</th><th colspan="3">Covered Bank</th></tr>
<tr><th colspan="3">$100 billion or more in total consolidated assets, but which are not G-SIBs</th><th colspan="3">$100 billion or more in total consolidated assets</th></tr>
<tr><th>Category II</th><th>Category III</th><th>Category IV</th><th>Internally Issuing Bank</th><th colspan="2">Externally Issuing Bank</th></tr>
<tr><td>≥ $700B in total assets or
≥ $75b in cross-jurisdictional activity</td><td>≥ $250B total assets or
≥ $75B in nonbank assets, wSTWF, or OBS*</td><td>Other firms with $100B to $250B total assets</td><td>Consolidated subsidiary bank of Covered Entities or a foreign G-SIB IHC

(and affiliated banks of Internally Issuing Banks)</td><td colspan="2">Subsidiary bank that is not consolidated with Covered Entities or a foreign G-SIB IHC. Further broken down into two groups:

(and affiliated banks of Externally Issuing Banks)</td></tr>
<tr><td colspan="3" rowspan="2"></td><td rowspan="2"></td><th>Mandatory Externally Issuing Banks</th><th>Permitted Externally Issuing Banks</th></tr>
<tr><td>Bank that is not a controlled subsidiary of a parent entity</td><td>Consolidated subsidiary bank of a company that is not a Covered Entity, a U.S. G-SIB, or a foreign G-SIB subject to the current TLAC rule
or
Subsidiary bank that is controlled by, but not consolidated with, another company</td></tr>
<tr><td colspan="3">Covered Entities include:
• BHCs
• SLHCs
• U.S. IHCs of foreign banking organizations that are not G-SIBs—specific rules apply to these Covered IHCs</td><td colspan="3">Covered Banks include:
• National banks
• State-chartered banks
• Federal savings and loan associations (thrifts)
• State-chartered thrifts</td></tr>
</table>

*STWF means short-term wholesale funding; OBS means off-balance sheet expenses.

Note: Category I firms, which are generally G-SIBs or U.S. IHCs of foreign banking organizations considered G-SIBs, would be covered under the proposed rule. The proposed rule proposes certain changes to the TLAC rule, discussed below.

Eligible LTD

Internal vs. External

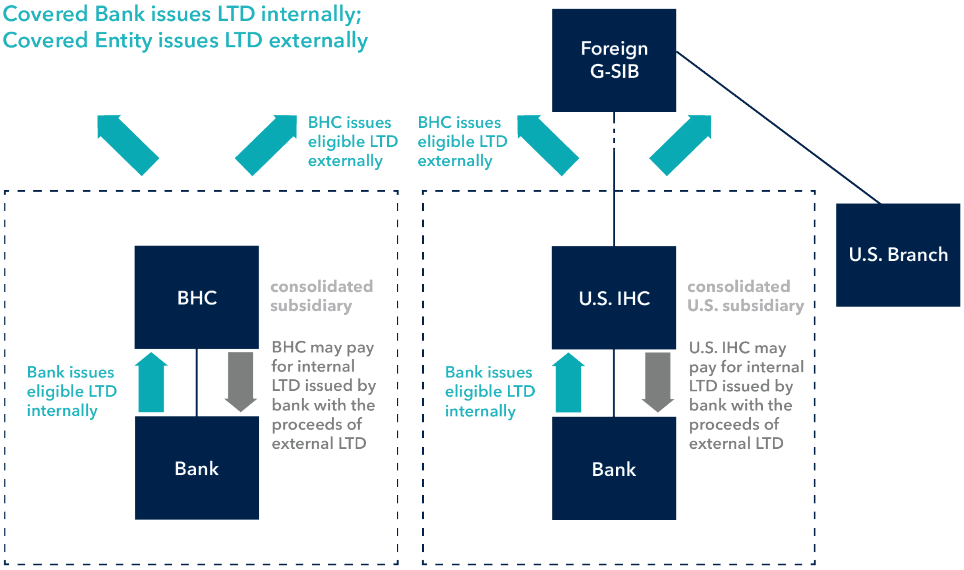
The proposed rule distinguishes between two types of eligible LTD: debt that is issued to third-party, nonaffiliate investors, referred to as "eligible external LTD," and debt that is issued to parents and affiliates, referred to as "eligible internal LTD."

A Covered Bank that is not a controlled subsidiary of a parent entity would be required to issue eligible external LTD, meaning its debt would be issued to a party that is not an affiliate of the Covered Bank. A Covered Bank that is a consolidated subsidiary of a parent entity that is not a Covered Entity would be permitted to issue both eligible internal LTD and eligible external LTD.

A Covered Bank that is a consolidated subsidiary of a Covered Entity would be required to issue eligible internal LTD, meaning debt issued to a company in the United States that consolidates the Covered Bank for accounting purposes. Practically, this would generally allow proceeds raised by the issuance of eligible LTD by a Covered Entity to be downstreamed to its Covered Bank subsidiary in return for the eligible internal LTD.

Internally Issuing IDIs

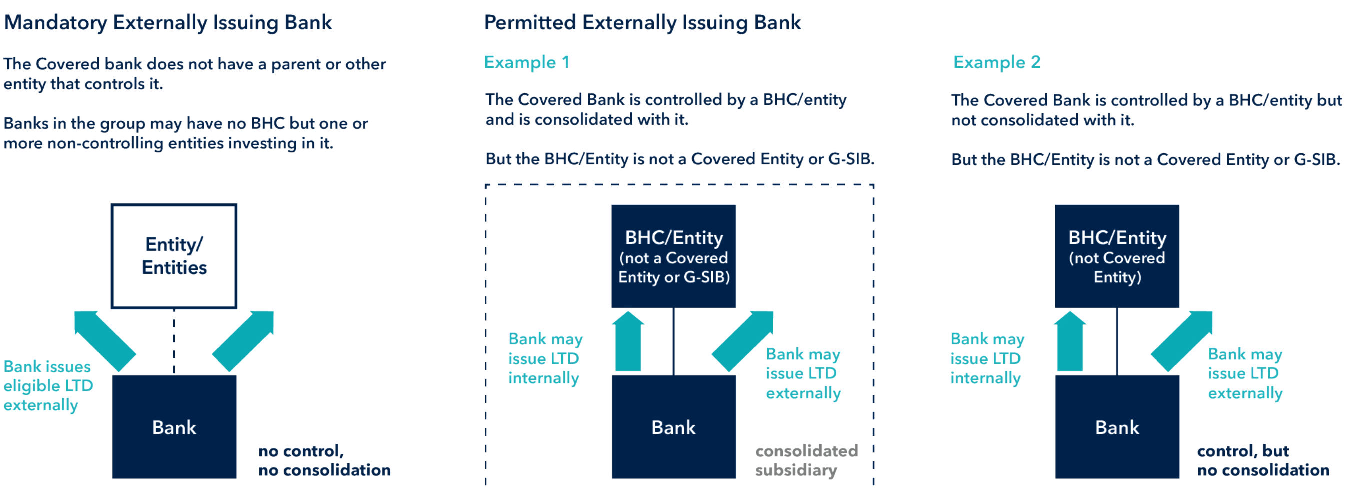
Covered Bank issues LTD internally; Covered Entity issues LTD externally



Note: Other banks affiliated with Covered Bank not shown.

Externally Issuing IDIs

Mandatory vs. Permitted Externally Issuing Bank



Note: In all examples, the BHC, if applicable, may pay for internal LTD issued by the bank with the procees of externally issued LTD. Other banks affiliated with Covered Bank not shown.

Features

Under the proposed rule, eligible LTD would need to have certain plain vanilla features. Although the requirements for all eligible LTD would generally be the same, eligible external LTD would have certain features that are not applicable to eligible internal LTD.

Eligible LTD Features

Type	Requirements
Issuance	• Paid in and issued directly by the Covered Entity or Covered Bank
Security/Guaranty	• Not secured or guaranteed by the Covered Entity or Covered Bank • Not secured or guaranteed by a subsidiary or affiliate of the Covered Entity or Covered Bank • Not subject to any other arrangement that legally or economically enhances the seniority of the instrument
Maturity	• Maturity greater than or equal to one year from the date of issuance
Governing law	• Governed by the laws of the United States or any state
Plain vanilla	• Not a structured note • No credit-sensitive features, such as an interest rate, that are reset periodically based in whole or in part on the institution's credit quality, unless issued internally by a Covered IHC • Must not provide that the instrument may be converted into or exchanged for equity of the institution, unless issued internally by a Covered IHC • Must not provide the holder of the instrument a contractual right to accelerate payment of principal or interest on the instrument, except a right that is exercisable (1) on one or more dates that are specified in the instrument, (2) in the event of the issuer entering into insolvency or resolution proceedings, or (3) the issuer's failure to make a payment on the instrument when due that continues for 30 days or more
If issued by a Covered Bank	• Contractually subordinated to deposits and general unsecured creditors

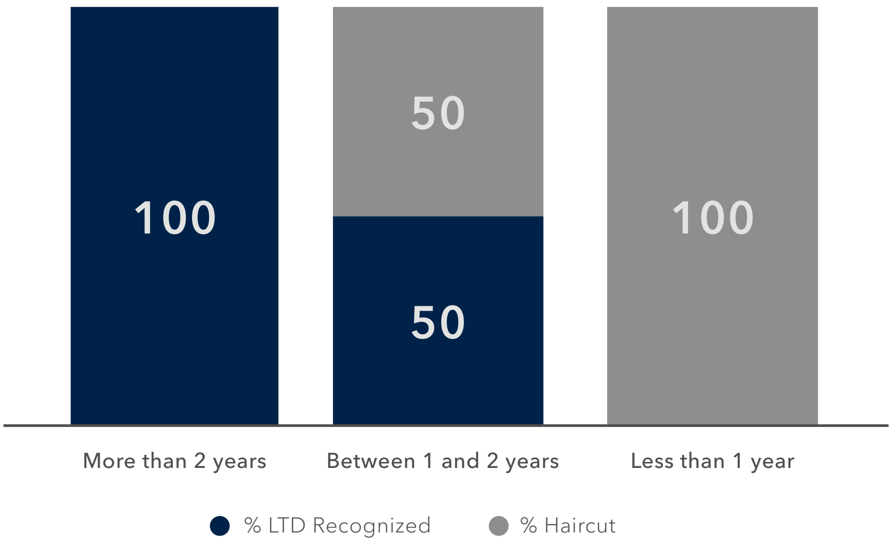
Additional Eligible LTD Requirements

Eligible External Debt Securities	• For debt issued by a Covered Bank, debt that is issued to, and remains held by, a person that is not an affiliate of the Covered Bank, unless the affiliate controls, but does not consolidate, the Covered Bank • The debt must be issued in denominations of at least $400,000
Eligible Internal Debt Securities	• For debt issued by a Covered Bank, debt that is issued to, and held by, a company that the Covered Bank is a consolidated subsidiary of (e.g., its parent holding company) • The debt issued by a Covered IHC would be required to include a contractual conversion trigger and would not include a prohibition against credit-sensitive features

Comparison of Eligible LTD Requirements		
Requirements/Features	**Eligible External LTD**	**Eligible Internal LTD**
Paid in and issued directly by the Covered Entity or Covered Bank	•	•
Unsecured	•	•
Has a maturity greater than one year from the date of issuance	•	•
Governed by U.S. law	•	•
Has "plain vanilla" features	•	• (exceptions for Covered IHCs)
Must not have a credit-sensitive feature	•	• (unless issued by Covered IHCs)
Must not be a structured note	•	•
Must not have a contractual provision for conversion into or exchange for equity	•	• (unless issued by Covered IHCs)
Must not have acceleration clauses (with some exceptions)	•	•
When issued by a Covered Bank, contractually subordinated to deposits and general unsecured creditors	•	•
Issued in a minimum denomination of $400,000	•	
Must be held by a nonaffiliate	• (unless issued by an Externally Issuing Bank and held by an affiliate that controls but does not consolidate the issuing Covered Bank)	
When issued by a Covered Bank, must be issued to and held by the company that consolidates the issuing Covered Bank		•
When issued by a Covered IHC, may have credit-sensitive features		• (Covered IHCs only)
When issued by a Covered IHC, must include a contractual conversion trigger		• (Covered IHCs only)

Eligible LTD would be required to have a maturity greater than one year from the date of issuance. However, as eligible LTD approaches maturity, the amount would be reduced for purposes of satisfying the requirement. Specifically, principal due to be paid on eligible LTD in one year or more, but less than two years, would be subject to a 50% haircut for purposes of the LTD requirement. Principal due to be paid on eligible LTD in less than one year would not count toward the external LTD requirement.

Haircut on Eligible LTD Approaching Maturity



Eligible LTD Amount

Covered Entities and Covered Banks would each be required to maintain outstanding eligible LTD in an amount that is greater than 6.0% of each of their total risk-weighted assets, 3.5% of each of their average total consolidated assets, and 2.5% of each of their total leverage exposure if they are subject to the supplementary leverage ratio rule. The proposed eligible LTD amount relies on a "capital refill framework," whereby assuming a failed Covered Entity's or Covered Bank's equity capital is significantly or completely depleted, the eligible LTD outstanding would be sufficient to capitalize a newly formed bridge depository institution with an amount necessary to comply with the minimum leverage capital requirements and common equity tier 1 risk-based capital requirements plus buffers, accounting for some balance sheet depletion.

Specific Considerations for Covered IHCs

As previously noted, the proposed rule would set forth certain requirements for eligible internal LTD that would be specific to Covered IHCs only. First, the proposed rule would require certain Covered IHCs (where the resolution strategy of the Covered IHC's foreign parent follows a single point of entry model) to issue only eligible internal LTD. Second, eligible internal LTD issued by Covered IHCs would be required to include a contractual provision, approved by the Federal Reserve, that would provide for immediate conversion or exchange of the instrument into common equity tier 1 capital of the Covered IHC upon the Federal Reserve's issuance of an internal debt conversion order. Third, eligible internal LTD issued by Covered IHCs would not be subject to a prohibition on credit-sensitive features.

Only certain Covered IHCs would be permitted to issue debt externally to third-party investors. Specifically, Covered IHCs of FBOs with a top-tier group-level resolution plan that contemplates their Covered IHCs or subsidiaries of their Covered IHCs entering into resolution, receivership, insolvency, or similar proceedings in the United States (that is, resolution Covered IHCs) would be permitted to issue eligible external LTD. Conversely, Covered IHCs of FBOs that do not contemplate their Covered IHCs or subsidiaries of their Covered IHCs entering into resolution, receivership, insolvency, or similar proceedings (that is, non-resolution Covered IHCs) would be required to issue eligible LTD internally, from the Covered IHC to a foreign parent or a wholly owned subsidiary of the foreign parent.

Eligible internal LTD issued by a Covered IHC would be required to contain a contractual conversion feature, which would allow the Federal Reserve to require the Covered IHC to convert or exchange some or all of the eligible internal LTD into common equity tier 1 capital on a going-concern basis (that is, without needing to enter a resolution proceeding). The Federal Reserve would be able to require the Covered IHC to exercise the conversion feature upon the Federal Reserve's determination that the Covered IHC is "in default or in danger of default" (defined by reference to Title II of the Dodd-Frank Act) and if any of the following three specified circumstances were to apply:

1. The top-tier FBO or any of its subsidiaries were placed into resolution proceedings
2. The home country supervisory authority consented to the conversion or exchange or did not object to the conversion or exchange following 24 hours' notice
3. The Federal Reserve made a written recommendation to the secretary of the treasury that the FDIC should be appointed as receiver of the Covered IHC under Title II of the Dodd-Frank Act

Additionally, the proposed rule would not prohibit eligible internal LTD issued by Covered IHCs from including certain credit-sensitive features, unlike other eligible LTD. The preamble to the proposed rule explained that this prohibition was removed to make the requirements consistent with the requirements for eligible internal LTD issued by U.S. IHCs subject to the Federal Reserve's TLAC rule.

The proposed rule would require the top-tier FBO of a covered IHC to certify six months after the effective date of the final rule (and thereafter, upon changes to resolution strategy) to the Federal Reserve whether the planned resolution strategy of the top-tier FBO involves the covered IHC or its subsidiaries entering resolution, receivership, insolvency, or similar proceedings in the United States.

Grandfathering Previously Issued LTD

The federal banking agencies anticipate that some Covered Entities and their subsidiary Covered Banks, as well as potentially other Covered Banks, will have external LTD outstanding when the rule is finalized. To account for this, the proposed rule would provide certain exceptions for the following categories of outstanding external LTD instruments, which otherwise would not be eligible for purposes of the LTD rule. These exceptions would be limited to LTD instruments issued by Covered BHCs and SLHCs, resolution covered IHCs and their subsidiary Covered Banks, and permitted and required externally issuing Covered Banks.

The exceptions would apply to the following categories of external LTD, even if the LTD does not conform to all the eligibility requirements that will apply to issuances of eligible internal or external LTD:

1. Instruments that contain otherwise impermissible acceleration clauses
2. Instruments issued with principal denominations that are less than the proposed $400,000 minimum amount
3. In the case of legacy instruments issued externally by a Covered Bank, instruments that are not contractually subordinated to general unsecured creditors

Eligible legacy external LTD issued by a consolidated subsidiary Covered Bank of a Covered Entity could be used to satisfy the minimum external LTD requirement applicable to its parent Covered BHCs/SLHCs or resolution Covered IHC, as well as any internal LTD requirement applicable to the subsidiary itself. To qualify as eligible legacy external LTD, the instrument would need to be issued prior to the date that the final rule is published in the *Federal Register*.

Clean Holding Company Requirements

Clean holding company requirements have been proposed to improve the resiliency of Covered Entities, limit certain transactions that can give rise to financial stability risks before failure, and simplify a Covered Entity so that it and its relevant subsidiaries can be resolved in a prompt and orderly manner.

Accordingly, the proposed rule would generally prohibit Covered Entities from having the following categories of outstanding liabilities:

1. Third-party debt instruments with an original maturity less than one year
2. Third-party Qualified Financial Contracts (QFCs)
3. Guarantees of a subsidiary's liabilities if the Covered Entity's insolvency or entry into a resolution proceeding would create default rights for a counterparty of the subsidiary (guarantees subject to cross-defaults)
4. Liabilities that are guaranteed by a subsidiary of the Covered Entity or that are subject to rights that would allow a third party to offset its debt to a subsidiary upon the Covered Entity's default on an obligation owed to the third party

The proposed rule would also limit the total value of a Covered Entity's (parent-only, on an unconsolidated basis) non-eligible LTD liabilities owed to nonaffiliates that would rank at either the same priority as or junior relative to eligible LTD to 5% of the value of the Covered Entity's common equity tier 1 capital (excluding equity tier 1 minority interest), additional tier 1 capital (excluding tier 1 minority interest), and eligible LTD amount. These limits would apply only to corporate practices and liabilities of the Covered Entity, and would not directly restrict the corporate practices and liabilities of the subsidiaries of the Covered Entity.

Clean Holding Company Requirements	
Requirement/Limit	**Explanation**
External Short-Term Debt Instruments	• The proposed rule would prohibit Covered Entities and Covered Banks from externally issuing debt instruments with a maturity of less than one year. This includes, among other types of debt, both secured and unsecured short-term borrowings • A liability has an original maturity of less than one year if it would provide the creditor with the option to receive repayment within one year of creation of the liability, or if it would create such an option or an automatic obligation to pay upon the occurrence of an event that could occur within one year of the creation of the liability
Third-Party QFCs	• The proposed rule would permit covered BHCs/SLHCs to enter into QFCs only with their subsidiaries • The proposed rule would permit Covered IHCs to enter into QFCs only with their affiliates, with the exception of entry into certain credit enhancement arrangements, with respect to QFCs between a Covered Entity's subsidiary and third parties • QFCs are defined consistent with Title II of the Dodd-Frank Act and include securities contracts, commodities contracts, forward contracts, repurchase agreements, and swap agreements, consistent with the TLAC rule

Guarantees Subject to Cross-Defaults	• The proposed rule would prohibit a Covered Entity from guaranteeing (including by providing credit support for) any liability between a direct or indirect subsidiary of the Covered Entity and an external counterparty if the Covered Entity's insolvency or entry into resolution (other than resolution under Title II of the Dodd-Frank Act) would directly or indirectly provide the subsidiary's counterparty with a default right (defined broadly in the proposed rule to include, among others, the right to liquidate, terminate, cancel, rescind, or accelerate such agreement or transaction, set off or net amounts owing in respect thereto, exercise remedies in respect of collateral or other credit support, demand payment or delivery thereunder, suspend, delay, or defer payment or performance thereunder or any similar rights) • Guarantees by Covered Entities of subsidiary liabilities, in the case of covered BHCs/SLHCs, or affiliates, in the case of covered IHCs, that are not subject to such cross-default rights would be unaffected by the proposal. Also not affected are subsidiary guarantees with cross-default rights that would be stayed if the underlying contracts were subject to the Federal Reserve, OCC, or FDIC's rules requiring stays of QFC default rights in certain scenarios. The foregoing rules do not apply to Covered Entities
Upstream Guarantees and Offset Rights	• The proposed rule would prohibit Covered Entities from having outstanding liabilities that are subject to a guarantee from any direct or indirect subsidiary of the holding company (upstream guarantees) • Similarly, the proposed rule would prohibit Covered Entities from issuing an instrument if the holder of the instrument has a contractual right to offset the holder's liabilities, or the liabilities of an affiliate of the holder, to any of the Covered Entity's subsidiaries against the Covered Entity's liability under the instrument • This proposed prohibition includes all such offset rights regardless of whether the right is provided in the instrument itself

Cap on Certain Liabilities	• For covered BHCs/SLHCs, the proposed rule would limit the amount of non-contingent liabilities to third parties (i.e., persons that are not affiliates of the Covered Entity) that are not eligible LTD, common tier 1 capital, or additional tier 1 capital and that would rank at either the same priority as or junior to the Covered Entity's eligible LTD in the priority scheme of either the U.S. Bankruptcy Code or Title II of the Dodd-Frank Act to no more than 5% of the sum of common equity tier 1 capital (excluding common equity tier 1 minority interest), and eligible LTD amount • The cap would not apply to instruments that were eligible external LTD when issued and have ceased to be eligible (because their remaining maturity is less than one year) as long as the holder of the instrument does not have a currently exercisable put right, nor would it apply to payables (such as dividend- or interest-related payables) that are associated with such liabilities • Liabilities that would be expected to be subject to the cap include debt instrument with derivative-linked features; external vendor and operating liabilities, such as for utilities, rent, fees for service, and obligations to employees; and liabilities arising other than through a contract (e.g., liabilities created by court judgment) • This cap on certain liabilities would not subject a Covered Entity to the cap if the Covered Entity elects to subordinate all of its eligible LTD to all of the Covered Entity's other liabilities • The proposed rule proposes a 5% calibration, which is consistent with the 5% calibration for the similar cap on unrelated liabilities that applies to the parent holding companies of U.S. G-SIBs and U.S. IHCs of foreign G-SIBs. The proposed cap would apply to the parent-only balance sheets of Covered Entities • The set of liabilities that would count toward the unrelated liabilities cap for a resolution covered IHC would be different from the liabilities that would count toward the cap for non-resolution covered IHCs because resolution covered IHCs are permitted to issue eligible LTD externally to third parties. The cap for resolution covered IHCs applies to unrelated liabilities owed to parent and sister affiliates, as well as to unaffiliated third parties, because these IHCs have the option to issue external LTD • The cap on unrelated liabilities for non-resolution covered IHCs does not include liabilities owed to foreign affiliates because for such entities, the eligible LTD held by foreign affiliates should, in a resolution scenario, convert to equity of the covered IHC, through actions of either the parent or the Federal Reserve

Capital Deductions

Under current rules, U.S. G-SIBs and their subsidiary insured depository institutions, as well as Category II banking organizations, must deduct from their capital a portion of eligible LTD of US G-SIBs and IHCs of non-US G-SIBs.

Likewise, under the proposed LTD rule, U.S. G-SIBs and their subsidiary insured depository institutions, as well as Category II banking organizations, would be required to deduct a portion of the eligible LTD of Covered BHCs and Covered Banks.

We note that under the proposed capital rule also currently pending, Covered BHCs/SLHCs and Covered Banks would also become subject to the same deduction framework as U.S. G-SIBs, and thus, other deductions would be required.

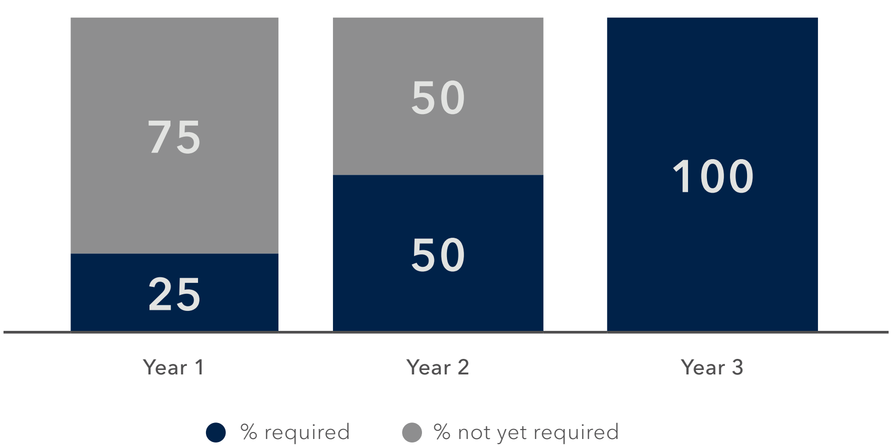
These deductions would be required to avoid financial sector contagion, whereby large, complex banking organizations might otherwise hold each other's debt for capital purposes.

Phase-In and Implementation Considerations

Under the proposed rule, the agencies would provide a three-year phase-in period for Covered Entities and Covered Banks for compliance with the proposed rule. Covered Entities and Covered Banks that meet the applicable $100 billion threshold at the time of the rule's finalization would have three years to comply. The same three-year phase-in period would apply for Covered Entities and Covered Banks that become subject to the rule after it is finalized.

During the three-year phase-in period, Covered Entities and Covered Banks would need to meet 25% of their LTD requirement within one year after finalization of the rule, 50% within two years after of finalization, and 100% within three years. The transition period would not restart for a Covered Bank that changes charters. Likewise, a holding company would not have an additional three years to transition from, for instance, the Federal Reserve's rule for BHCs to its rule for SLHCs.

LTD Requirement Phase-In Period for Newly Covered Entities and Banks



Covered Entities that transition from being subject to the proposed LTD requirements to the Federal Reserve's existing TLAC rule would have three years to comply with the TLAC rule's requirements. But during that three-year period, those entities would be required to continue to comply with the proposed LTD rule's requirements, and therefore, during this transition period, the Covered Entity would be required to issue new eligible LTD if necessary to maintain the minimum eligible LTD requirement set forth in the proposed rule.

Proposed TLAC Changes

In addition to other changes under the proposed rule, the Federal Reserve has also proposed changes to the TLAC rule. The proposed changes are meant to harmonize the agency's proposed LTD requirements with the Federal Reserve's TLAC rule and would include the following changes:

- Allowing only 50% of the amount of eligible LTD with a maturity of one year or more but less than two years to count toward the TLAC requirements
- Requiring that eligible LTD be issued in minimum denominations of $400,000
- Amending the clean holding company requirements to allow underwriting agreements, fully structured share repurchase agreements, and direct compensation agreements (these agreements would not constitute impermissible QFCs)
- Requiring certain quantitative and qualitative disclosures related to the creditor ranking of their liabilities

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