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Federal banking agencies propose new long-term debt requirement

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Center *for* **Regulatory Strategy** **US**

On August 29, 2023, US federal banking regulators—the Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC) (collectively the "Agencies")—issued three proposals regarding minimum long-term debt (LTD) for large banking organizations and resolution planning.[1] The requirements set out by the Agencies will compel impacted institutions to re-examine existing capabilities, potentially establish new resolution strategies, and implement supporting operational and technology solutions. Industry comments are due November 30, 2023.

This paper details the applicability, requirements, and key considerations of the proposed LTD Requirements Rule (LTD Rule). We cover the key details of the resolution planning proposals in a separate paper: *Federal banking agencies propose new resolution planning requirements.*

The proposed LTD Rule is aimed at providing the Agencies with enhanced resolution options for distressed or failing banks, limiting the need to merge with global systemically important banks (G-SIBs), while reducing overall costs to the Deposit Insurance Fund (DIF) and minimizing risks and impacts to the broader financial system. Over the years, the Agencies have adopted rules to foster resiliency and orderly resolvability of banking organizations. The recent growth in the size of many insured depository institutions (IDIs), along with the recent banking failures, has focused public attention on the US mid-tier and regional banking market. These mid-tier and regional banks are facing a significant uptick in regulatory requirements and scrutiny, as reflected in this proposal.

The proposed LTD Rule will affect certain large holding company (HC) and insured depository institutions (IDIs) with $100 billion or more in assets, which will be used to absorb losses before depositors are affected.[2]

The impact of the proposed LTD Rule is expected to be substantial. The proposed LTD Rule is expected to increase funding costs for impacted institutions and cause some Category II and III banks, currently employing the multiple point-of-entry (MPOE[3]) resolution strategy, to re-evaluate and potentially change their resolution strategy to a single point-of-entry (SPOE[4]) strategy, which will have a downstream impact on the resolution plan and required capabilities.

Applicability (who will be affected)

The proposed LTD Rule applies mainly to large banking organizations and their IDIs as outlined in figure 1. It is driven by a view that these entities present significant risks to the financial system and thus require additional mitigants. A key difference from the existing rules, is that large banking organizations subject to enhanced prudential standards (EPS) requirements, will include those with $100 billion or more in total assets, if the proposal is adopted.

Figure 1: Proposed LTD Rule applicability

Proposed Requirements	Current applicability	Proposed applicability
LTD Rule	US G-SIBs and US IHCs of foreign G-SIBs	**Applicable HCs based on tailored EPS category (figure 2 below):** • Category II, III, and IV bank holding companies (BHCs) and savings and loan holding companies (SLHCs) • Category II, III, and IV intermediate holding companies (IHCs) of foreign banking organizations (FBOs) that are not G-SIBs **Applicable IDIs:** • Standalone IDIs with $100B or more in total assets • Consolidated subsidiary IDIs of non-G-SIBs with $100B or more in total assets • Consolidated subsidiary IDIs of foreign G-SIB IHCs with $100B or more in total assets • Any IDI that is affiliated with an IDI in one of the first three categories

Figure 2: Tailored enhanced prudential standards

	Category I	Category II	Category III	Category IV
Tailored enhanced prudential standards (EPS)	US G-SIBs	≥$700B total US assets or ≥$75B cross-jurisdictional activity	≥$250B total US assets or ≥$75B in nonbank assets, weighted short-term wholesale funding(wSTWF) or off balance-sheet exposure	Other firms with $100B to $250B US total assets

Proposed timeline to align with new expectations

Proposed LTD Rule transition: A three-year transition period has been proposed to minimize the effect of implementation of the proposal, as well as to spread the impact of increased credit demand and to average out the cost of borrowing in the US economy over a longer period (figure 3). Entities are required to meet the minimum long-term debt requirements incrementally over the transition period, which will commence from the effective date of the final LTD Rule.

Figure 3: LTD Rule transition timeline

No. of year(s) post Final Rule becomes effective	Percentage of LTD
Year 1	25%
Year 2	50%
Year 3	100%

Note: The three-year transition period will not reset if an IDI changes charters in between

Requirements and impacts of the proposed rules and guidance

The proposed LTD Rule establishes minimum LTD requirements for the in-scope entities and establishes certain restrictions on operational structures that would facilitate an orderly and prompt resolution in the event of distress or failure:

LTD requirements at different levels: The LTD Rule would mandate LTD issuance at both the HC and IDI levels, as outlined below:

- At the HC level, eligible LTD must be issued externally
- At an IDI level:
  - Eligible LTD for IDI subsidiaries of HCs must be issued internally to the holding company
  - Eligible LTD for IDIs that are not a subsidiary of covered HCs must be issued externally to non-affiliates.

Relative to previous rulemaking, this is a significant change. The objective of the internally issued LTD is to be leveraged to absorb losses that may otherwise be borne by uninsured depositors and certain other creditors of the subsidiary IDI in the event of its failure. This is intended to promote market confidence and limit the potential for bank runs.

Minimum-eligible LTD requirements: The proposed rule requires all in-scope entities to maintain minimum LTD of no less than the greater of:

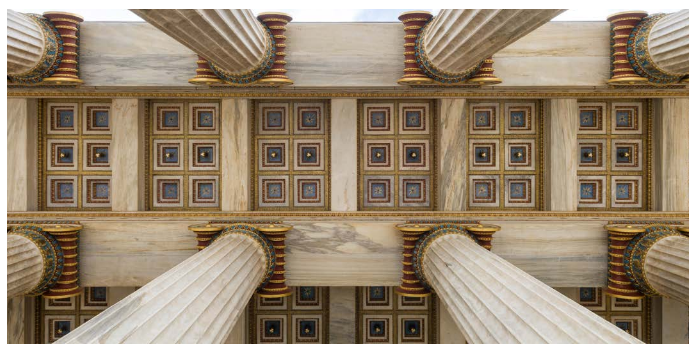
- 6% of risk-weighted assets, or
- 3.5% of average total consolidated assets, or
- 2.5% of total leverage exposure for entities subject to the supplementary leverage ratio (SLR).

This calibration is based on a capital-refill framework, under which each covered entity will have enough eligible LTD to recapitalize the entity in the event of failure and/or resolution when the entity's capital is completely depleted. The recapitalization goal is to bring back the capital level to the minimum leverage capital requirements and common equity tier 1 risk-based capital requirements that are applicable.

The proposal would permit legacy external LTD issued by IDIs to satisfy minimum requirements.

Clean holding company requirements: The proposed LTD Rule would impose "clean holding company requirements" on HCs, akin to those imposed on US G-SIBs and IHCs of foreign G-SIBs. These requirements prohibit activities such as issuing short-term debt with a maturity of less than one year, entering into qualified financial contracts (QFCs) with third parties (with certain exceptions), and issuing guarantees subject to cross-defaults. HCs must also comply with a 5% cap on certain liabilities that are not eligible LTD.

These requirements are intended to improve the resiliency of entities and reduce financial stability risks to the broader financial system.



Deduction of investments in eligible external LTD from regulatory capital: The proposed LTD Rule extends the capital deduction framework in the capital rule for certain institutions to include eligible external LTD issued by HCs and mandatory or permitted externally issuing IDIs to meet the minimum LTD requirement outlined in the proposal. This expands the capital rule's deduction framework for investments in LTD to Category III and IV banking organizations and broadens its application to eligible LTD issued by HCs and mandatory or permitted externally issuing IDIs.

Adopting this approach would reduce interconnectedness and contagion risk by discouraging US G-SIBs, US G-SIB subsidiaries, and Category II banking organizations from investing in the capital of other financial institutions and in the LTD issued by banking organizations.

In addition to proposing LTD requirements for non-G-SIB institutions, the proposed LTD Rule also makes certain changes to existing total loss-absorbing capacity (TLAC) requirements for US and foreign G-SIBs:

- **Extension of 50% haircut in LTD:** Currently, the TLAC rule mandates a 50% haircut to eligible LTD that is due within one and two years, but this haircut only applies to the HC's or IDI's LTD requirements, and not to their TLAC requirements. The proposed rule now extends this 50% haircut to the TLAC requirement for both US G-SIBs and IHCs of foreign G-SIBs, thus simplifying the rule. However, this change is estimated to reduce the aggregate TLAC across G-SIBs by $65 billion. The impacted entities would need to adjust their LTD issuance to mitigate the impact of reduced TLAC.
- **Minimum denomination of issued eligible LTD:** Under the proposed rule, new external LTD issued by HCs, mandatory and permitted externally issuing IDIs and resolution covered IHCs must have a minimum denomination of $400,000. This minimum denomination is intended to limit direct investment in eligible LTD by retail investors and households, increasing the relative investment share of institutional investors in qualified LTD. However, internal LTD issued by an IDI or by an IHC would not be subject to the minimum principal denomination requirement.
- **Exemption from certain agreements in "Clean Holding Company" requirements**: Currently, the TLAC rule applies Clean Holding Company requirements to the operations of in-scope entities to improve their resiliency and resolvability. The proposed rule clarifies some of these requirements saying that underwriting agreements, fully paid structured share repurchase agreements, and certain compensation agreements for employees and directors will not be considered QFCs for the purposes of the Clean Holding Company Requirements. The proposed rule also grants the FRB the authority to exempt other QFCs from this prohibition.
- **Restriction on third-party QFCs:** This restriction on third-party QFCs is intended to reduce significant risks that could otherwise potentially result in the failure of a sizable banking organization that is a party to third-party QFCs.
- **Increased disclosure requirements for US G-SIBs:** US G-SIBs would also face heightened LTD-related disclosure requirements mainly on creditor ranking, individually and in aggregate at the resolution entity, to enhance transparency in their long-term debt activities. The increased transparency and discretion of disclosure requirements is intended to ensure that the disclosure data is easily accessible to market participants and regulators to promote prompt and orderly resolution when needed.

Key considerations and next steps

The LTD requirements are expected to affect the funding models and funding costs of in-scope entities, especially those that are primarily deposit funded. As entities replace their traditional funding source of deposits with long-term debt, funding costs are likely to increase. In combination with recent FRB interest rate tightening, entities will feel the additional burden of borrowing longer term and related pressure on their net interest margins.

The proposal extends to all banking organizations above the $100 billion threshold, with virtually no tailoring for firms in Categories II–IV under the FRB's tailoring rule. Banks must prepare to adjust their LTD issuance to comply with the proposed new requirements and restrictions of minimum denomination, striking an optimal balance between profitable margins and successful rule compliance. Impacted entities should consider designing an LTD and TLAC requirements adoption and transition plan that carefully assesses costs and benefits of alternative funding structures.

Banks must consider enhancements in data management capabilities as they work on providing incremental disclosures to the regulators.

In analyzing the transition from their current state to the enhanced requirements under the proposed LTD Rule proposal, impacted organizations must, at a minimum, begin planning for alignment and compliance, and take the following into consideration:

- **After a thorough analysis of the proposed rules, institutions must perform an assessment against regulatory expectations and existing processes, identifying potential gaps**
  - Conduct comprehensive risk, cost, and benefit analysis to determine the impact of LTD issuance on the bank's funding model, risk profile, capital structure, and overall financial strength
  - Develop LTD issuance strategy or revise existing strategies to incorporate the new $400,000 minimum denomination requirement
  - Monitor and track LTD impact on overall resolution strategies, including potential transitions from MPOE to SPOE
  - Develop and periodically review the contingency plan related to LTD and TLAC requirements to address potential challenges or uncertainties in implementation or in case of market downturns
  - Enhance the risk models to capture the effect of LTD rule change so that the capital ratios are maintained well within limits, and revise capital planning to include LTD
- **Review and prioritize potential gaps**
  - Understand and determine the duration and type of instruments and the timing of issuance to optimize the funding model
  - Establish strong compliance governance and oversight to ensure the issuance of LTD is in accordance with applicable guidelines
- **Develop plans**
  - Develop a strategic plan for the three-year transition period to meet the LTD guidelines, considering the bank's financial health and long-term vision
- **Consider the potential impact of the proposal on already existing challenges, such as potential staffing/skills gaps, reliability of underlying data, supporting processes and technology, and governance**
  - Enhance data and technology capabilities required to produce information for the monitoring, reporting, and disclosure of long-term debt

Given the depth of the newly proposed LTD Rule, firms must proactively begin assessing their current capabilities to identify where challenges may exist in moving forward. Changes in the frequency and types of reporting will challenge current resourcing, technology, and governance and will require organizations to take a deeper look to forge an operational and sustainable path to alignment.

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Endnotes

1. Board of Governors of the Federal Reserve System (FRB), Office of the Comptroller of the Currency (OCC), and Federal Deposit Insurance Corporation (FDIC), "Agencies request comment on proposed rule to require large banks to maintain long-term debt to improve financial stability and resolution," press release, August 29, 2023; FRB and FDIC, "Agencies propose guidance to enhance resolution planning at large banks," August 29, 2023; FDIC, "FDIC Board of Directors issues proposed rule to strengthen resolution planning for large banks," press release August 29, 2023.
2. Affected institutions include bank holding companies (BHCs) and savings and loan holding companies (SLHCs), certain intermediate holding companies (IHCs) of foreign banking organizations (FBOs), and large insured depository institutions (IDIs).
3. The US MPOE approach entails multiple US material entities entering separate resolution proceedings.
4. Under a US SPOE approach, only the top tier US material entity holding company enters bankruptcy and all US material entity subsidiaries remain operating as a going concern.

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