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Legal Update

Long-Term Debt Requirements Proposed for US Regional Banks

On August 29, 2023, US federal banking regulators issued a proposal for long-term debt (“LTD”) requirements for certain midsize and larger US banking organizations (the “LTD Proposal”).[1] The LTD Proposal is important because it would require many regional and larger banking organizations to issue significant amounts of LTD. While it would be phased-in over three years, regulators estimate that affected banking organizations would need to issue approximately $70 billion of new LTD over that time. Some banking organizations have already begun issuing LTD that would satisfy the proposed requirements, and more are expected to do so in the coming months.

The LTD Proposal would apply to most US banking organizations with $100 billion or more in total assets, except for certain organizations that are, or are affiliated with, global systemically important banks (“G-SIBs”) (these organizations, as discussed below, are already subject to LTD requirements). The LTD Proposal would encompass approximately 18 larger and midsized depository institution holding companies and their subsidiary insured depository institutions (ranging from traditional regional banking organizations to credit card and other niche organizations), one US intermediate holding company (“IHC”) of a foreign banking organization, and seven or eight other US banking organizations. The LTD Proposal would not directly affect the eight US G-SIBs or their subsidiaries, which already are subject to more stringent LTD requirements, nor would it affect credit unions, US branches and agencies of foreign banking organizations, or the non-US operations of foreign banking organizations.

In addition, as discussed below, the LTD Proposal also contains proposed changes to the current total loss-absorbing capacity (“TLAC”) rule applicable to US G-SIBs.

Comments on the LTD Proposal must be submitted by November 30, 2023. In this Legal Update, we provide background on the existing LTD requirements, discuss the LTD Proposal, and highlight some of its potential impacts. The LTD Proposal should also be considered in the context of the recent proposals issued by the US banking regulators that would significantly revise the risk-based capital and resolution planning requirements for certain banking organizations and change the method for calculating the capital surcharge for US G-SIBs.

Background

In response to the 2008 financial crisis, US federal banking regulators adopted a series of measures that aimed to improve the resolvability of large US banking organizations. A central reform of this initiative was a requirement that US G-SIBs and top-tier IHCs of non-US G-SIBs maintain a minimum amount of TLAC, including a minimum amount of eligible LTD.[2] The purpose of TLAC was to provide a mechanism for resolving a banking organization in manner that preserved the viability of its operations while imposing losses on the equity holders and LTD holders of its top-tier holding company.[3] These rules also prescribe clean holding company requirements and certain additional buffers, the breach of which would result in limitations on the capital distributions and discretionary bonus payments.

In October 2022, the Federal Reserve and FDIC released an advance notice of proposed rulemaking ("ANPR") on whether they should impose additional resolution-related obligations on larger regional banking organizations that are not G-SIBs, including LTD and clean holding company requirements.[4] The LTD Proposal largely follows the requirements discussed in the ANPR.

LTD Proposal

Scope. The LTD Proposal would apply LTD requirements to:

1. Most top-tier depository institution holding companies[5] that have more than $100 billion in total assets but are not a US G-SIB
2. IHCs of foreign banking organizations that have more than $100 billion in total assets, but that are not controlled by a non-US G-SIB (with the top-tier depository institution holding companies above "covered holding companies")
3. Insured depository institutions ("IDIs") that have more than $100 billion in total assets but are not controlled by a US G-SIB[6]
4. IDIs that are affiliated with an IDI that has more than $100 billion in total assets but are not controlled by a US G-SIB (with the IDIs above, "covered IDIs")

Eligible LTD. Similar to the TLAC requirements applicable to G-SIBs, eligible LTD would be defined as debt that is paid in full and issued directly by the entity subject to the requirement, is unsecured, has a maturity of greater than one year from the date of issuance, has "plain vanilla" features (e.g., highly limited acceleration rights), is issued in a minimum denomination of $400,000, and is governed by US law.[7]

Principal due to be paid on eligible long-term in one year or more and 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 requirement. LTD could not contain an embedded derivative, have credit sensitive features, contain contractual conversion features, or include acceleration rights other than on payment defaults. Structured notes are not considered to be eligible LTD; however, traditional rate-linked notes generally would be considered eligible LTD.[8] All of these features are consistent with the G-SIBs' eligible LTD requirement.

However, the $400,000 minimum denomination requirement is not currently applicable to eligible LTD issued by US G-SIBs, although in certain jurisdictions, securities regulators do limit sales of bail-in debt securities to retail investors. The high minimum denomination requirement is intended generally

to disincentivize direct holdings of LTD by retail investors. Given the general market convention for much lower denominations, it will remain to be seen whether this requirement adversely affects marketing of the new debt.

There would be limited grandfathering of LTD that is issued before a final rule is adopted and that contains impermissible terms (e.g., impermissible acceleration clauses and minimum denominations).

Holding Company Requirement. Covered holding companies would be required to directly issue and maintain outstanding minimum levels of eligible LTD.[9] For a covered holding company, this would be an amount that is the greatest of (i) 6% of the covered holding company's total risk-weighted assets, (ii) 3.5% of its average total consolidated assets, and (iii) 2.5% of its total leverage exposure if the covered entity is subject to the supplementary leverage ratio rule.[10] A covered holding company would be prohibited from redeeming or repurchasing eligible LTD prior to its stated maturity date without obtaining prior approval from the Federal Reserve if the redemption or repurchase would cause the covered holding company's eligible long-term to fall below the requirements.

IDI Requirement. Covered IDIs would be required to directly issue and maintain outstanding minimum levels of eligible LTD that is contractually subordinated to deposits and general unsecured claims. Whether that debt could be issued internally or externally would depend on the structure of the banking organization.

- A covered IDI that is a consolidated subsidiary of a covered holding company would be required to issue its eligible LTD to a US company that consolidates the IDI for accounting purposes.[11]
- A covered IDI that is not a controlled subsidiary of any entity would necessarily be required to issue its eligible LTD to a party that is not an affiliate of the covered IDI.
- A covered IDI that is a consolidated subsidiary of another entity that is not a covered holding company would be permitted to issue its eligible LTD to a parent entity that controls the covered IDI or to investors that are not affiliates.

A covered IDI that issues LTD to an IHC would be required to maintain the debt at the IHC-level, not at the level of a foreign banking organization.

Regardless of the structure, a covered IDI would be required to maintain outstanding eligible LTD in an amount that is the greater of 6% of the covered IDI's total risk-weighted assets, 3.5% of its average total consolidated assets, and 2.5% of its total leverage exposure if the covered IDI is subject to the supplementary leverage ratio.

Clean Holding Company Requirements. Covered holding companies would be subject to clean holding company requirements. This would prohibit covered holding companies from issuing short-term debt (maturities of less than one year) instruments to third parties, entering into qualified financial contracts with third parties, providing new guarantees that are subject to cross-defaults, having liabilities that benefit from upstream guarantees from a subsidiary or that are subject to contractual offset against amounts owed to subsidiaries. The LTD Proposal also generally would cap the amount of a covered holding company's liabilities that are not long-term and that rank at either the same priority as or are junior to its eligible external LTD at 5% of the sum of the covered holding company's common equity Tier 1 capital, additional Tier 1 capital, and eligible LTD amount. Liabilities that are expected to be subject to the cap include structured notes, external vendor and operating liabilities and obligations to employees and liabilities arising other than through a contract.

Capital Deductions. Currently, US G-SIBs, their subsidiary IDIs, and Category II banking organizations are required to deduct a portion of eligible LTD of US G-SIBs and IHCs of non-US G-SIBs from capital. Under the LTD Proposal, US G-SIBs, their subsidiary IDIs, and Category II banking organizations would be required to deduct a portion of the eligible LTD of covered holding companies and covered IDIs under the regulatory capital requirements. Additionally, under the parallel capital proposal that banking regulators are considering, covered holding companies and covered IDIs would become subject to the same deduction framework as US G-SIBs, meaning that they would also need to deduct a portion of eligible LTD of other organizations.

TLAC Revisions. The LTD Proposal would revise aspects of the TLAC requirements that currently apply to US G-SIBs and IHCs of non-US G-SIBs. These changes include: (i) imposing a 50% haircut on eligible LTD with a maturity of one year or more but less than two years that counts only towards the TLAC requirement; (ii) requiring eligible LTD to be issued in minimum denominations of $400,000; (iii) permitting US G-SIBs to directly enter into underwriting agreements as an issuer of securities, fully paid structured share repurchase agreements, and employee and director compensation agreements for stock options in the US G-SIB; and (iv) requiring US G-SIBs to make certain quantitative and qualitative disclosures related to the creditor ranking of their liabilities.

Transition Period. Covered holding companies and covered IDIs would have three years to comply with the new requirements. Over that three-year period, they would need to meet 25% of their long-term requirements by one year after finalization of the rule, 50% after two years of finalization, and 100% after three years. A three-year phase-in also would apply to banking organizations that become subject to the requirements at a later date.

Potential Impacts

The LTD Proposal would likely increase the cost of capital for most covered banking organizations. Because many of these banking organizations currently fund themselves largely with low-cost deposits, the LTD Proposal would increase the leverage of these banking organizations by requiring the issuance of a substantial amount of higher-cost LTD. This burden would be exacerbated because they would need to issue the debt in what is currently an unfavorable economic environment, while at the same time the parallel capital proposal also requires them to raise significant amounts of new capital. Given recent periodic softness in the new issue markets, this requirement could be challenging in the time period allotted by the LTD Proposal. At a minimum, it could give investors greater leverage over affected banking organizations to exact more investor-friendly pricing and other terms.

There is a much greater diversity of structures among covered banking organizations compared to the US G-SIBs. Some holding companies have extensive activities that are independent of their IDIs, while others have significant private ownership. For these organizations, complying with the clean holding company requirements may be extremely laborious, and require radical changes to their organizational structures and licensing arrangements. Additionally, for all covered banking organizations, the interaction between the LTD Proposal and the contemporaneous proposals on resolution planning requirements would require substantial changes to their living wills.

The LTD Proposal would also increase the complexity of these banking organizations' capital planning, particularly for banking organization that previously had little LTD. These banking organizations would have to be active issuers of LTD and devote time to ensuring that all regulatory requirements

are satisfied. This could divert attention from other, more pressing issues, such as managing deposit concentrations and enhancing contingency funding plans.

From a policy perspective, the LTD Proposal would effectively operate as a form of deposit insurance. Because many of these banking organizations currently fund themselves largely with deposits and have few assets outside of their IDI, the LTD Proposal would transfer losses that would otherwise be incurred by uninsured depositors in a resolution of the banking organization to holders of LTD. FDIC Chair Gruenberg has indicated that he believes that imposing losses on uninsured depositors can trigger banking runs and, therefore, a LTD is needed to prevent such an outcome.[12] While expanding deposit insurance would require the approval of Congress, the LTD Proposal provides a means for *de facto* extending deposit insurance through regulation.

The LTD Proposal also would advance continued ring-fencing of the US banking system that has occurred since the 2008 financial crisis. The LTD Proposal would require subsidiary IDIs of covered holding companies and IHCs of non-US G-SIBs to issue internal LTD to support MPOE resolution strategies and provide the FDIC with additional options in an insolvency situation. This requirement currently does not apply to the US G-SIBs and would impose burdensome capital planning and management requirements on covered holding companies. It also does not contemplate that an organization could avoid the need for this requirement by adopting an SPOE resolution strategy. As noted by FDIC Vice Chair Travis Hill, "the long-term debt we care about needs to be at the bank – and only at the bank."[13]

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Endnotes

[1] *FDIC Board Meeting* (Aug. 29, 2023), https://www.fdic.gov/news/board-matters/2023/board-meeting-082923-open.html; *Agencies request comment on proposed rule to require large banks to maintain long-term debt to improve financial stability and resolution* (Aug. 29, 2023), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230829a.htm. The US federal banking regulators consist of the Board of Governors of the Federal Reserve System ("Federal Reserve"), Office of the Comptroller of the Currency, and

Federal Deposit Insurance Corporation ("FDIC"). The FDIC and Federal Reserve issued proposals related to resolution planning requirements at the same time as the LTD Proposal. We do not address these proposals in this Legal Update.

[2] 82 Fed. Reg. 8266 (Jan. 24, 2017).

[3] A G-SIB may plan for resolution under a single-point-of-entry ("SPOE") resolution strategy or a multiple-point-of-entry ("MPOE") resolution strategy. All US G-SIBs have adopted SPOE strategies.

[4] See our Legal Update on the advance notice: https://www.mayerbrown.com/en/perspectives-events/publications/2022/10/us-banking-regulators-solicit-comment-on-resolutionrelated-obligations-for-larger-regional-banks.

[5] The LTD Proposal would not apply to a savings and loan holding company with 25% or more of its total consolidated assets in insurance underwriting subsidiaries (other than assets associated with insurance underwriting for credit), a savings and loan holding company with a top-tier holding company that is an insurance underwriting company, or a grandfathered unitary savings and loan holding company that derives a majority of its assets or revenues from activities that are not financial in nature.

[6] This would include six subsidiary IDIs of IHCs owned by non-US G-SIBs that would become subject to LTD requirements under the LTD Proposal, even though their IHC already is subject to a LTD requirement.

[7] The minimum denomination of $400,000 requirement would not apply to LTD that will be internally held (e.g., LTD issued from an IDI to a holding company). Eligible internal long-term issued by an IHC would not need to include a prohibition against credit sensitive features.

[8] The definition of a structured note does not include a non-dollar-denominated instrument or an instrument whose interest payments are based on an interest rate index (for example, a floating rate note linked to the federal funds rate or to the secured overnight financing rate), in each case that satisfies the proposed requirements in all other respects.

[9] If an IHC's non-US parent company follows an SPOE resolution strategy, then the IHC would need to issue eligible LTD internally within the organization and include a contractual conversion provision that is approved by the Federal Reserve. If an IHC's non-US parent company follows a multiple point of entry ("MPOE") resolution strategy, then the IHC would be permitted to issue eligible LTD externally. The non-US parent would need to certify to the Federal Reserve if it has adopted an SPOE or MPOE strategy.

[10] The supplementary leverage ratio generally would apply to all covered holding companies under the parallel capital proposal being considered by banking regulators.

[11] In practice, the proceeds raised by the issuance of eligible LTD by a covered holding company generally would be downstreamed to its covered IDI subsidiary in return for eligible internal LTD that would satisfy the covered IDI's own eligible LTD requirement.

[12] Martin Gruenberg, *The Resolution of Large Regional Banks and Lessons Learned* (Aug. 14, 2023), https://www.brookings.edu/events/the-resolution-of-large-regional-banks-and-lessons-learned-with-martin-gruenberg/.

[13] Travis Hill, *Statement on the Proposed Long-term Debt Requirements for Large Banks* (Aug. 29, 2023).

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