FinReg
Davis Polk Insights on Financial Regulation

Federal Reserve May Simplify the TLAC Rule

By Randall D. Guynn, Gabriel D. Rosenberg, Alison M. Hashmall & Nancy Lee on January 30, 2018

POSTED IN BANK CAPITAL, BANK REGULATION, DODD-FRANK, FDIC, FEDERAL RESERVE, TLAC

In his recent speech that we have covered in a series of **blog posts**, Federal Reserve Vice Chair for Supervision Randal Quarles announced that he would like the Federal Reserve to achieve "meaningful simplification of our framework of loss absorbency requirements," referring to both the Federal Reserve's capital and its total loss absorbing capacity (TLAC) rules. While Vice Chair Quarles did not provide any further details on what he had in mind, here are three simplifications or other changes that we believe the Federal Reserve might consider.

First, consistent with Treasury's recommendation in its **Report to the President on Banks and Credit Unions**, the Federal Reserve might revisit its calibration of internal TLAC applicable to the U.S. operations of large foreign banking organizations. The Federal Reserve calibrated its internal TLAC requirement at 89% of the external TLAC requirement imposed on large U.S. banking organizations, excluding internal and external TLAC buffers. This is at the high end of the 75%-90% range proposed by the Financial Stability Board (FSB) in its **international guidelines**. The EU predictably retaliated by proposing an internal TLAC requirement on the European operations of large U.S. and other non-EU banking organizations at the 90% level. This move reflects the perverse incentives created by a collective action problem that we described in a **blog post** on the FSB's final guiding principles on internal TLAC. Interestingly, the Bank of England recently **proposed** to calibrate its internal TLAC requirement at 75% of external TLAC—a positive call for international cooperation and step towards mitigating the collective action problem.

Second, the Federal Reserve might consider eliminating its separate long-term debt requirement, allowing firms to satisfy their internal or external TLAC requirements entirely with equity if they choose. Most firms will likely choose to satisfy their TLAC

requirements with a combination of debt and equity, but why prohibit a firm from satisfying its requirement entirely with equity, which is able to completely absorb losses?

The justification for the separate long-term debt requirement was to ensure a reliable trigger existed for putting a firm into an FDIC receivership under Title II of the Dodd-Frank Act before the firm ran out of sufficient TLAC to recapitalize its operating subsidiaries. The separate long-term debt requirement provided that certainty because balance-sheet insolvency is a clear trigger under Title II, and a separate long-term debt requirement guarantees that a firm will still have long-term debt that can be "bailed in" (e.g. converted to equity) after the firm becomes balance-sheet insolvent. If a firm were able to satisfy its TLAC requirement entirely with equity, it might not have any TLAC left once it became balance-sheet insolvent.

But after the Federal Reserve's TLAC rule was finalized, the FDIC and the Federal Reserve required the U.S. G-SIBs to include triggers in their Title I resolution plans that would require them to file for bankruptcy well before balance-sheet insolvency, when they would still have sufficient assets to recapitalize their operating subsidiaries. Since a bankruptcy filing is a clear trigger for Title II, the justification for the separate long-term debt requirement no longer applies.

Third, the Federal Reserve could simplify the TLAC rule by allowing long-term debt securities that are able to absorb losses but that may not qualify as TLAC, such as structured notes, to remain outstanding at the parent company level rather than being subject to the rule's 5% cap on liabilities deemed to be unrelated to TLAC.