June 7, 2019

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Office of the Comptroller of the Currency
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Ann E. Misback, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, D.C. 20551

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington D.C. 20429

Re: Regulatory Capital Treatment for Investments in Certain Unsecured Debt Instruments of Global Systemically Important U.S. Bank Holding Companies, Certain Intermediate Holding Companies, and Global Systemically Important Foreign Banking Organizations (Docket ID OCC–2018–0019 and RIN1557–AE38; FRB Docket No. R–1655 and RIN 7100–AF43; FDIC RIN 3064–AE79)

Ladies and Gentlemen:

The Securities Industry and Financial Markets Association ("SIFMA") appreciates the opportunity to comment on the notice of proposed rulemaking (the "Proposal")[1] issued by the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the Federal Deposit Insurance Corporation (the "FDIC") and the Office of the Comptroller of the Currency (the "OCC" and, collectively with the Federal Reserve and FDIC, the "Agencies"), that would address the regulatory capital treatment of an advanced approaches banking organization's holdings of certain unsecured debt instruments ("covered debt instruments") issued by global systemically important banking organizations ("G-SIBs") and certain subsidiaries thereof, including debt instruments issued for purposes of meeting minimum total loss absorbing capacity ("TLAC") and, where applicable, long-term debt ("LTD") requirements, and unsecured debt instruments issued by G-SIBs that are pari passu or subordinated to such debt instruments. We fully

[1] Regulatory Capital Treatment for Investments in Certain Unsecured Debt Instruments of Global Systemically Important U.S. Bank Holding Companies, Certain Intermediate Holding Companies, and Global Systemically Important Foreign Banking Organizations, 84 Fed. Reg. 13814 (Apr. 8, 2019).

support the letter that we have submitted in response to the Proposal jointly with the Bank Policy Institute (the "Joint Letter"). We would like to take the opportunity in this letter, however, to further stress the importance of ensuring that the Proposal's framework for market making is effective and efficient and to propose specific revisions to that framework.

The Agencies note in the preamble to the Proposal that they expect it "will have the benefit of improving the resiliency and enhancing the resolvability of advanced approaches banking organizations in the event that an entity required to issue LTD or TLAC fails or encounters material financial distress."[2] The Proposal is also intended to be complementary to existing capital requirements aimed at reducing interconnectedness and related contagion risk among banking organizations by limiting the extent to which they can invest in capital instruments of other financial institutions.[3]

Since the financial crisis, the details and calibration of all of these various rulemakings relating to capital and TLAC have undergone several rounds of public comment, including at the level of the Basel Committee, the Financial Stability Board, and within the United States. A primary concern that we have raised throughout the rulemaking and public comment processes has been the market's ability to provide sufficient liquidity in these loss absorbing instruments issued by G-SIBs, which is critical to promoting resiliency and resolvability. Along these lines, we are particularly concerned about the Proposal's deduction requirements given the sheer size of TLAC as an asset class. Assuming a G-SIB holds only enough regulatory capital to meet its total risk-based capital minimum, it must issue additional TLAC-eligible instruments in an amount equal to at least 10% of risk-weighted assets ("RWAs") to meet its minimum TLAC requirement (excluding buffers), which was equal to $662 billion for the U.S. G-SIBs combined as of March 31, 2019.[4]

We appreciate that the Proposal responded to concerns we previously raised in our comment letter on the Federal Reserve's TLAC proposed rule issued in 2015[5] by including a market-making exemption in this Proposal. In particular, the Proposal would include a limited market-making exemption for investments in a covered debt instrument held with short-term intent for 30 business days or less up to a threshold of 5% of CET1 capital. We recommend that the Proposal's market-making exemption be improved in two ways.[6]

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[2] 84 Fed. Reg. at 13818.

[3] See 84 Fed. Reg. at 13817 (Similar limitations "already apply to investments in capital instruments of banking organizations in order to reduce interconnectedness and pro-cyclicality within the financial system in times of stress.").

[4] In the United States, the minimum TLAC requirement (excluding buffers) as a percentage of risk-weighted assets ("RWAs") is 18%, whereas the minimum total risk-based capital ratio (excluding buffers), which can be met with common and preferred equity and subordinated debt (regulatory capital), is 8%, leaving a difference of 10% of RWA. See §§ 12 C.F.R. 217.10(a)(3), 252.63(a)(1).

[5] The Clearing House Association, SIFMA, the American Bankers Association, the Financial Services Roundtable and the Financial Services Forum, Comment Letter on the Notice of Proposed Rulemaking on External TLAC, Long-Term Debt, Clean Holding Company and Other Requirements Applicable to U.S. G-SIBs, https://www.federalreserve.gov/secrs/2016/april/20160422/r-1523/r-1523_032816_130250_545759023734_1.pdf. Note, however, that our previous comment letter also requested a market-making exemption for own covered debt instruments, which was not included in the Proposal. Id. See Section II below for further discussion of this issue.

[6] We also support the recommendations regarding the market making exemption set forth in the Joint Letter.

First, we recommend that the market-making exemption be aligned with the existing definition of market making-related activities in the regulations implementing the Volcker Rule, which would entail eliminating the Proposal's 30-day restriction. This change would make the exemption much more workable for market making-related activities—which, consistent with the Volcker Rule, include hedging activities in respect of customer-facing market making[7]—in covered debt instruments and would reduce operational complexity by relying on an existing framework. Second, we recommend that the Agencies include a separate but parallel 5% threshold for market-making activity in a covered G-SIBs' own covered debt instruments, as G-SIBs are the most significant and active market makers in their own debt. We believe that it is appropriate to depart from the final TLAC holdings standard established by the Basel Committee on Banking Supervision, which includes the 30-day restriction, because the Volcker Rule implementing regulations apply a requirement and compliance program to market making-related activities that goes beyond internationally agreed standards and are adequate to implement the market-making exemption for TLAC cross-holdings.

I. Align 5% Threshold for Market-Making Activity with Volcker Rule Implementing Regulations

Under the Proposal, an advanced approaches banking organization must combine the amount of its "non-significant" investments in the capital of unconsolidated financial institutions with the amount of any net long position in covered debt instruments issued by G-SIBs ("TLAC cross-holdings"), and deduct any excess over 10% of the banking organization's common equity tier 1 capital ("CET1") using the corresponding deduction approach.[8] Under this approach, any excess over 10% would be deducted on a pro-rata basis, which means that the banking organization would need to take deductions from both CET1 capital and tier 2 capital to account proportionally for its holdings in capital and covered debt instruments. In recognition of the potential impact of such a punitive approach to the liquidity of the G-SIB debt market—because investments in covered debt instruments could lead to a deduction from CET1 capital under the pro rata deduction approach—and "[t]o help support a deep and liquid market for covered debt instruments," the Agencies have proposed a separate market-making exemption from this deduction approach for TLAC cross-holdings.[9]

To qualify for the market-making exemption as proposed, a TLAC cross-holding must 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."[10] This definition is very similar to the Market Risk Capital

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[7] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5617, 5618 (Jan. 31, 2014) (stating that the Volcker Rule's exemption for market making-related activities permits "market making-related hedging," on the basis that "management of risk is a key factor that distinguishes permitted market making-related activity from impermissible proprietary trading.").

[8] Under the corresponding deduction approach, a banking organization is required to make deductions from the component of capital for which the instrument in question would qualify if it were issued by the banking organization itself. A banking organization that does have a sufficient amount of a specific component of capital available from which to make the required deduction is required to deduct any shortfall from the next higher (more subordinated) component of regulatory capital. See 12 C.F.R. §§ 217.22(c)(2), (f). Under the Proposal, an investment in a covered debt instrument generally would be treated as an investment in a tier 2 capital instrument and, therefore, under the corresponding deduction approach, would be deducted from the banking organization's own tier 2 capital (to the extent available).

[9] 84 Fed. Reg. at 13821.

[10] Proposal § __.2 (Definition of "excluded covered debt instrument").

Rule's definition of trading position[11] and the Volcker Rule statutory definition for the "trading account," which defines the universe of activity subject to the Volcker Rule's proprietary trading prohibition.[12] However, the Proposal's market-making exemption is inconsistent with the Market Risk Capital Rule and the Volcker Rule in that the Proposal would require that to qualify for the market-making exemption, a TLAC cross-holding must be held for 30 business days or less.[13] The 30-day restriction would apply not only to direct (cash) positions, but also to indirect (index) and synthetic (derivative) positions.

We have concerns that the market-making exemption, as proposed, would be both ineffective and inefficient:

- First, the 30-day restriction would limit the effectiveness of the market-making exemption, contrary to the Agencies' stated purpose of promoting liquid markets in covered debt instruments. Specifically, because of the 30-day restriction, the market-making exemption would be useful only for a subset of cash positions, given that some are held for longer than 30 days, which is consistent with the type of activity that is considered market making-related activity under the Volcker Rule. In addition, derivative positions generally are held for longer than 30 days (because they are generally hedged and not sold), which means the market-making exemption would be unavailable for a large portion of this entire category.
- Second, by introducing regulatory inconsistency among the various rules that apply at the enterprise level—that is, among the Market Risk Capital Rule, the Volcker Rule and the Proposal—the 30-day restriction would add unnecessary administrative and operational complexity to the Proposal. If the market-making exemption is adopted as proposed, firms would be required to develop multiple internal technological systems and compliance frameworks to manage to the different standards without any corresponding policy benefit—and, indeed, the result would undermine the policy goal of the proposed exemption.

Accommodating direct cash positions, as well as hedging in respect of market making in such cash positions, through an effective market making exemption is necessary to support the liquidity of the G-SIB debt market. TLAC-eligible "cash" instruments serve the critical function of providing additional loss-absorbing capacity to G-SIBs in the event of insolvency or resolution, and a deep and liquid hedging market is critical to the liquidity and pricing of TLAC-eligible instruments. Further, as noted, hedging is an integral part of market making-related activities and is recognized as such under the Volcker Rule.[14] When making markets for customers in cash instruments, market makers may need to use a derivative instrument to hedge the associated risk. Accordingly, the market making exemption in the Proposal should be revised to effectively cover both the need to hold market making cash positions and associated hedges (including derivatives). Because derivatives typically are not "sold," they may be held longer than 30 days. In fact, the Volcker Rule-implementing agencies have explicitly acknowledged that evaluating whether a derivative is held for permissible making marketing purposes based solely on the time period

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[11] 12 C.F.R. § 217.202(b).

[12] 12 U.S.C. § 1851(h)(6) (Defining "trading account" to mean "any account used for acquiring or taking positions in [certain] securities and instruments…principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements)…").

[13] Proposal § __.2 (Definition of "excluded covered debt instrument").

[14] See supra note 7.

for which it is held is not appropriate.[15] Therefore, if the proposed exemption does not accommodate the ability of firms to effectively hedge market making positions, including by holding derivatives for more than 30 days in some cases, advanced approaches banking organizations would not be able to rely on the exemption, and the policy rationale that motivated the Agencies to propose it would be undermined.

Furthermore, an effective exemption is necessary to support market making activity in hedging products that are related to TLAC instruments. G-SIBs are important market makers of hedging products that allow clients and customers to hedge not only their exposures to TLAC, but also broader credit risk. For example, a pension fund may decide that it is overexposed to corporate liabilities and, instead of shifting the make-up of its investment portfolio (by, for example, divesting of TLAC instruments), would rather temporarily purchase credit protection (either through single-name or index-based credit default swaps, depending on the exposure). In this example, a market maker may provide the pension fund with a derivative, which the pension fund would hold as a hedge (from the market maker's perspective, the derivative is a customer-facing position). The ability of buy-side investors, such as the pension fund in this example, to hedge credit risk (including credit risk arising from holding TLAC instruments) in the derivative market therefore supports liquidity and price stability in the cash market, as investors are able to hedge price movements as an alternative to divestiture. Accordingly, a lack of hedging options could be deleterious to TLAC cash instrument liquidity, which runs counter to the Agencies' intention to support a deep and liquid market for these instruments. For this reason, without revisions to the market-making exemption in the Proposal, market makers may be limited in their ability to provide risk management products to buy-side customers, which in turn may hamper liquidity in the cash market for TLAC instruments.

For the reasons stated above, SIFMA recommends that the Agencies eliminate the 30-day restriction and revise the definition of "excluded covered debt instrument" to include any covered debt instrument acquired by a trading desk engaged in market marking-related activities or risk-mitigating hedging activities in respect of market making-related activities,[16] in each case as defined and monitored under the Volcker Rule implementing regulations.[17] Consistent with Federal Reserve Vice Chairman Quarles' statements in January 2018 regarding the need to simplify and improve the efficiency of the post-crisis regulatory framework, these recommended changes would have the added benefit of simplifying the capital rules and avoiding the regulatory complexity that results from having multiple definitions in multiple frameworks for the same activity, all without undermining the Agencies' stated policy objective.[18]

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[15] Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432, 33495 (July 17, 2018) (proposing to, among other things, eliminate derivatives from the Volcker Rule implementing regulations' aging metric data used to monitor compliance with the exemption for market making-related activities because aging "does not appear to provide a meaningful indicator of potential impermissible trading activity or excessive risk-taking.").

[16] In some cases, market making positions may need to be hedged by a risk-mitigating hedging trading desk.

[17] Volcker Rule Implementing Regulations §§ __.4(b), 5 (describing permitted market making-related activities and risk-mitigating hedging activities). We believe this recommended approach would be appropriate even if the Volcker Rule implementing regulations are revised, as we expect there will continue to be exemptions for market making-related activities and risk-mitigating hedging activities.

[18] See Randal K. Quarles, Vice Chairman for Supervision, Bd. of Governors of the Fed. Reserve Sys., Early Observations on Improving the Effectiveness of Post-Crisis Regulation (Jan. 19, 2018) ("Efficiency of regulation can be improved

II. Provide Parallel 5% Threshold for Covered G-SIBs' Market Making in Own Covered Debt Instruments

Although we appreciate the Agencies' recognition of the need for a 5% threshold for non-significant investments in covered debt instruments, the Proposal's 5% threshold would not accommodate a covered G-SIB's positions held in its own covered debt instruments maintained as part of market making-related activities. Such holdings would, as a result, be subject to the punitive treatment of a full deduction.

While the Proposal recognizes the need for market making in order to "support a deep and liquid market for covered debt instruments,"[19] it does not currently consider the fact that G-SIBs are, as a general matter, the most significant and active market makers in their own debt. Requiring a full deduction for such holdings could discourage firms from continuing to provide robust market making in their own covered instruments, particularly in a stress event, where their role is most necessary.

In order to fully support market liquidity, we therefore also request that the Agencies provide for a separate 5% threshold to allow for market making in own holdings of covered debt instruments. We also request that any such 5% threshold also take into account the comments made in Section I of this letter, and align the definition of market making required to use the threshold with the Volcker Rule treatment of market making-related activities.

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We appreciate the Agencies' consideration of the foregoing comments and strongly urge them to consider the importance of designing a market-making exemption that supports a deep and liquid market in loss-absorbing instruments. We would be pleased to discuss our comments or otherwise assist in any way that is helpful. Please contact Carter McDowell by phone at 202-962-7327 or by email at cmcdowell@sifma.org.

Sincerely,

Carter McDowell
Managing Director and Associate General Counsel
Securities Industry Financial Markets Association

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through a variety of means. For example, it can mean achieving a given regulation's objective using fewer tools.... Confusion that results from overly complex regulation does not advance the goal of a safe system.").

[19] 84 Fed. Reg. at 13821.