June 7, 2019

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Docket ID OCC-2018-0019 (OCC); Docket No. R-1655 (Federal Reserve); RIN 3064-AE79 (FDIC)

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

To Whom It May Concern:

Americans for Financial Reform Education Fund (AFR Education Fund) appreciates the opportunity to comment on the above referenced Notice of Proposed Rulemaking (NPRM or Proposal) by the Board of Governors of the Federal Reserve (the Board), the Office of the Comptroller of the Currency, and the Securities and Exchange Commission (collectively, the Agencies). AFR Education Fund is a coalition of more than 200 national, state, and local groups who have come together to advocate for reform of the financial industry. Members of AFR include consumer, civil rights, investor, retiree, community, labor, faith based, and business groups.[1]

In 2016 U.S. and international regulators put in place new requirements for Total Loss Absorbing Capacity (TLAC) for systemically important banks. These rules supplement existing capital requirements with additional requirements for systemically important (G-SIB) banks to issue specified types of unsecured long term debt (unsecured LTD or TLAC debt). The theory behind this requirement is that in the event of the failure of a G-SIB bank, unsecured LTD can be

[1] A list of coalition members is available at: http://ourfinancialsecurity.org/about/our-coalition/

wiped out (or converted to equity in a bridge company) with limited economic disruption. Converting the debt would assist regulators in financing the continued operation of the bank during resolution, in order to minimize the impact of the bank failure on the financial system and the economy. It should be noted that this is at this point mainly a theory, since there are few if any modern examples of regulators wiping out significant amounts of bank debt during a period of financial stress while minimizing economic fallout.

If the theory behind issuance of unsecured LTD by G-SIBs is to actually work, it is crucial that the right kind of investors hold this debt. Investors in unsecured bank LTD should be entities with a long time horizon for holding illiquid assets, who are able to wait out a period of financial stress for converted debt to perhaps regain value. Most importantly, they should be diversified and hold many assets that are not highly correlated with the banking and financial sector.

Other banks would be the worst possible holders of unsecured G-SIB LTD, meeting none of the above conditions. If a G-SIB fails and debt held by other banks is written down, this become a mechanism of contagion throughout the banking sector, heightening the financial stress created by the initial bank failure. If there is substantial banking sector exposure of any kind to unsecured G-SIB LTD then regulators will likely be reluctant to write down the debt at all, meaning that it will not be loss-absorbing. This will increase pressure for public bailouts of failing banks in the next financial crisis.

It is well understood that banks should not hold loss absorbing G-SIB LTD, and the Proposal acknowledges this and attempts to put in place disincentives to investment in such debt by major banks. However, we are concerned these disincentives are much too weak. Our specific concerns are as follows:

Deducting TLAC debt from Tier 2 capital is not a strong disincentive to investment: The proposal would deduct any investments in unsecured TLAC debt from the amount of Tier 2 capital held by the bank. Unlike Tier 1 and common equity capital, we do not believe the market looks to total capital ratios that include Tier 2 capital as a significant indicator of bank solvency. In addition, regulatory penalties for falling short of total capital requirements are not as severe as penalties for failing to meet Tier 1 buffers. Tier 2 capital instruments are also less expensive and easier to issue than common equity, making it easier to make up any shortfall.

We are thus concerned that the Tier 2 capital deduction will be seen as mainly an accounting issue, and large banks will continue to buy unsecured G-SIB debt if they feel they can earn a significant spread on such debt, despite the deduction.

The Tier 2 capital deduction does not even apply to banks below $700 billion in size that are not internationally active: Incredibly, the proposal would exempt all banks that are not "Category 1" (G-SIB) banks or "Category 2" (banks over $700 billion in size or with over $75 billion in cross-border exposures) from even the Tier 2 capital deduction. This exemption would include dozens of the largest banks in the country holding trillions of dollars in assets, who would be extremely exposed to financial sector disruptions but apparently would be completely free to purchase unsecured G-SIB LTD. The only reason given for this exemption is that the approach in this proposal would be "complex" to implement. This is not a good reason. It is also concerning that the agencies appear to believe it is complex to identify loss-absorbing unsecured debt. The entire TLAC model is based on the idea that investors will easily be able to identify loss-absorbing debt and will only purchase it if they understand the heightened risk.

The proposal contemplates what could be a significant role for large banks in market-making unsecured G-SIB debt: The proposal creates a limited exemption from the Tier 2 capital deduction for bank market-making in unsecured G-SIB debt, in order to help support a "deep and liquid" market in such debt. We are concerned that a significant market making operation in G-SIB debt could create major bank exposure to this debt if hedges used for market making and trading fail in periods of financial stress.

The proposal caps the fully exempted market making amount at a gross long exposure of five percent of common equity Tier 1 capital. However, we are concerned that market making operations will not be limited to this level. The deduction beyond the exempted amount is based on net, not gross exposure (i.e. beyond the five percent threshold banks must deduct five percent of net exposure from Tier 2 capital). Banks conducting market making operations in G-SIB debt are likely to be skilled at hedging their exposures in normal markets, reducing measured net exposure. However, as stated above, such hedges could fail in periods of financial stress.

To address these issues, we recommend that the Agencies restrict banks more strongly from investing in unsecured G-SIB debt, either through strict and enforceable caps on exposure, or at least by changing the Tier 2 capital deduction to a deduction from Tier 1 common equity. We also urge the Agencies to extend these restrictions, at a minimum, to all Category 3 and Category 4 banks, and consider extending them to smaller regional banks as well. Finally, we do not believe the Agencies should encourage a market making role for large banks in unsecured G-SIB debt. If such a market-making role is permitted then the capital deduction for market making holdings should be based on gross exposure and not net exposure.

Finally, we are concerned that the Agencies appear to lack data on bank holdings of unsecured G-SIB debt, and also that the Agencies feel that it would be complex for banks to identify their own holdings. This raises important questions about the TLAC debt regime as a whole. For the debt write down arrangements to work it is critical that investors understand when they are purchasing debt that will be first in line to be written down in a bank resolution, and that only investors prepared to absorb such losses buy unsecured G-SIB debt. But several elements in the proposal discussion imply that this is not the case. As a first step, we strongly support the additional bank reporting requirements related to TLAC debt holdings in these proposals. However, we would also urge the agencies to work with the Securities and Exchange Commission to put in place steps to make TLAC debt easier for investors to identify.

Thank you for the opportunity to comment on these Proposed Rules. If you have questions, please contact Marcus Stanley, the AFR Education Fund's Policy Director, at 202-466-3672 or marcus@ourfinancialsecurity.org

Sincerely
Americans for Financial Reform Education Fund