

March 30, 2012

Jennifer Johnson

Secretary

Board of Governors of the Federal Reserve System

20th Street and Constitution Ave., NW

Washington, DC 20551

Ladies and Gentlemen:

On December 20, 2011, the Federal Reserve Board (FRB) published for comment a Notice of Proposed Rulemaking (NPR) to implement Sections 165 and 166 of Title I of the Dodd-Frank Act. These sections provide the FRB with broad powers to implement heightened supervisory standards and remediation requirements for US banking organizations with assets of more than \$50 billion and any non-bank financial institutions identified by the Financial Stability Oversight Council (FSOC) as posing a systemic risk to the financial system (hereinafter referred to as covered institutions). These and other provisions of Title I must be read and understood in conjunction with Title II of Dodd-Frank, which gives the FDIC the authority to place large, nonbank systemic entities,

including the nonbank subsidiaries of bank holding companies, into a bankruptcy-like receivership process, where shareholders and unsecured debt holders absorb losses associated with the orderly resolution of the institution.

The broad goals of Title I are to reduce the risk of failure of a systemic institution because of the potentially large external effects on the financial system and the greater economy. Title I mandates the imposition of rigorous prudential standards for large, inter-connected institutions.

These standards are of critical importance because the distress and suspected insolvency of a systemic institution can be disruptive even before such an institution actually reaches the point of “failure,” which is defined as an imminent default on its debts. Because these institutions tend to be very complex and opaque, it is difficult for the markets to accurately assess their solvency. Their enormous exposure to various risks can make investors nervous whenever a serious prospect of default is suspected. This highlights the critical importance of prudential regulation and supervisory standards for systemic institutions, as well as greater transparency and simplification of their legal structures.

The FDIC was charged with creating a process to resolve such institutions in an orderly way should they fail. This is a challenging task, and Title I was designed to enhance the capability of the FDIC to be successful in both planning as well as carrying out the resolution in the event it should be called upon to

implement the plan. For instance, the “living will” requirement of Title I -- which is to be jointly implemented by the Fed and FDIC -- is essential to the FDIC’s ability to plan and prepare for an orderly resolution, but heightened prudential standards also play a key role. Importantly, Title I’s mandate to identify and reduce credit exposures among financial institutions will better enable the FDIC to impose losses on debt-holders and counter-parties in a Title II resolution without causing material losses on other financial institutions, which could in turn threaten system stability. Moreover, as we discuss below, the adequacy of the capital structure of a systemic institution to absorb losses in a Title II resolution should also be a matter of central concern to the FRB in discharging its obligations under Title I.

This NPR is very complex, encompassing 173 pages and 95 specific questions. It includes capital and leverage requirements, liquidity standards, limits on counter-party concentrations, stress testing, risk management, and early remediation. Given the breadth of the proposal, we are focusing on only a few key aspects which we believe are crucial to the effective integration of these rules with the broader purposes of Dodd-Frank: to end too-big-too-fail and taxpayer bailouts.

First, we commend the FRB for considering some market indicators of risk as well as institutionalizing a more forward looking supervisory process through stress-testing and early remediation, though we feel compelled to express our grave

concerns about the premature capital distributions which the FRB approved as a result of stress tests it completed this year and in 2011. Dividends and buybacks inevitably slow the pace at which these large banks build their capital buffers. The FRB's first priority should be to strengthen their capital positions. And while we also commend the increased transparency which accompanied the announcement of this year's stress test results, we believe that more information should be disclosed to enable the market to fully evaluate the tests' usefulness as a measure of financial strength.

We are also pleased that the FRB is trying to identify, measure and cap credit exposures, with more severe limits being placed on exposures between the largest institutions. However, we would urge the FRB to examine carefully the netting that is allowed under these rules to make sure that they fully account for counterparty exposures in a stress situation. In addition, in these and other areas, we believe the FRB has ignored two of the most important lessons of the crisis: in times of stress, the only capital that the market trusts is tangible common equity and similarly, given the inevitable subjectivity of risk weighting assets, the market will view leverage ratios (relative to total tangible assets) as a more important indicator of financial solvency than risk-weighted capital. Investors will also look beyond model predictions and loss recognition as stipulated in accounting measures, and attempt to assess the true value of the institution's assets.

Though Basel III is far from perfect, we do believe that its new definition of tangible common equity is far superior to dated Tier 1 and Tier 2 capital measures, and certainly far superior to the loose concept of “Consolidated Capital Stock” found in the FRB’s proposed credit exposure limits. We would strongly encourage the FRB to consistently use the Basel III definition of tangible common equity as the appropriate measure of going-concern loss absorbency, whether in the context of stress testing, remediation, or credit exposure limits. Similarly, leverage ratios should be given at least as much weight as risk-based measures, particularly in determining the adequacy of an institution’s capital in a stressed environment.

We also believe that in discharging its responsibilities under these and other provisions of Title I, the FRB must give greater priority attention to how they interrelate with Title II of Dodd-Frank. Working in consultation with the Fed and international regulatory authorities, the FDIC is developing a resolution strategy that involves a single receivership at the holding company level, with subsequent recapitalization of the firm by existing and new investors. For the largest financial organizations, this approach to resolution recognizes that they are currently managed on an enterprise-wide basis, with thousands of legal entities in numerous jurisdictions; thus seizing control of the entity through a single receivership at the “top of the house” is currently the most efficient and practical means of resolving it.<sup>1</sup>

Using this resolution approach, the FDIC would be appointed as receiver of the ultimate parent holding company of the financial group, following the company's failure and the completion of the statutory appointment process. A bridge financial company would be formed immediately, into which most or all of the assets of the failed financial company, including its investments in and loans to subsidiaries, would be transferred. The viable subsidiaries—both domestic and foreign—of the financial company would remain open and operating. Following the completion of a valuation process, the enterprise would be recapitalized by converting existing investors' claims in the failed financial company into a combination of equity and debt in the new enterprise.

This model has the advantage of returning the enterprise to private ownership in as short a time as possible, while avoiding the creation of an even bigger 'too big to fail' company which would result from the sale of all or substantial portions of the failed institution to another systemic entity. Because there will be greater value in running the global franchise on a business-as-usual basis than in ring-fencing foreign assets and causing them to be liquidated quickly at distressed valuations—which in turn maximizes value for foreign creditors and minimizes disruption to foreign markets—it can be expected that foreign

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<sup>1</sup> See FDIC. Meeting of the Systemic Resolution Advisory Committee, Resolution Strategy Overview Presentation, Jan. 25, 2012. See also Hearing on International Harmonization of Wall Street Reform: Orderly Liquidation, Derivatives, and the Volcker Rule before the Senate Banking Committee, 112<sup>th</sup> Cong. (2012), Statement of Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System.

authorities and counter-parties would be motivated to cooperate in this resolution strategy.

As noted by Governor Tarullo in recent Congressional testimony, “[t]his approach holds great promise, but ensuring its viability as a resolution option requires, among other things, that each SIFI maintain an amount of long-term unsecured debt that is sufficient to absorb very significant losses at the firm.”<sup>2</sup> Indeed, a prerequisite to the success of the recapitalization model is the continued presence of a significant portion of long-term unsecured indebtedness—together with increased levels of equity capital and subordinated indebtedness—at the ultimate parent level of each U.S.-based systemic institution that is sufficient to absorb loss in the rest of the group.<sup>3</sup> Basel III specifies only minimum requirements, and national regulators must assess the capacity of the relevant institutions in their jurisdiction and the capital markets to allow healthy capitalization that would ensure improved health and stability for the financial system.

Consequently, at a minimum, we believe that institutions covered by Title I should be required to have ratios of 20% of common and preferred equity and

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<sup>2</sup> Hearing on International Harmonization of Wall Street Reform: Orderly Liquidation, Derivatives, and the Volcker Rule before the Senate Banking Committee, March 22, 2012, 112<sup>th</sup> Cong. (2012), Statement of Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System.

<sup>3</sup> We note that the amount of unsecured indebtedness at the parent company level that will be required to effect the recapitalization model also could be proportional to a company’s total consolidated indebtedness.

subordinated debt to total (non-risk weighted) consolidated assets and 30% of total equity and unsecured long-term debt to such assets.

In order to facilitate a Title II resolution and a recapitalization strategy, the mandatory proportion of unsecured debt should have the following features:

- be issued at the ultimate parent company in the SIFI structure;
- be issued on a senior, unsecured basis;
- be governed by U.S. law (e.g., New York State law);
- be for a tenor of more than 360 days; and
- not be guaranteed, linked to or otherwise supported by any subsidiary or affiliate of the ultimate parent company issuer.<sup>4</sup>
- not be held by another systemic institution.

Imposing such a requirement on systemic institutions would have a number of important benefits. Not only would it help ensure the success of the FDIC's resolution strategy by mandating adequate post-resolution capacity to absorb losses occurring anywhere within the financial organization, it would also provide for a more stable funding structure and greater market discipline on the largest institutions. We realize that such a standard would require the largest financial organizations to significantly increase the amount of subordinated and

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<sup>4</sup> To meet this standard, such indebtedness should be carved out of any cross-default or cross-acceleration provisions in the contracts and/or indebtedness of subsidiaries and affiliates.



long-term debt or equity issued by the parent; but this would have the salutary effect of extending the average maturity of these institutions' liability structure, countering their continued disproportionate reliance on unstable short term funding. In addition, by reinforcing the credibility of the Title II resolution process, purchasers of these unsecured debt instruments will have incentives to closely scrutinize the risks of their investments, and likely require a higher risk premium, based on financial analysis, not implied government guarantees. This will in turn raise funding costs, constraining the growth of large institutions through market forces.

Finally, such a requirement would be simple, hard to game and easy to enforce, which brings us to our final comment on the FRB's NPR. These proposed rules are still heavily reliant on supervisory judgment. As we saw during the years leading up to the 2008 financial crisis, financial regulators are not infallible. The strength of supervisory resolve ebbs and flows, in accordance with political will and agency leadership. In contrast, simple, straightforward rules, particularly capital standards and other "skin in the game" requirements remain constant regardless of whether regulation is in or out of fashion, and they rely as much on economic incentives and market discipline to achieve their aims as examiner judgment. In particular, we strongly urge the FRB to move ahead with hard and fast rules to substantially raise tangible common equity capital requirements, which

are at least as strong as those agreed to by the Basel Committee. That must be the FRB's top priority.

Sincerely,



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