The Systemic Risk Council

The Honorable Janet L. Yellen
Chair, Board of Governors of the Federal Reserve System
20th St. and Constitution Ave. NW
Washington, DC 20551
regs.comments@federalreserve.gov

April 14, 2016

Re: Comments regarding the TLAC Proposal (Docket No R-1523; RIN 7100-AE37)

Dear Chair Yellen:

The Board of Governors of the Federal Reserve System (the **Board**) on October 30, 2015 released a proposed rule requiring, among other things, significant banking groups to issue and maintain at all times a specified minimum amount of debt securities that could, via special resolution or bankruptcy procedures, absorb losses once equity is either exhausted or insufficient to maintain orderly operation of the business.[1] This component of the overall total loss-absorbing capacity (**TLAC**) proposal is known as the proposed long-term debt (**LTD**) requirements. The Systemic Risk Council (the **Council** or **we**)[2] is strongly supportive of the TLAC proposal and the LTD requirements, and we wish to affirm that support on the public record in light of opposition to parts of the proposal from the financial services industry.

1. OVERVIEW

The 2008-09 phase of the Great Financial Crisis underlined that the failure of significant financial intermediaries can impose costs on the general public (social costs) that massively exceed the private costs of the failure borne by management, shareholders, creditors and employees. The combination of panic, confusion and severe impairment of the provision of core financial services to households and businesses plunged the economy into a deep recession, from which recovery has been slow, faltering and largely incomplete.

In the aftermath of the crisis, there has been broad consensus on a vital point: it must be possible for each and every financial intermediary to fail in an orderly manner without taxpayers having to provide solvency support in order to avoid an economic and social calamity. The Council supports the key components of the reform program that was developed to that end. They include:

[1] The proposed rule was published in the Federal Register on November 30, 2015; see 80 Fed. Reg. 74926.

[2] The independent, non-partisan Systemic Risk Council (www.systemicriskcouncil.org) was formed to monitor and encourage regulatory reform of U.S. and global capital markets, with a focus on systemic risk. The Council is funded by the CFA Institute, a global association of more than 125,000 investment professionals who put investors' interests first and set the standard for professional excellence in finance. The statements, documents and recommendations of the private sector, volunteer Council do not necessarily represent the views of the CFA Institute. The Council works collaboratively to seek agreement on each of its recommendations. This letter fairly reflects the consensus views of the Council but does not bind its individual members.

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(a) Higher tangible common equity and liquid asset requirements, to reduce the probability of distress;

(b) Greater use of robust, resilient, prudently managed and well-regulated central counterparties, in order to reduce and simplify the network of counterparty credit exposures among intermediaries that propagate losses around the system and fuel fears of contagion;

(c) A special resolution regime that enables orderly failure; and

(d) Greater and more effective transparency, as a precondition for the enhanced market discipline that the other reform measures can incentivize.

In the United States, the Dodd-Frank Act has provided the basic legislative underpinning for that reform program, which is also reflected in the international policies of the Financial Stability Board (**FSB**), as endorsed by the G20 leaders.[3]

The Board's proposed LTD requirements, which are the subject of this letter, concern the third component of the reform package: establishing a special resolution regime for any distressed intermediary—however big or complex—that is a credible and vastly preferable alternative to taxpayer bailouts of fundamentally insolvent institutions. The essential ingredients of such a reform package are:

(a) A legislative regime that gives the necessary powers to the appropriate regulatory authorities and/or the courts;

(b) Requirements for financial organizations to be structured—legally, organizationally and financially—so as to facilitate the deployment of those powers without causing devastating disorder; and

(c) Requirements for relevant financial organizations to maintain outstanding at all times a sufficient amount of liabilities that, through special resolution or in bankruptcy, can be converted into equity in order to absorb losses without interrupting the core operational services upon which the economy relies or causing uncontrollable disruption in the financial system.

The first of those ingredients has been provided in the United States via the Dodd-Frank Act and subsequent rulemakings, largely by the Board and the Federal Deposit Insurance Corporation. The Board's proposed LTD requirements are designed to provide the third ingredient.

In broad terms, the Board has proposed as follows:

(a) Those U.S.-domiciled bank holding companies (**BHCs**) that have been designated as global systemically important banks (**G-SIBs**) must, after a transition period, have outstanding TLAC equal to not less than the greater of (a) 18% of the group's total consolidated risk-weighted assets (**RWAs**) and (b) 9.5% of its total leverage exposure;

(b) Within that mandatory TLAC issuance, such BHCs must have outstanding LTD equal to not less than the greater of (a) 6% of the group's RWAs plus the applicable G-SIB surcharge[4] and (b) 4.5% of its total leverage exposure;

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[3] Pub. L. No. 111-203 (July 21, 2010); see, e.g., Financial Stability Board, Implementation and Effects of the G20 Financial Regulatory Reforms (Nov. 9, 2015), available at http://www.fsb.org/wp-content/uploads/Report-on-implementation-and-effects-of-reforms-final.pdf.

[4] See Board, Regulatory Capital Rules: Implementation of Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies, 80 Fed. Reg. 49082 (Aug. 14, 2015).

(c) The U.S. intermediate holding companies (**IHCs**) for large U.S. subgroups of foreign banking organizations (**FBOs**) that have been designated as G-SIBs must have outstanding TLAC equal to not less than the greater of (a) 16% of such IHC's RWAs, (b) 6% of the IHC's total leverage exposure (if the IHC is subject to the supplemental leverage ratio) and (c) 8% of the IHC's average total consolidated assets; and

(d) Within that mandatory TLAC issuance, such IHCs must have outstanding LTD equal to not less than the greater of (a) 7% of the IHC's RWAs, (b) 3% of the IHC's total leverage exposure (if applicable) and (c) 4% of the IHC's average total consolidated assets.

The Council offers comments on those components of the proposed rule and a broader observation on the capital-structure requirements of the post-crisis regime.

2. MINIMUM LTD REQUIREMENT FOR U.S.-DOMICILED G-SIBS

The essence of the Board's proposed rule is to stipulate certain features of the capital structure of U.S.-domiciled G-SIBs in order to ensure that their common equity and long-term debt take losses and, thus, help to recapitalize and restructure a distressed G-SIB prior to losses being imposed upon debt more closely associated with its provision of operational services or with normal commerce.

Debt issued by a "clean" top-tier holding company would be structurally subordinated to all of the claims of the senior creditors of its subsidiary operating companies, including trade creditors and holders of uninsured deposits. It is also necessary that the internal capital structure of the group is such that losses in any of those subsidiaries that exceed the subsidiary's equity reach the holding company: this is sometimes known as "internal TLAC."

(a) External Subordinated Debt Requirement

For the special resolution or bankruptcy proceeding of a G-SIB to work in the manner described above, the top-tier company must have an amount of long-term debt outstanding that is sufficient when written off and/or converted into equity—i.e., bailed-in—to cover its subsidiary operating companies and re-capitalize the group as a whole.[5] That will ensure recapitalization of those parts of the organization whose disorderly failure would entail significant social costs. Hence, there is a need for a mandatory minimum of bail-in debt at holding company level, as embodied in the LTD requirement.

An important detail of the Board's plan that has attracted comment is the minimum requirement for debt issuance by the top-tier holding companies in addition to an aggregated minimum requirement for equity and debt. In this, it departs from the minimum requirement approved by the G20, and on balance is somewhat tougher.[6] The Council believes the Board's plan to be the prudent approach.

Those arguing against the Board's proposal have maintained that equity is preferable to debt, since it can absorb losses outside of a bankruptcy or special resolution proceeding; and that, to the extent that a G-SIB has equity in excess of minimum requirements, its "surplus equity" should count towards a total "equity plus debt"

[5] Questions have been raised as to whether it is feasible to resolve a systemically significant firm without major disorder and social costs via an ordinary bankruptcy proceeding, given various provisions of the U.S. Bankruptcy Code and, in the case of internationally active groups, the absence of an international treaty regarding the effect or treatment of such bankruptcy proceedings. We do not address that issue here. The international proposals for special resolution proceedings for systemically significant firms, and the plans being developed in the United States for special resolution, are designed to avoid such problems

[6] See Financial Stability Board, Consultative Document: Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in Resolution (Nov. 10, 2015), available at http://www.fsb.org/wp-content/uploads/TLAC-Condoc-6-Nov-2014-FINAL.pdf.

requirement. Some illustrative numbers for a hypothetical regime will bring out the difference between this approach and the Board's proposal.

Take a case where, as under the Board's proposal, there are minimum requirements for each of equity and debt—say, hypothetically, 10% of assets (on some measure) for both. Some industry commenters have argued that it would be preferable to frame a TLAC regime as a minimum requirement for "equity plus debt" of 20%, with at least 10% having to be equity. The difference arises when a group has equity of, say, 13%. Under the former regime, the group would still need to meet a debt requirement of 10%, whereas under the alternative the group would need to meet a residual debt requirement of 7%.

The former approach, which is that taken by the Board, is plainly more prudent, provided that the amount of surplus equity maintained by a G-SIB is broadly invariant to the specification of the mandatory bail-in debt requirement. We believe that that would be the case, since management and equity holders would have strong incentives to maintain the organization as a going concern and, in particular, to avoid the restrictions on dividend payments that would arise, under the terms of the capital conservation buffer requirements, when equity capital ratios fall below certain thresholds.[7]

Separately, we believe that a minimum requirement for bail-in debt would do a better job of strengthening a G-SIB's resilience, given fluctuations in the value of a firm's equity base. Whereas a firm's equity will fall when those of its assets that are marked to market fall in value, eroding its capacity to absorb other losses as a going concern, the amount of debt outstanding that is available to absorb losses through a bankruptcy or special resolution proceeding would remain fixed in nominal terms. While bail-in debt requirements are not a substitute for prudent equity capital requirements, they are a useful supplement (whatever the level of the minimum equity requirement).

Finally, we disagree with any suggestion that the Board's approach would damage the international competitiveness of the U.S. banking industry. On the contrary, by providing and signaling greater resilience in the event of a crisis, the proposed rule could enhance the competitive position of the U.S. financial system.

We accordingly recommend that the Board maintain the separate requirement for a minimum amount of LTD as a core part of its proposed TLAC rule for G-SIBs.

(b) Lack of Internal Debt Requirement

The proposed rule does not impose requirements governing how losses exceeding the equity of a subsidiary operating company would be transmitted to the top-tier holding company of a domestic G-SIB.

We urge the Board to fill in this gap, since it is essential to ensuring that special resolution or bankruptcy procedures can be applied only at the holding company level. Absent such measures, distressed operating subsidiaries might themselves have to go into special resolution or bankruptcy, entailing the greater disturbance to stability that resolution policies are intended to avoid.

As well as a quantitative requirement, it is important to be clear about how the internal TLAC would be triggered. Probably the best route would be for the regulator to be able to trigger the LTD component of the internal TLAC if otherwise the conditions for putting the operating subsidiary into special resolution or bankruptcy would be met. If that is not possible under existing law, it is important that another route be found that does not put the decision into the hands of the company itself. There may be contractual solutions to this.

[7] See 12 C.F.R. § 217.11(a).

3. MINIMUM LTD REQUIREMENT FOR IHCS OF FOREIGN G-SIBS

The Board's proposal for the U.S.-domiciled IHCs of foreign G-SIBs is essentially the same as its proposal for domestic G-SIBs, but with the important difference that the minimum quantum of mandatory bail-in debt must be issued to a foreign G SIB's home country holding company rather than directly to the market.

The Council has supported the Board's desire to ensure the resilience of the U.S. operations of FBOs, which it has pursued by requiring foreign G-SIBs with large U.S. operations to establish U.S.-domiciled IHCs.[8] Nevertheless, we are doubtful about the workability of some of the details of the Board's proposed mandatory bail-in debt requirement for IHCs. That is because they make no distinction between organizations that are subject to two different resolution strategies:

(a) Those foreign groups where the home country authorities plan that, in the event of distress, different parts of the group would be resolved separately by their local authorities (known as Multiple Points of Entry or **MPOE**); and

(b) Those foreign groups where the home country authorities plan that they would lead a single group-wide resolution from the top-tier company in the group (known as Single Point of Entry or **SPOE**).

In effect, the Board's proposed rule assumes that all foreign G-SIBs with a significant U.S. presence would be resolved through the SPOE strategy. So far as we are aware, that is not so. Alternatively, the Board may be seeking, via its proposed rule, to constrain the home country authorities of such foreign G-SIBs to adopt the SPOE strategy if those G-SIBs are to be allowed to operate material subsidiaries in the United States. If that were the goal, it would be preferable for it to be stated explicitly, so that the markets and foreign authorities could proceed accordingly. The Board's proposed rule would also place IHCs at a competitive disadvantage because it would not permit them to tap U.S. capital markets directly to raise the required LTD and would make such LTD subject to debt conversion triggers not applicable to large domestic BHCs. This treatment is also inconsistent with the framework established by the FSB.[9] It would not be in the interests of U.S. authorities or the American people for invalid assumptions to be made about the plans and/or capabilities of foreign authorities. It seems unlikely that this could be overcome simply by setting higher internal TLAC requirements for the U.S. IHCs of those foreign groups that would be resolved under an MPOE strategy.

It is possible that, under certain circumstances, it would be in the interests of the United States for a foreign G-SIB's IHC to issue all or some of the minimum amount of mandatory bail-in debt directly to the markets rather than to its home country holding company. That would be so where (a) there was doubt about the capacity or willingness of the home country authorities to execute a SPOE resolution of the group as a whole and (b) a successfully resolved U.S. subgroup would be viable or could be wound down in an orderly way on a stand-alone basis.

We accordingly recommend that the Board refine this part of the proposed rule, in order to recognize unavoidable interdependencies with the resolution planning of the Board's foreign counterparts.

4. NEED FOR SIMPLIFICATION OF POST-CRISIS CAPITAL STRUCTURE REQUIREMENTS

The Council is concerned that the post-crisis requirements for banks' capital structure are unduly complex. We believe that some streamlining would aid comprehension by the public, their elected representatives, investors and bank boards. We also believe that streamlining could be achieved in a way that would reduce the risk of the

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[8] See Comment Letter of the Council to The Hon. Ben. S. Bernanke, Chair of the Board (April 5, 2013), available at http://www.systemicriskcouncil.org/wp-content/uploads/2013/04/Final-SRC-Comment-Letter-to-FRB-re-FBO-EPS-4-5-13.pdf.

[9] See supra n.3.

kind of volatility seen recently in European banking markets and which threatened, however briefly, to spill over to the United States.

Since the G20 Summit last fall, it has become clear that the core requirements for a bank's capital structure, meaning the components of capital that do the heavy lifting to maintain a safe and sound banking system during periods of material financial distress, are:

(a) A minimum requirement for tangible common equity, which by definition absorbs losses smoothly and, thus, is central to the viability of an organization as a going concern; and

(b) A minimum requirement for mandatory long-term subordinated bail-inable debt, which is central to the orderly bankruptcy or special resolution of a gone concern.

Notwithstanding the simplicity of that categorization, the minimum regulatory capital requirements for banks, as set out in the Basel III Accord and implemented in U.S. regulations as well as in for example European Union directives and regulations, currently have a different structure. They include minimum requirements for "Additional Tier 1" (**AT1**) instruments and "Tier 2" instruments as part of "capital," implying that these instruments can absorb losses on a going concern basis.[10]

In broad terms, however, the instruments eligible to meet the Tier 2 requirements are often debt securities of various types and, in some jurisdictions, such debt instruments are eligible to meet AT1 requirements. These classes of capital are the legacy of a pre-crisis regime that failed to anticipate or cater to the orderly resolution of large and complex financial intermediaries. As has been apparent recently, such debt instruments are a confusing element of the current regime, as they are not unambiguously either going-concern or gone-concern capital instruments. As a general matter, a debt instrument cannot absorb losses on a going-concern basis. Debt can absorb losses in a special resolution regime or ordinary bankruptcy, but the AT1 and Tier 2 requirements were not drawn up with careful consideration of either.

The hazards of this situation were illustrated by recent fears concerning the AT1 "capital" of some significant European banking organizations. Such securities sometimes provide for the issuer, its regulator, or both to suspend coupon payments in certain circumstances. In addition to capital markets suffering a few days of infectious concern regarding the possibility of such an event, there were complaints that a bank might choose, or be required, to suspend coupon payments on such instruments without its equity taking a hit and with dividends and bonuses prospectively being paid to equity holders and management at year-end. In other words, there has been concern that bondholders might take losses first rather than only after equity holders and only via the bankruptcy or special resolution of a firm judged to be no longer viable. We see merit in those concerns.

The Council believes that the articulation, by the international authorities and by the Board, of requirements for mandatory bail-inable debt provides an opportunity to rationalize regulatory requirements for banks' capital

[10] See Basel Committee on Banking Supervision, Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems (rev. June 2011), available at http://www.bis.org/publ/bcbs189.pdf; 12 C.F.R. pt. 217; European Union Regulation (EU) No. 575/2013, available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32013R0575'; and European Union Directive 2013/36/EU, available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32013L0036.

structure that has not existed before. We accordingly recommend that the Board explore this opportunity with its fellow banking authorities domestically and, also, internationally in global standard-setting bodies.

Respectfully submitted,

Sir Paul Tucker, Chairman
On behalf of the Systemic Risk Council
www.systemicriskcouncil.org

Copy: Stanley Fischer
Jerome H. Powell
Daniel K. Tarullo
Lael Brainard
Board of Governors of the Federal Reserve System
Chairman Martin J. Gruenberg
Federal Deposit Insurance Corporation
Comptroller Thomas J. Curry
Office of the Comptroller of the Currency

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- Nout Wellink, Former President of the Netherlands Central Bank and Former Chair of the Basel Committee on Banking Supervision

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