February 1, 2016

Mr. Robert deV. Frierson
Secretary, Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue N.W.
Washington, D.C. 20551

Re: Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations; Regulatory Capital Deductions for Investments in Certain Unsecured Debt of Systemically Important U.S. Bank Holding Companies, Docket No. R-1523

Dear Mr. Frierson:

Thank you for the opportunity to comment on the proposed rule to establish minimum "total loss-absorbing capacity" or TLAC requirements for systemically important bank holding companies (or GSIBs) and for the intermediate holding companies of systemically important foreign banking organizations. I share the Federal Reserve Board's view that it is in the public interest to increase the resiliency of the largest financial institutions to prevent the need for future taxpayer assistance to forestall a more serious financial crisis. However, in my opinion, the proposed TLAC regulation is not the best way to accomplish this goal.

My analysis of the proposal suggests that TLAC will not remove the risk that the largest financial institutions may require future taxpayer assistance should the country face another financial crisis. Indeed the uncertainties associated with using TLAC in a Dodd-Frank Title II resolution are likely to create a new important source of systemic risk — uncertainty about which investors bear losses in a GSIB resolution — a risk that did not exist in the prior financial crisis. Moreover, the language of the proposed TLAC rule promises new protections to a huge volume of outstanding GSIB operating subsidiary liabilities. These new protections will provide tangible too-big-to-fail (TBTF) benefits to eight GSIBs that are not accessible to smaller institutions that are not eligible for a TLAC-Title II resolution. As a result, TLAC will not end TBTF, but instead will ensure that the largest financial institutions continue to benefit from a funding cost advantage created by their GSIB status as the TLAC plan makes it clear that regulators intend to preserve GSIB subsidiary institutions intact while smaller institutions will continue to fail and be liquidated under deposit insurance resolution rules.

The TLAC Notice of Proposed Rulemaking, and the companion Financial Stability Board TLAC proposal[1], argue that TLAC will solve a number of important policy issues. However, neither document provides evidence to support these claims. There are many conceptual and practical issues raised by the TLAC proposal. My specific comments on the TLAC proposal will be organize around five serious issues that must be addressed before moving forward with the proposed TLAC regulation.

[1] http://www.fsb.org/wp-content/uploads/TLAC-Condoc-6-Nov-2014-FINAL.pdf

The first issue of concern is regulators' failure to address or discuss the possibility that that TLAC will not work as planned. The TLAC proposal presumes that a Title II resolution can be used to keep a GSIB's critical operating subsidiaries open and operating. But what happens if a Title II resolution cannot be authorized? While this is clearly a possibility under the Dodd-Frank Act language that authorizes the use of Title II orderly liquation authority, the TLAC proposal is completely silent on this issue.

Secondly, TLAC relies on the use of a Title II resolution, but the "clean" parent holding company requirements in the TLAC proposal make it *less* likely that a GSIB parent company would be in danger of default if a critical operating subsidiary failed. The clean parent requirements will make the parent holding company less exposed to liquidity pressures and make it more difficult for the Secretary of Treasury to conclude that a GSIB parent company is in danger of default. Should the courts subsequently rule in favor of GSIB parent company shareholders and TLAC investors who seek damages for the illegal seizure of their property in a Title II resolution, taxpayers will ultimately be on the hook for the losses regulators illegally transferred to parent holding company investors.

A third important but unrecognized issue created by the TLAC proposal is that TLAC extends new government guarantees on nearly $5 trillion in GSIB subsidiary liabilities that are not currently insured by Federal deposit insurance. The government charges nothing for the new guarantees extended in the TLAC proposal, but merely asserts that TLAC debt investors will suffer the losses that would otherwise have been imposed on the subsidiary liabilities of these GSIBs should these subsidiaries face losses that tested their solvency. The assertion that the losses associated with these new guarantees will be paid for by TLAC investors incorrectly presumes that a Title II resolution is always an option when a critical GSIB subsidiary fails.

Fourthly, TLAC requirements, as they are currently proposed, will *not* remove or even limit the TBTF interest rate subsidy currently enjoyed by the largest financial institutions. The proposed TLAC regulation requires GSIB parent holding companies to issue and maintain minimum amounts of TLAC-compliant debt, but the proposal does not restrict how new TLAC funds are used. The GSIB's investment strategy for TLAC funds has important implications for a GSIB's TBTF funding subsidy. Unless TLAC funds are down-streamed to critical operating subsidiaries—primarily large subsidiary banks—and the funds are used to replace insured deposit funding (the first best solution) or at least be required to replace uninsured subsidiary liabilities, the GSIBs' TBTF funding cost subsidies will not be reduced. Indeed, the TBTF subsidies are likely to increase if investors believe the government's promise to protect nearly $5 trillion in formerly uninsured subsidiary liabilities credible.

Finally, TLAC adds new complexity to a complex system of capital and other prudential regulations. Virtually all of the regulatory goals of TLAC could be achieved by imposing higher minimum regulatory capital requirements on GSIBs' critical operating subsidiaries.[2] Higher minimum capital requirements at GSIB critical operating subsidiaries is a much more

[2] The new equity at subsidiaries could be funded with parent holding company debt issues similar to what is envisioned in the proposed TLAC regulations. However, in my opinion, there is no need to require holding companies to issue debt. The holding company management should decide how to raise any needed capital injection.

transparent approach than the TLAC proposal. Furthermore, it would not suffer from the legal uncertainties that may prohibit Title II resolution and protect TLAC investors from bearing losses. A detailed discussion of these fives important issues follows.

1. The alleged benefits of TLAC are only available in a Dodd-Frank Title II Resolution. If the GSIB parent holding company is not eligible for a Title II resolution, TLAC investors will not be required to bear the loss of a failing bank subsidiary.

TLAC regulation will require GSIB parent holding companies to issue and retain an outstanding balance of TLAC-compliant subordinated debt whose sole purpose is to absorb losses in a Dodd-Frank Title II resolution. In order for TLAC to recapitalize failing subsidiaries, the GSIB parent company must be in default or in danger of default and the Secretary of the Treasury must substantiate that the GSIB's failure in a bankruptcy proceeding would cause serious disruptions to the US financial system.

The Dodd-Frank Act created Orderly Liquidation Authority in Title II to allow financial institutions to fail using an administrative process managed by the FDIC instead of resolving the institution in judicial bankruptcy. The underlying assumption, although never substantiated, is that a government-run resolution process is quicker, more orderly, and less destructive of remaining franchise value than a court-administered bankruptcy.[3]

The TLAC rule is intended to facilitate a Title II resolution using the FDIC's proposed single point of entry (SPOE) resolution strategy.[4] Under this strategy, the parent holding company is taken into a Title II receivership. Resources owned by the GSIB parent company's shareholders and TLAC debt investors are then used to recapitalize the failing GSIB's operating subsidiaries, or at least the ones that regulators believe must be kept open and operating in order to prevent a wider financial crisis.

The regulatory view expressed in the Federal Reserve Board's TLAC proposal as well as in the FDIC's proposed SPOE strategy is that the survival or failure of the GSIB's parent holding company has no bearing on US financial stability. The GSIB parent company is viewed as a shell corporation with little or no interaction with financial markets outside of the GSIB group. The parent merely owns financial claims issued by its subsidiaries and manages the group.[5] Regulators believe that GSIBs are important to financial stability only because they own and manage important operating subsidiaries—large bank subsidiaries, broker dealers, or other large financial subsidiaries—that provide critical financial services that must be maintained to avoid triggering a financial crisis.

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[3] In a recently published paper. two FDIC economists show that the bank receivership process on average takes more than twice as long (about 5 years on average) as a bankruptcy proceeding (about 2 years on average). See Bennett and Unal (2014), "Understanding the Components of Bank Failure Resolution Costs," Financial Markets, Institutions & Instruments, pp. 349-389. Post-FDICIA through 2014, the simple average loss rate on failed bank receiverships calculated from publically available FDIC data is 23.6 percent.

[4] https://www.fdic.gov/news/board/2013/2013-12-10_notice_dis-b_fr.pdf

[5] Indeed the "clean parent holding company" requirements proposed in the TLAC rule are intended to limit the parent companies transactions to ensure that failure of the parent company does not trigger the failure of its operating subsidiaries.

If a so-called "clean" GSIB parent company[6] suffers losses that put it in danger of default, it is only because one or more of its critical operating subsidiaries has suffered losses which are large enough to render one or more of GSIB's operating subsidiaries insolvent. To prevent these operating subsidiaries from failing, the government will take the GSIB parent company into a Title II receivership and use its assets to recapitalize the GSIB's operating subsidiaries and keep them from failing. Thus, if regulators believe that the continued operation of a large bank, broker dealer, or other GSIB operating subsidiary is critically important to financial stability, the FDIC will use parent company resources to cover the failing subsidiaries' losses and recapitalize the subsidiary to keep it from failing. This process in essence is FDIC's strategy for using Title II resolution powers to "liquidate" a large failing financial institution without triggering a financial crisis.

When it comes saving a large failing GSIB bank subsidiary, one that renders the GSIB parent company in danger of default, there is an important legal obstacle that could prevent the FDIC's from using the SPOE plan. The problem arises when the parent company resources are insufficient to recapitalize the failing GSIB bank subsidiary to keep the bank from failing.

If the GSIB's failing subsidiary is an institution other than a bank,[7] the FDIC is empowered to borrow from the Treasury using the Dodd-Frank Orderly Liquidation Fund to inject resources to keep a GSIB subsidiary from failing. However, Dodd-Frank expressly prohibits the use of the Orderly Liquidation Fund if the proceeds of the loan are used to benefit the Deposit Insurance Fund. It is difficult to see how using borrowed orderly liquidation funds to recapitalize a failing bank subsidiary would not violate this provision of Dodd-Frank Act.

The regulatory solution is to require GSIBs' parent holding companies to maintain a minimum amount of outstanding long-dated subordinated debt (TLAC debt). The resources generated by this TLAC debt can be used recapitalize a failing bank subsidiary in a Title II resolution after the parent company's equity capital is exhausted. TLAC debt, in conjunction with the parent holding company minimum regulatory capital requirements, are intended to be large enough to absorb any failing subsidiary bank's losses (absorbed by equity) and then to recapitalize the institution using resources contributed by the GSIB parent company's TLAC debt investors, so that the bank subsidiary remains adequately capitalized, open and operating.

A problem arises if TLAC debt resources are unavailable to recapitalize a GSIB's failing subsidiary bank. This problem could happen, for example, if the subsidiary bank failure does not put the GSIB's parent company in danger of default, or if the Secretary of the Treasury decides against using Title II. In a recently published paper, Peter Wallison and I demonstrate that many of the GSIBs' parent companies could absorb the capital losses associated with the failure of their largest bank subsidiary without themselves becoming

[6] A clean GSIB parent company is essentially a parent company that does not have outstanding financial contracts or investments other than its investment in operating subsidiaries that could trigger a parent company default.
[7] I use the term bank to refer to any insured depository institution.

insolvent.[8] If this were to happen, Title II orderly liquidation is not an option, and TLAC debt resources will be unavailable to recapitalize the failing bank subsidiary.

Some might argue the Federal Reserve's source of strength powers will allow the Federal Reserve Board to require the GSIB's parent company to recapitalize a subsidiary bank regardless of the bank's loss. However, prior legislation and the courts have set limits on the losses the Federal Reserve Board can impose on a bank's parent holding company using its source of strength powers.[9] The balance of the evidence shows that it is clearly possible that a large bank subsidiary of a GSIB could fail without putting the GSIB parent company in danger of default which would prevent the use of a Title II resolution.

Another scenario in which Title II may be unavailable is a condition similar to the last financial crisis. Should a number of GSIBs simultaneously suffer losses and be in danger of default, the Secretary could authorize multiple Title II resolutions. However, such an act would place a large percentage of US banking system assets under direct government control and FDIC supervision. It is improbable that the FDIC staff would have the capacity to manage multiple Title II resolutions simultaneously. It is also highly unlikely that financial markets would be calmed by the prospect of multiple simultaneous Title II resolutions. In fact, the act of taking multiple GSIBs into a Title II resolution would almost certainly spark a financial crisis that would shut down normal financial market functions.

If a Title II resolution is unavailable, a large GSIB bank subsidiary would either have to be rescued with taxpayer support, sold to another large healthy GSIB creating a new larger GSIB, or be allowed to fail and be resolved in a Deposit Insurance Fund receivership. Regulators have already argued that the GSIB subsidiary bank failure option would likely have systemic implications—which is reason for Title II, SPOE and TLAC in the first place. However, with Title II powers now in place, and the regulators' TLAC and SPOE plans to use them publically revealed, the failure option becomes even more problematic. TLAC and SPOE promise to protect the *all* the liabilities of important GSIB operating subsidiaries. Reneging on these explicit promises would almost certainly strengthen the negative systemic impact of a large bank failure compared to market reactions in the last financial crisis.

To summarize, even if the TLAC rule works according to the Federal Reserve Board plans in a Title II resolution, there is no guarantee that a Title II resolution will be available should a large systemically important bank subsidiary fail. If Title II is unavailable, the TLAC and FDIC SPOE plans cannot be used to keep the large systemically important bank subsidiaries open and operating. Absent open bank assistance, failing GSIB bank subsidiaries will face the deposit insurance bank resolution process, a fate which regulators believe could spark a wider financial crisis. The proposed TLAC and related SPOE proposals do not address this possibility.

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[8] Paul Kupiec and Peter Wallison (2015). "Can the 'Single Point of Entry' strategy be used to recapitalize a systemically important failing bank?" *Journal of Financial Stability*, 20, pp. 184–197.

[9] I provide an extensive review of the history and litigation associated with the Federal Reserve Board's source of strength doctrine in, Kupiec (2015), "Is Dodd-Frank Orderly Liquidation Authority Necessary to Fix Too-Big-to-Fail?" http://ssrn.com/abstract=2678234 or http://dx.doi.org/10.2139/ssrn.2678234

2. The "clean" parent holding company provisions of the proposed TLAC rule will make it more difficult to use a Title II resolution.

The current TLAC proposal will increase the probability that regulators could face a large systemically important bank failure without being able to use a Title II resolution. The "clean" parent holding company component of the TLAC rule limits a GSIB parent company's use of short-term debt and its issuance of qualified financial contracts. In reality, the inability of a financial institution to roll over its maturing short-term debt, or the default on its qualified financial contract collateral agreements, are the primary reasons why financial firms are forced into bankruptcy. Typically, bankruptcy is triggered by an inability to meet liquidity demands and is only rarely if ever triggered by long-term debt covenant violations or balance sheet insolvency.

By limiting the short-term liquidity demands faced by a GSIB's parent company, the "clean" parent holding company requirements in the current TLAC proposal will make it less likely that a GSIB parent company will be in default or in danger of default should a large bank subsidiary suffer crippling losses. If the GSIB parent's capital structure is primarily comprised of equity and long-term subordinated debt with little repo or other short-term debt financing that is vulnerable to "run" risk, there is little likelihood that a parent GSIB would quickly and unquestionably become in danger of default. The use of Title II, if approved, would undoubtedly spark court cases and years of litigation as parent company investors pursued compensation for the unlawful taking of their property.

3. The proposed TLAC rule extends trillions of dollars in new implied government guarantees for the liabilities issued by GSIB subsidiaries.

The TLAC proposal, and the closely related FDIC SPOE resolution strategy, discuss a Title II resolution strategy that will protect *all* the liabilities of GSIB operating subsidiaries, or at least those that regulators deem "critically important" for the function of the US financial system. The regulators' public plans envision that, should any of these operating subsidiaries suffer losses that endanger their solvency, the losses will transferred to the GSIB's parent company using a Title II resolution and the liabilities of the operating subsidiaries will be fully protected against loss. Thus the TLAC proposal, in effect, extends an implied government guarantee to all the liabilities issued by GSIB operating subsidiaries.

Based on publicly available data for September 2015, the bank subsidiaries owned by the eight US GSIBs had total assets of $7.54 trillion. GSIB assets comprise about 47.4 percent of all assets in the US banking system. GSIB subsidiaries issued about $6.73 trillion in liabilities, or about 47.7 percent of all liabilities issued by US banks. Of the GSIBs' subsidiary bank liabilities, about $2.4 trillion are explicitly insured by Federal deposit insurance. Thus, as a result of the new TLAC proposal, the government will guarantees $4.33 trillion in additional liabilities that are not currently insured.[10]

[10]In these calculations, I have only assumed that regulators would only consider large subsidiary banks to be critical. If it turns out that regulators protect all GSIB subsidiary liabilities using TLAC and SPOE, the subsidiary liabilities that will be protected total about $7 trillion.

In return for new government protection on $4.33 trillion GSIB subsidiary bank liabilities, the government charges nothing. In theory, the TLAC bond investors are the ones providing this new insurance coverage.[11] However, these TLAC investors will earn a risk premium for years but potentially never suffer insurance losses if the distressed subsidiary bank cannot be rescued using a Title II resolution.

4. Requiring TLAC debt at the parent holding company does not necessarily remove large institution TBTF interest rate subsidies.

The TLAC regulation will require GSIB parent holding companies to issue and retain an outstanding balance of subordinated debt. However, it does not place any restrictions on how TLAC funds are used. Unless TLAC funds are required to be "down streamed" to GSIB bank subsidiaries as "back-to-back" TLAC debt or subsidiary equity, and the proceeds are used by the subsidiary to invest in safe assets or retire insured deposits, TLAC at the holding company will not reduce the GSIB's implicit TBTF funding cost subsidy. This result is formally developed in Kupiec (2015), "Will TLAC Regulations Fix the G-SIB Too-Big-to-Fail Problem."[12]

GSIB interest subsidiaries are generated when some GSIB liabilities are implicitly or explicitly insured by the government, but the government does not charge a fair insurance premium for the guarantee. Within a GSIB, these subsidies arise when a bank subsidiary's insured deposits are charged less than a fair market insurance premium for the guarantee, or if investors believe that the GSIB's uninsured liabilities are likely to receive government protection from default even though there is no explicit insurance guarantee.

The TLAC proposal not only keeps the guarantee on all GSIBs' bank subsidiary insured deposits, it also explicitly guarantees *all* of the liabilities issued by GSIB subsidiary banks and other critical operating subsidiaries. This TLAC proposal effectively extends government guarantees beyond insured bank deposits to an additional $4.33 trillion in GSIB bank subsidiary liabilities. If the goal is to reduce TBTF subsidiaries, the proceeds from parent TLAC debt should ideally be used to replace explicitly insured bank deposits.[13] A second best alternative to require TLAC debt to replace uninsured GSIB bank subsidiary liabilities. This requirement at least partially limits the extent by which TLAC and SPOE expand government guarantees.

The current TLAC proposal places no restrictions on the use of TLAC funds. Without restrictions, the GSIBs will raise the required TLAC funds but invest them in a way that maximizes their TBTF funding cost advantage. Given the expanded implicit default protection promised GSIBs' subsidiary liabilities, in my assessment, the current TLAC rule will increase—not decrease — the funding cost advantage enjoyed by GSIBs.

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[11] According to my calculations, the GSIB parents would have been required to maintain, in total, roughly $575 million in outstanding TLAC debt should the rule have been in force as of September 2015.

[12] http://ssrn.com/abstract=2631617 or http://dx.doi.org/10.2139/ssrn.2631617

[13] The same effect occurs if the subsidiary banks uses TLAC fund to purchase default free US Treasury securities.

5. The proposed TLAC regulation adds complexity to a regulatory system already plagued by overly complex capital and other prudential regulations. There is a simpler, more transparent way to satisfy TLAC regulatory goals.

If the goal of TLAC is to keep critically important GSIB operating subsidiaries open and operating, why not just raise the minimum regulatory capital requirements on critically important subsidiaries? The capital would be immediately available to keep critical operating subsidiaries open and operating without regard to the legal availability of a Title II resolution. There would be no extension of additional government guarantees to liabilities of GSIB operating subsidiaries. Moreover, there would be no question that GSIBs' systemically important subsidiaries had sufficient capital to absorb exceptionally large losses and continue to be adequately capitalized and operating in financial markets.

There is a cost to this alternative approach of raising operating subsidiary minimum capital requirements. Keeping TLAC at the parent holding company reduces the amount of TLAC needed because regulators can (in theory) rely on loss diversification across GSIB subsidiaries. Since only some GSIB subsidiaries are likely to incur losses while others will post profits, the resources needed to recapitalize losses at critical operating subsidiaries will be smaller if regulators can keep TLAC at "the top of the house" and distribute it to GSIB operating subsidiaries only when needed.

Because the higher minimum capital solution does not count on loss diversification, the resources needed to increase capital at each critical operating subsidiary may be larger than the proposed minimum TLAC debt requirement. However, the higher minimum capital solution removes the problem that a Title II resolution may not be possible and so TLAC may not be available when it is needed.

The cost of requiring "fortress" balance sheets at systemically important GSIB subsidiaries can be reduced if GSIB parent holding companies are allowed to raise the required funds by issuing debt at the parent holding company level and down-stream funds as equity to systemically important operating subsidiaries. Implemented in this way, the proposal to increase minimum capital requirements at critical operating subsidiaries is equivalent to the current TLAC proposal in many ways. It will require parent holding companies to issue TLAC-like debt, but in addition, require the GSIB parent company to down-stream the proceeds of the TLAC debt issue as equity to systemically important operating subsidiaries to satisfy higher minimum regulatory capital requirements. This is a much simpler and more transparent solution to the issues that regulators are trying to solve with the TLAC proposal.

Thank you for the opportunity to comment on the proposed TLAC rule.

Yours sincerely,

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