American Federation of Labor and Congress of Industrial Organizations

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February 1, 2016

Via Electronic Submission to: regs.comments@federalreserve.gov

Mr. Robert deV. Frierson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Re: Docket No. R-1523 and RIN 7100 AE-37; AFL-CIO Comment on Total Loss Absorbing Capacity Rule

Dear Mr. deV. Frierson:

I am writing to you today on behalf of the American Federation of Labor and Congress of Industrial Organizations (the "AFL-CIO") to provide comments on the Federal Reserve's proposed rule on the Total Loss-Absorbing Capacity of Systemically Important Bank Holding Companies. We appreciate the opportunity to share our thoughts and concerns on this matter.

The AFL-CIO is the umbrella federation for U.S. labor unions, comprised of 56 affiliated unions, representing 12.5 million union members nationwide. Union-sponsored and Taft-Hartley pension plans hold more than $587 billion in assets. Our members, as both taxpayers and pensioners, were deeply affected by the Great Recession of 2008. Their stories relay the real life implications of financial crises for working people and compel us to be vigilant as the rules of the game are being written in anticipation of future bank failures.

The Dodd-Frank Act aimed to put an end to Too Big To Fail (TBTF) bail outs. To that end, it created the Orderly Resolution process. We commend the Federal Reserve taking action to bring these processes into practice by proposing these rules. We support capital requirements for Global Systemically Important Banks (GSIBs) in the U.S. as well as of the regime proposed for the Intermediate Holding Companies (IHCs) of foreign GSIBs. We, however, have serious reservations about the "eligible external Long Term Debt" (LTD) that would be issued under this proposal.

First, retirement savers as major investors in the equity and LTD of large financial institutions will largely be the investors responsible for taking on the first losses the next time a bank fails. This has broader policy implications that must be considered explicitly and in consultation with a variety of stakeholders. Second, there are several features of the LTD that obscure its risk, explicitly for the purposes of marketability. This reflects an improper balancing of concerns in the rationale underlying the proposed rules. New high-risk debt products, especially any that will be issued at this scale, should be designed with investor safety in mind. Third, there are several common sense adjustments that would alleviate some of these problems, for example requiring executives to receive incentive compensation in the form of LTD, removing misleading features from LTD, and mandating comprehensive, plain English disclosures to accompany this new debt.

1. **The proposal implicitly creates "loss absorbing investors" and restricts the pool of potential investors such that retirement savers will be primary holders of that risk. More substantial and explicit policy consideration must be given to the consequences of allowing Americans saving for retirement to bail out the next failing bank.**

The bank failures of 2008 wrought havoc on the savings of millions of working Americans and the balance sheet of the U.S. government. While the economy has recovered to some extent, everyday Americans are still grappling with the very real consequences of the crash: reduced retirement security, stagnant wages, increasing debt, and greater financial insecurity overall. Individual Americans' interest in and dependence on the health of our financial system has never been more apparent.

Given those substantial interests, it's essential to speak plainly about what these rules propose to do. Regulators must find a pool of money that will be available to absorb the losses created by the next mega-bank failure. Dodd-Frank seeks to prevent taxpayers from ever again being held responsible for that bill. Through the negotiations around Dodd-Frank, banks also ensured that they would not pay into their own TBTF insurance fund. Because of the complexity, opacity and interconnectedness of those banks' subsidiaries, regulators have also determined that those institutions cannot absorb the losses and instead their "normal operations" should be protected.[1]

If not the taxpayers, the banks, their subsidiaries or their counterparties, then who? The proposed solution compels banks to offer a new type of "debt" that, in the case of a mega-bank failure can be converted to equity and/or cancelled entirely. This

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[1] Federal Reserve System Proposed Rule "Total Loss-Absorbing Capacity", 80 Fed. Reg 74944 (November 30, 2015); See also Federal Deposit Insurance Corporation Notice "Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy", 78 Fed. Reg. 76615 (December 10, 2013).

provides obvious benefits in a resolution proceeding. The ability to wholly eliminate obligations would greatly improve the balance sheet of any institution. To answer the question then, these debt holders will hold the pool of money that regulators will use to absorb potential losses in the case of the next bank failure. In other words, they will be the “loss absorbing investors” in our economy.

The rules deter any of the BHCs or their subsidiaries from holding LTD in two ways. First, by deducting any investment in or exposure to LTD from a BHC’s regulatory capital, and second, through its stated preference that “the holding company’s creditors be limited to those entities that can be exposed to losses without materially affecting financial stability.” [2] The purpose of these provisions is explicitly to “substantially reduce the incentive of a Board-regulated institution to invest in unsecured debt issued by a covered BHC.”[3]

This deterrence makes sense because those institutions are also susceptible to runs and their holding the LTD in the case of a failure could further contagion rather than contain it. Yet this leaves us with the same question. Who will be the loss absorbing investors of our economy? Two of the remaining primary consumers for this debt are pension funds and mutual funds, i.e. the retirement savings accounts of middle class Americans.[4] In this way, the rule implicitly identifies retirement savings as the “desirable” accounts to carry the risk of the potential catastrophic losses of a future bank failure.

Making retirement savers the loss absorbing investors of our economy may be the best of limited options but it demands far more serious policy consideration and debate. One issue that demands attention and action is that mutual funds may often be in a position where they are incentivized to seek out the higher coupon that would presumably come with LTD without adequate incentives or sophistication to fully appreciate the long term risks of the product. This would put the retirement savings of millions of Americans at risk.

Another serious shortcoming that merits additional discussion is putting the retirement savings of hard working Americans at risk to protect the subsidiaries of BHCs and their counterparties, i.e. uninsured depositors and shadow banking creditors close to Wall Street, perpetuates the structural flaws of the TBTF banking system. It protects the risk takers and forces savers to carry the losses when those risks come to fruition. The American public found it unpalatable for taxpayers to bear the losses; it’s unclear

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[2] 80 FR 74945
[3] 80 FR 74950
[4] Hedge funds are another potential consumer of this debt however for many of the concerns expressed above, would likely also not be “desirable” buyers.

that imposing losses instead on middle class savers would adequately address those concerns.

It also bears mentioning that the taxpayers are still on the hook by way of the Orderly Liquidation Fund (OLF). Although the drafters of Dodd-Frank originally envisioned the OLF being funded by the banks themselves, that provision was eliminated at the behest of bank lobbyists while the bill was in conference. Instead, now, if the OLF is called on to provide liquidity to a BHC in receivership, it will have to take a loan from the Treasury, ultimately funded by taxpayers.[5] While a liquidity loan from the OLF is supposed to be fully repaid within five years, the OLF has the discretion to extend that term indefinitely.[6] Thus taxpayers still have exposure to systemically unsafe banking institutions.

Recognizing that some of the necessary prophylactics would fall outside the scope of the Federal Reserve's authority, we call on the Federal Reserve to support common sense protections by other regulators and legislators. Specifically, the SEC should cap the percent of total fund value that any mutual fund can invest in eligible external LTD.

2. **The proposed rules design LTD in a way that obscures risk explicitly for the sake of marketability. Given that the holders of this debt will be liable to absorb the losses created by the next bank failure, the imperatives of transparency must outweigh any consideration of marketability.**

There are two places in particular where the proposed rules give cause for concern: their treatment of acceleration rights and of contractual subordination. In both cases, concerns about the marketability of LTD led the Federal Reserve to allow for potentially misleading rights and language to be included with the debt. Implicit in this weighing of priorities is the assumption that investors will be more likely to purchase the product if they understand less about how the risks and rights will work.

In the case of acceleration rules, the Fed prohibited acceleration clauses for LTD but made an exception in cases of insolvency or a payment default event. The reasoning provided makes clear that it is because the rights have little or no practical value and their exclusion might limit the market for the debt. They argue first that payment default event acceleration clauses are "a standard feature of senior debt instruments, such that a prohibition on such rights could be unduly disruptive to the potential market for the external LTD" and then proceed immediately to acknowledge that those clauses are acceptable because they cannot be effectively exercised:

[5] Dodd-Frank Wall Street Reform and Consumer Protection Act §210(n)(5), (6).
[6] Dodd-Frank §210(n)(9)(B), (o)(1)(B), (C).

> "[T]he payment default of a covered BHC on an eligible external LTD instrument would likely be a credible event of such significance that whatever diminished capacity led to the payment default event would also be a sufficient trigger for an insolvency event acceleration clause, in which case a prohibition on payment default event clauses **would have little or no practical effect.**"[7]

A similar reasoning is applied to the lack of a requirement that the eligible external LTD instruments be contractually subordinated to non-loss absorbing debt. Such a requirement does apply to the internal LTD issued by an IHC in case jurisdictional issues arise, but is explicitly excluded in the case of external LTD. The proposed rule first acknowledges that the requirement, applied to external LTD "could improve the market discipline imposed on a covered BHC by increasing the clarity of treatment for eligible external LTD holders relative to other creditors."[8] In spite of this, the requirement is excluded as the proposal "seeks to retain the broadest possible market for eligible external LTD instruments."[9]

Both examples belie an improper balancing between concerns about marketability and about transparency. The reasoning provided could be read as deliberately deceptive. Referring to LTD as "senior debt" is also misleading. This is all especially alarming given the current pervasive efforts to roll back investors' access to information. The Disclosure Effectiveness Initiative at the SEC and the new accounting rule on materiality are only two examples of an aggressive campaign to limit corporate disclosures.

The very real threat of reduced information is demonstrated perfectly by the misleading features the rules contemplate including in LTD. Such a blatant disregard for investor protection – and by proxy, for the market discipline and systemic safety and soundness that come with informed investors – is wholly unacceptable from a federal regulator.

3. **To address the concerns raised above, we call for clear and comprehensive disclosure and the mandatory use of LTD in executive compensation to better align the interests of executive decision makers and their long term investors.**

This proposal governs who will absorb the losses in the case of the next bank failure. The rules go further by implicitly identifying retirement savers as the account

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[7] 80 FR 74936
[8] 80 FR 74937
[9] 80 FR 74937

who should carry the bulk of the risk of this new type of debt. By some estimates banks will have to issue over $500 billion in new debt.[10]

Directing this debt to be used for <u>executives' incentive compensation</u> would provide many benefits. Specifically we propose the mandatory use of LTD for all executive incentive pay with holding periods equal to the shorter of 10 years or the maturity of the bond, regardless of retirement date. Additionally, we propose prohibit hedging this type of compensation. Finally, we would also support subordinating executive compensation LTD to all other LTD. This arrangement would create shared risk between executives and the long term loss absorbing investors who would still carry the majority of that risk. This is consistent with the mandates of §956(b) of Dodd-Frank as it would better align the incentives of executives than typical equity awards. That, in turn, would improve the marketability of the debt, an apparent concern in the proposal.

Finally, comprehensive and clear <u>disclosure</u> is absolutely essential in order to avoid imposing catastrophic losses caused by reckless mega-banks on under-informed and/or under-compensated retirement savers. The rules as proposed call for the BHC to "publicly disclose a description of the financial consequences to unsecured debtholders of the global systemically important BHC entering into a resolution proceeding in which the global systemically important BHC is the only entity that would be subject to the resolution proceeding."[11]

Beyond that, we call for a front page warning in large red lettering making clear in one sentence, "If the bank fails, your full investment is subject to complete loss. You will have no rights in a Title II bankruptcy." Additionally, we believe that the contract should directly lay out how and when regulators could or would convert this debt, including possible future scenarios where this debt might become convertible in a Title I bankruptcy.

As referenced above, requiring disclosure is of the utmost importance in the current environment. The SEC's Disclosure Effectiveness Initiative is directed at reducing the amount of information corporations provide to investors. Similarly, the new "materiality" accounting rule proposed would provide issuers with significantly more discretion over what they disclose and far less accountability for disclosing too little.

LTD demonstrates clearly that the risks of misleading investors are real. Without meaningful disclosure, investors run the risk of grossly underpricing the risk of these new instruments and perpetuating the systemic risks the rules seek to avoid.

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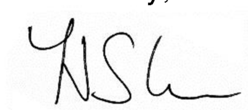
[10] Eddings & Li, "Wall Street Frets Fed Proposal Will Become $550 Billion Headache" *Bloomberg Business* January 12, 2016; available at: http://www.bloomberg.com/news/articles/2016-01-13/wall-street-frets-fed-proposal-will-become-550-billion-headache

[11] 80 FR 74953

Thank you for taking the AFL-CIO's views into consideration regarding this matter. Regulating the total loss absorbing capacity of our biggest financial institutions is important for our financial stability; however, introducing new debt instruments to the market with unique and unusual risk profiles, targeted at specific consumers, namely pension funds and retirement savers, raises serious concerns for our members. For that reason, we call on the Fed to amend the final rules to exclude all acceleration rights, require eligible external LTD to be contractually subordinated, expand the mandatory disclosures, and compel its use for executive compensation. If the AFL-CIO can be of further assistance, please contact Corey Klemmer at (202) 637-5379 or cklemmer@aflcio.org.

Sincerely,



Heather Slavkin Corzo, Director
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opeiu #2, afl-cio