

United States Senate

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BANKING, HOUSING, AND
URBAN AFFAIRS

BUDGET

INTELLIGENCE

RULES AND ADMINISTRATION

March 3, 2016

The Honorable Janet L. Yellen
Chair
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Dear Chair Yellen:

I write to express my support for the Federal Reserve's proposal on Total Loss Absorbing Capacity (TLAC) and long-term debt.

The purpose of a long-term debt requirement as envisioned by the TLAC proposal is to help facilitate a wind-down of a failing financial institution without triggering a Lehman Brothers-style domino effect in the markets. TLAC is vital to the efficacy of either a bankruptcy (Dodd-Frank Title I) or Orderly Liquidation (Dodd-Frank Title II) scenario, and is an essential tool in ending the phenomenon of "too big to fail."

Having long-term debt at the holding company is necessary for a single point of entry resolution, which would have the FDIC enter a financial institution at the top-tier holding company level, and transfer its assets to a new entity while keeping most liabilities at the old entity.

Shareholders would be wiped out, culpable senior management would be fired, and the new entity would be recapitalized by converting long-term debt to equity. After taking write-downs, creditors of the old entity would still have a claim on the new entity, which would continue to maintain operations critical to the financial system and avoid a Lehman-esque freeze in the marketplace from a disorderly dissolution. The law requires that this process be accomplished without exposing taxpayers to loss, and having long-term debt at the top-tier holding company that can be used to absorb loss and serve as a source of capital helps accomplish this goal.

Recently, five financial industry groups wrote to the Federal Reserve in opposition to the elements of the TLAC proposal. Specifically, the groups urged the Federal Reserve to allow banks subject to TLAC to eliminate the proposal's long-term debt requirement. I believe this request is flawed and the Federal Reserve should not fall susceptible to such efforts to undermine the efficacy of the rule and the entire resolution regime that rests upon its construction.

There are multiple reasons why long-term debt is necessary to facilitate an orderly resolution. First, a financial company would likely fail only after either the markets or regulators had determined that it had insufficient equity to be viable. Debt offers certainty that loss absorbing resources will be available in the circumstance where equity has been depleted and access to equity markets is not available to shore up capital. In a scenario where a financial institution

enters into bankruptcy, markets will need confidence in the source of new capital. As equity may be drawn down, markets may not be willing to do business with that entity, risking a disorderly resolution. Second, book equity is a lagging indicator – and as such, is misleading about the extent to which loss absorbing capacity remains in a troubled financial institution. Third, markets price equity on the basis of expected returns, not on the risk of default, as with debt. Therefore, long-term debt pricing would provide better insights into market expectations of the probability of a financial institution's failure. Relatedly, it is unlikely markets will distinguish between equity held for the purposes of a single point of entry resolution versus operating capital. As such, banks are likely to take on additional risk to increase returns to all equity, exacerbating concerns about financial stability.

Additionally, I look forward to the Federal Reserve clarifying how loss absorbing resources will be pre-positioned or used to absorb losses at operating companies. Such a clarification will offer markets significant transparency into the complexity and stability of large financial institutions.

Finally, the financial industry groups have raised opposition to the Federal Reserve's stricter TLAC requirement than that of foreign counterparts. Strong banks are profitable and lend in all credit cycles, and I believe the proposed TLAC rule will enhance both the competitive position of U.S. financial institutions and the safety and soundness of the financial system.

As I noted, this issue is vital to ending too big to fail. Thank you for your attention to this significant issue. If you have any questions, please contact Milan Dalal on my staff at (202) 224-2023.

Sincerely,

A handwritten signature in blue ink that reads "Mark R. Warner".

Mark R. Warner

United States Senator

cc: The Honorable Stanley Fischer, Vice Chairman

The Honorable Daniel K. Tarullo, Governor

The Honorable Jerome H. Powell, Governor

The Honorable Lael Brainard, Governor