February 3, 2016

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

VIA ELECTRONIC MAIL: regs.comments@federalreserve.gov

Re: Docket No. R-1523, RIN 7100 AE-37; Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations and Related Requirements (the "**Proposed Rule**")

Dear Sir or Madam:

The Committee on Capital Markets Regulation (the "**Committee**") is grateful for the opportunity to comment on the Proposed Rule released by the Board of Governors of the Federal Reserve System (the "**Fed**") regarding total loss-absorbing capacity ("**TLAC**") and related requirements for global systematically important banks ("**G-SIBs**").[1]

Founded in 2006, the Committee is dedicated to enhancing the competitiveness of U.S. capital markets and ensuring the stability of the U.S. financial system. Our membership includes thirty-five leaders drawn from the finance, investment, business, law, accounting, and academic communities. The Committee is chaired jointly by R. Glenn Hubbard (Dean, Columbia Business School) and John L. Thornton (Chairman, The Brookings Institution) and directed by Hal S. Scott (Nomura Professor and Director of the Program on International Financial Systems, Harvard Law School). The Committee is an independent and nonpartisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations.

TLAC refers to the equity and unsecured debt that G-SIBs will be required to issue or maintain beyond their existing capital requirements. TLAC holdings are intended to absorb losses so that these banks can be resolved without disruption to their critical operations or taxpayer-funded recapitalizations.

[1] 17 CFR Parts 217 and 252; 80 FR 74926 "Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations; Regulatory Capital Deduction for Investments in Certain Unsecured Debt of Systemically Important U.S. Bank Holding Companies

The Federal Deposit Insurance Corporation ("**FDIC**") has indicated that its preferred resolution strategy for G-SIBs is a Single Point of Entry ("**SPOE**") recapitalization under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") In an SPOE recapitalization, the FDIC is appointed as receiver to a G-SIB's top-tier U.S. holding company, which is placed into a temporary "bridge" financial company. The "bridge" company is then capitalized through the conversion of existing equity and debt into new equity. Accordingly, capitalization of the bridge company requires access to sufficient loss-absorbing instruments (i.e., the equity and unsecured liabilities that are "bailed in") at the parent level. This resolution structure is designed to facilitate the recapitalization of the bank's subsidiaries without interruption to their operations. To recapitalize the operating subsidiaries, loans from the parent to the subsidiaries may be forgiven, or assets may be transferred from the parent to the subsidiaries.

Summary of the Proposed Rule

As currently drafted, the Proposed Rule requires the top-tier U.S. holding company of a G-SIB to maintain minimum levels of TLAC and long-term unsecured debt ("**LTD**"), along with a related buffer. The minimum levels of TLAC and LTD required for a certain entity generally increase as that entity's risk-weighted assets ("**RWA**") and total leverage exposure increase. The Proposed Rule effectively requires covered entities to hold TLAC in an amount greater than 20.5% of their RWA.

Importantly, the Proposed Rule also requires G-SIBs to hold roughly half of their TLAC in the form of LTD, not equity. Eligible LTD must also have certain features: it must be unsecured, governed by U.S. law, and "plain vanilla," meaning that it lacks certain qualities the Fed deems "exotic."[2] For example, structured notes are not eligible to be LTD. In general, U.S. top-tier bank holding companies ("**covered BHCs**") must issue their TLAC and LTD to third-party investors, while foreign banks' top-tier U.S. intermediate holding companies ("**covered IHCs**") must issue theirs internally (i.e., within the company).[3]

The Proposed Rule also contains a "clean holding company" requirement that substantially limits covered BHCs' permitted liabilities. Under this provision, covered BHCs are prohibited from issuing short-term debt (e.g. deposits) to third-parties.[4] A covered BHC's non-contingent liabilities to third parties (such as obligations to employees) are also capped at 5% of its TLAC.[5] This rule is grounded in the idea that "certain financial arrangements… could impede an entity's orderly resolution."[6]

Finally, banking organizations (including BHCs, state member banks, all IHCs and large savings and loan holding companies) must make a regulatory capital deduction

[2] 80 FR 74929; 74935.
[3] See 80 FR 74928-74930.
[4] 80 FR 74930.
[5] Id.
[6] 80 FR 74930

for investments in unsecured debt issued by covered BHCs.[7] Holdings that arise out of market-making activities are *not* exempt from this requirement.

Summary of Our Concerns with the Proposed Rule

The Committee supports the Fed's stated goal of improving the resolvability and resiliency of G-SIBs and generally endorses the TLAC approach.[8] In general, we believe that the Fed should seek to conform its final rule to the international standard for TLAC issued by the Financial Stability Board ("**FSB**"). In addition, we have four specific concerns with the Proposed Rule.

First, we are concerned that the Proposed Rule establishes an onerous minimum TLAC requirement that lacks empirical support and will impede economic growth. In particular, we question the Fed's decision to impose even stricter TLAC requirements than those set forth in the FSB's international standard.[9] As discussed in our comment letter regarding that proposal, we find the FSB's minimum TLAC standard to exceed the level that empirical data demonstrates to be appropriate.[10]

Second, we question the rationale and practicability of the Proposed Rule's discrete long-term debt requirement. We are especially wary of the Fed's extensive list of qualifications that debt must meet in order to be "eligible" LTD. On their face, certain of these requirements would disqualify a substantial amount of covered entities' outstanding debt issues from LTD eligibility, making compliance especially complex and costly. For example, LTD cannot contain acceleration clauses other than for payment default or insolvency, but the majority of G-SIBs' existing debt contains a clause that permits accelerated payment due to a breach of certain covenants. We recommend that, at a minimum, the Fed grandfather outstanding LTD that is otherwise capable of absorbing losses in the final rule.

Third, we are concerned that the Proposed Rule's "clean holding company" requirement is unnecessarily restrictive and could prevent covered BHCs from obtaining liquidity via temporary secured lending. We recommend that the final rule clarify that covered BHCs may obtain such loans.

Fourth, we believe that the mandatory regulatory capital deduction for holdings of covered BHCs' unsecured debt could decrease the liquidity of LTD and other TLAC

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[7] 80 FR 74930; Cleary Gottlieb Steen & Hamilton LLP, *The Federal Reserve Proposes TLAC and Related Requirements for U.S. G-SIBs and U.S. Intermediate Holding Companies of Foreign G-SIBs*, 1 (October 31, 2015).

[8] 80 FR 74928

[9] Financial Stability Board, Total Loss-absorbing Capacity (TLAC) Term Sheet, Nov. 9, 2015. http://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf

[10] See Letter from Committee on Capital Markets Regulation to Secretariat of the Financial Stability Board Re: "Adequacy of loss-absorbing capacity of global systemically important banks in resolution" (February 2, 2015) (*hereinafter,* "CCMR Letter"), available at: http://www.fsb.org/wp-content/uploads/Committee-on-Capital-Markets-Regulation-on-TLAC.pdf

instruments. If implemented, the rule will discourage banking organizations, including those that act as market makers, from transacting in TLAC instruments. We recommend that the final rule include an explicit market making exemption from the regulatory capital deduction.

The Proposed Rule is Stricter than the FSB Standard and Risks Impeding Economic Growth

The Proposed Rule builds on the international TLAC principles and term sheet issued by the FSB. As discussed in our comment letter regarding the FSB's original proposal, we believe that the minimum TLAC levels prescribed in the international standard are excessive and unsupported by empirical data.[11] Indeed, the Committee's empirical analysis found the FSB's TLAC levels to be 3.5 to 4.5 times the level of estimated capital diminution in a "severely adverse scenario" according to the Fed's stress test.[12]

The Proposed Rule goes even further than the FSB standard in several respects. First, the effective TLAC calibration is higher under the Fed proposal. The Proposed Rule effectively requires covered entities to hold TLAC in an amount greater than 20.5% of their RWA, while the FSB standard requires roughly 18% of RWA.

The Fed proposal also requires institutions to hold roughly half of their TLAC as LTD, while the FSB standard includes only an "expectation" that covered entities will maintain 33% or more of their TLAC in the form of debt liabilities.[13] This heightened LTD requirement is likely to increase the industry gap to implementation.[14] In addition, the Proposed Rule's "clean holding company" requirement imposes severe restrictions on the liabilities that covered holding companies can incur, while the FSB standard lacks a parallel provision.

The Fed's estimated U.S. G-SIB shortfall for its TLAC and LTD requirements is roughly $120 billion and the increased annual cost of funding for U.S. G-SIBs is estimated to range from $680 million to $1.5 billion.[15] Importantly, the Fed's analysis likely underestimates the costs because it assumes that G-SIBs' outstanding debt with the "primary attributes" of LTD will be "eligible" LTD under the rule.[16] In fact, much of the outstanding G-SIB LTD would not constitute "eligible" LTD, as further explained below.

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[11] Id.
[12] Id.
[13] Financial Stability Board, Total Loss-absorbing Capacity (TLAC) Term Sheet sec. 6, Nov. 9, 2015.
[14] See, e.g., Sullivan & Cromwell LLP *Loss Absorbency Requirements…* (November 4, 2015). https://www.sullcrom.com/loss-absorbency-requirements
[15] 80 FR 74938-74939.
[16] See 80 FR 74938; Davis Polk & Wardwell LLP "Federal Reserve's Proposed Rule on Total Loss-Absorbing Capacity and Eligible Long-Term Debt" (November 10, 2015) at 20 (*hereinafter,* "DPW").

In drafting even stricter TLAC requirements than those prescribed by the FSB, the Fed risks impeding economic growth. Requiring G-SIBs to issue large amounts of LTD and other TLAC instruments will increase the cost of capital for banking organizations.[17] Such costs are likely to be passed onto bank customers. The cumulative effect of these requirements is likely to be a widespread increase in the cost of capital, with its concomitant risks to economic growth.

The LTD Requirement Contains Overly-Restrictive Eligibility Criteria and Lacks a Sound Policy Rationale

The Proposed Rule's LTD requirement is severe not only in its calibration, but in its particularity regarding the characteristics of "eligible" debt. The specificity of qualifications for debt eligibility limits G-SIBs' options as to how they will comply with the rule; it also limits the universe of outstanding issues that constitute eligible LTD. By disqualifying LTD that is otherwise capable of absorbing losses, the Proposed Rule runs counter to the goal of improving the resiliency of G-SIBs.

One significant eligibility criterion is that the debt instruments may not contain provisions that give the holder the right to accelerate payment, except in certain limited circumstances.[18] The Proposed Rule would allow certain types of acceleration clauses, such as those for payment default, in part because they are a "standard feature of senior debt instruments, such that a prohibition on such rights could be unduly disruptive to the potential market for…LTD."[19] However, other acceleration clauses, like those permitting acceleration upon the breach of certain covenants, are also common in the terms of outstanding long-term debt issued by covered BHCs and covered IHCs, but are nevertheless ineligible as LTD under the Proposed Rule.[20] To avoid disruption to the potential LTD market, the Fed should, at a minimum, grandfather existing long-term debt issued by G-SIBs that contain standard acceleration clauses.

The Proposed Rule also bans structured notes from eligibility as LTD. This prohibition would exclude from LTD debt instruments that feature an embedded derivative component linked to equities, commodities or other assets or entities. As a result, roughly $90 billion of outstanding structured notes issued by the G-SIBs would not be eligible as LTD. Structured notes are deemed ineligible "because they contain features that could make their valuation uncertain, volatile, or unduly complex, and

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[17] See, e.g., CCMR Letter at 5.
[18] 80 FR 74935. Acceleration clauses that are exercisable at a fixed date or in the event of insolvency or payment default are permissible in eligible *external* LTD. Eligible *internal* LTD (i.e., LTD issued by covered IHCs) contains no such exceptions from the prohibition on acceleration clauses.
[19] 80 FR 74936.
[20] See, e.g., CGSH at 1; Davis Polk & Wardwell LLP "Federal Reserve's Proposed Rule on Total Loss-Absorbing Capacity and Eligible Long-Term Debt" (November 10, 2015) at 20 (*hereinafter,* "DPW").
http://www.davispolk.com/sites/default/files/2015_11_10_Federal_Reserves_Proposed_Rule_on_TLAC_and_Eligible_LTD.PDF

because they are typically customer liabilities (as opposed to investor liabilities)."[21] We question the extent to which these generalizations actually hold true for the large universe of securities that would be excluded under this prohibition.

Another noteworthy requirement is that LTD securities must be governed by U.S. law. This qualification applies not only to external LTD issued by domestic bank holding companies, but also to internal LTD issued by covered IHCs to parent foreign entities within their banking organization.[22] The requirement seeks to minimize the risk of legal challenge during U.S. insolvency proceedings and "to clarify that the conversion, exchange, and cancellation provisions of these instruments… are enforceable under U.S. law." [23] We do not believe that the unproven benefits of such protections justify the exclusion of existing foreign law LTD—at a minimum, outstanding issues should be grandfathered to eligibility.

In addition, debt with a remaining maturity of between one and two years is subject to a 50% haircut for purposes of satisfying LTD requirements.[24] This provision is aimed at "protect[ing]… loss-absorbing capacity against a run-off period in excess of one year."[25] Its rationale is therefore rooted in the assumption that a covered entity undergoing financial stress would be out of the capital markets for up to two years or more—this assumption is, in our view, unfounded. In addition, the haircut approach lacks empirical support and is more onerous than the FSB standard. We therefore recommend that otherwise eligible LTD with an outstanding maturity of over one year count at full value towards the LTD requirement.

The Fed states that the discrete LTD requirement is justified because "unlike existing equity, LTD can be used as a fresh source of capital subsequent to failure."[26] They contend that LTD provides a "known and observable quantity of loss-absorbing capacity" that "would not be at substantial risk of volatility or depletion before… resolution."[27] This theory is intuitively attractive, but untested. If an organization's capital holdings have been so depleted as to implicate resolution, the character of the securities is of marginal import—both equity and debt can absorb losses. In reality, a costly LTD requirement separate from the TLAC requirements is unlikely to meaningfully improve the safety of the financial system.

The Clean Holding Company Requirement Unduly Limits non-TLAC Liabilities

The "clean holding company" proposal severely limits the ability of covered entities to incur non-TLAC liabilities. Covered BHCs and covered IHCs will be forced to

[21] 80 FR 74935.
[22] 80 FR 74929.
[23] 80 FR 74937; 74942.
[24] 80 FR 74929; 74934. Debt with a remaining maturity of less than one year is ineligible as LTD. *Id.*
[25] See 80 FR 74936-37.
[26] 80 FR 74931.
[27] Id.

rearrange their capital structures and even their operational strategies in order to comply with these requirements. For example, the proposed 5% cap on non-TLAC/non-LTD liabilities will limit the holding companies' capacity to incur operational liabilities (e.g., rent, utilities, and obligations to employees) as well as non-contractual liabilities, including those that are difficult to control, such as court judgments.[28]

More importantly, the current text of the clean holding company proposal would seem to bar covered BHCs from obtaining liquidity via temporary secured lending.[29] We assume this result is unintended, particularly given the crucial role that liquidity provided by a lender of last resort plays in the resolution context. The Fed should clarify that the clean holding company provision has no effect on existing law regarding banks' access to liquidity during periods of financial stress.

The Regulatory Capital Deduction Will Breed Illiquidity of TLAC Instruments

The Proposed Rule requires BHCs, state member banks, all IHCs and large savings and loan holding companies[30] to make a regulatory capital deduction for any investments in unsecured debt issued by covered BHCs.[31] Holdings associated with market making activities are *not* exempt from this provision. As a result, these institutions will be deterred from absorbing the new debt issuances required by the Proposed Rule. The provision will inevitably reduce the liquidity of LTD and other TLAC instruments, making them more costly to issue and trade. These costs are likely to be passed onto consumers and impact the "real" economy. For example, bank customers across industries will be subject to increased borrowing costs. We recommend that the final rule include an express market making exemption from the regulatory capital deduction as it is a point well established that market making services and the immediate absorption of supply and demand imbalances are an essential component of a liquid market.[32]

In conclusion, the Committee generally supports the TLAC approach to improving the resolvability and resiliency of G-SIBs. We believe that, if the final rule addresses the above concerns and generally conforms to the global TLAC standards, it will be an important step toward improving the safety of our financial system.

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[28] 80 FR 74947.

[29] DPW at 17.

[30] The organizations subject to the regulatory capital deduction constitute all organizations subject to the Fed's regulatory purview.

[31] 80 FR 74930; Cleary Gottlieb Steen & Hamilton LLP, *The Federal Reserve Proposes TLAC and Related Requirements for U.S. G-SIBs and U.S. Intermediate Holding Companies of Foreign G-SIBs*, 1 (October 31, 2015).

[32] Secretary General of the Financial Stability Board, Svein Andersen has acknowledged recent market liquidity distortion as evidenced by smaller lot sizes and longer trading times out of large positions. While such distortions cannot necessarily be traded to any one particular regulatory reform, the FSB remains fearful that market participants might seize up when participants really need to trade: "It is a problem that regulatory authorities and the industry have to confront… Survey evidence shows the sum of what industry participants expect to be able to sell greatly exceeds the capacity of these markets to trade through." *Risk Article as of 2 Feb 2016*.

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Thank you very much for your consideration of our views. Should you have any questions or concerns, please do not hesitate to contact the Committee's Director, Prof. Hal S. Scott (hscott@law.harvard.edu), Executive Director of Research, John Gulliver (jgulliver@capmktsreg.org), or Senior Fellow, Megan Vasios (mvasios@capmktsreg.org) at your convenience.

Respectfully submitted,

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