

**Meeting Between Staff of the Federal Reserve Board and Credit Suisse Group AG
December 15, 2015**

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Summary: Staff of the Federal Reserve Board met with representatives of Credit Suisse to discuss the Board's outstanding proposal on long-term debt (LTD) and total loss-absorbing capacity (TLAC) requirements for the U.S. intermediate holding companies (IHCs) of foreign global systemically important banks (G-SIBs). The Credit Suisse representatives, among other things, (i) expressed concerns about the calibration of the LTD/TLAC requirements for IHCs of foreign GSIBs, (ii) encouraged the Board to eliminate the separate LTD requirement applicable to IHCs of foreign G-SIBs, (iii) expressed concern about the impact of the regulatory capital deduction element of the proposal on the ability of banking firms to make a market in the LTD of G-SIBs, and (iv) expressed concern that the LTD requirements applicable to IHCs for foreign G-SIBs would cause LTD instruments issued by such IHCs to be treated as equity rather than debt for tax purposes. A presentation provided by Credit Suisse that describes these issues in greater detail is attached.

Attachment



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Long-Term Debt and Total Loss-Absorbing Capacity NPR

Credit Suisse Perspectives

December 15, 2015

Pursuant to 12 C.F.R. § 261.15, we request that this document be treated as confidential by the Board of Governors of the Federal Reserve System ("FRB"). The data set forth in these materials are not available to the public. Moreover, these materials contain, variously, trade secrets, or privileged, commercial or financial information, furnished in confidence, that relates to the business, personal, or financial affairs of Credit Suisse for purposes of 12 C.F.R. § 261.14(a)(4); and records contained in or related to an examination, operating, or condition report prepared by, on behalf of, or for the use of an agency responsible for regulating or supervising financial institutions for purposes of 12 C.F.R. § 261.14(a)(8). These materials accordingly are exempt from public disclosure under the Freedom of Information Act, 5 U.S.C. § 552, and applicable regulations. We respectfully request that we be notified in advance and given an opportunity to be heard if it is proposed that any of these confidential materials, or the data contained therein, be made public. *See* Executive Order 12,600 (June 23, 1987).

Overview

US NPR is the last critical step to finalize the US bail-in regime and credibly end TBTF

- Quantity (>\$1.5 trillion) and quality calibrations are robust for this goal.

There are specific elements that can be improved, which we base on some general principles

1. The new regime is complex, and can lead to super-equivalent, unfair requirements.
 - Fairness (as well as resilience) suggests that Internal TLAC (ILAC) should not be tougher than Covered BHC standards, but this can occur due to the multiplicity of requirements.
 - SPE IHCs are treated as largely standalone for resolution purposes. However effective TLAC requirements are well above regional BHCs of similar size *despite* Source of Strength support.
2. IHC ILAC is different from External TLAC – balanced design is important for group resilience
 - ILAC is easier to manage (a single issuer & a single owner)
 - ILAC does not have a market monitoring function- permitting more flexibility
 - TLAC along with FRB supervisory powers eliminates the need for a strong separate LTD test
 - The US design should be set to enhance global resilience if replicated by other jurisdictions. The current rules may unintentionally have some negative effects, and could be improved
3. TLAC funding requirements will be large – approximately \$4 trillion globally (ex China). This requires access to big markets, trading support & multiple investor classes around the world.
 - While it is essential that TLAC be safe to use, the NPR imposes unnecessary restrictions that limit the scope and diversity of funding, and which could also hinder essential market making.

Key Recommendations

- 1. SPE Source of Strength Support:** The proposal should be amended to reflect the source-of-strength support of the parent entity, especially where home country requirements are robust
 - There is a fairness issue: IHCs are treated more harshly than similarly-sized standalone domestic firms (e.g., similarly sized US banks are not subject to any LTD/TLAC requirements).
 - But SPE supported IHCs are more resilient; we have the support of a well-funded, well-incentivized parent, in contrast to similarly sized US banks, who don't have any chance of parent support.
 - Swiss capital requirements are robust in international terms, ensuring strong group capacity on both a going and gone-concern basis (see appendix).
 - In our view, the rule should be amended to:
 - Account for parent source-of-strength support and strong holdco TLAC levels, as well as the strength of home country regulatory capital requirements.
 - Provide a greater discount for non-resolution entities (esp. for LTD elements)

Key Recommendations

2. Effective Super-Equivalence & Complexity:

The NPR has a high leverage standard AND an overlapping LTD test.

The combination of these rules results in a 4-pronged test for BHCs and a 6-pronged Test for IHCs

- The effect of this complex test produces super-equivalent requirements for many IHCs, including CS:
 - The effective minimum requirement for the CS IHC appears to be >25% of RWA – substantially above the Covered BHC minimum.
 - In SLR terms, the figure is >9%, roughly equal to the Covered BHC minimum.
 - In both cases, this violates the general principle that non-resolution IHCs should receive some benefit from the source-of-strength provided by their parent.
- The simplest solution would be to remove the separate LTD requirement for non-resolution IHCs, and streamline to a TLAC requirement using RWA and SLR:
 - ILAC has no monitoring function (as with external BHC debt)
 - A standalone TLAC-based rule can provide full resolvability benefits (along with supervisory tools that set out an appropriate sanctions ladder as TLAC declines)
 - At a minimum, the severity of the LTD requirements should be reduced for SPE IHCs
 - IHCs should be able to count preferred stock in LTD (meets the criteria of a fixed value instrument that could be converted in resolution).
 - LTD should be reduced for SPE firms, in line with the treatment elsewhere.
 - The additional leverage requirement (asset test) should be unnecessary if the firm calculates SLR, the asset test should only be a fallback if SLR is not available.

Key Recommendations

- 3. IHC Internal TLAC (ILAC):** The US should lead with a strong and adaptable architecture, that protects US interests and supports a strong global outcome
- The NPR sets IHC ILAC at the very top of the FSB range (close to a minimum of 90%), and bases this entirely on funded ILAC.
 - Together with the multi-pronged tests required by the NPR, this is likely to lead to situations where the sum of resolution entity ILAC > TLAC requirements (superequivalence)
 - We believe it will also lead to unnecessary brittleness for many banks, and a higher risk of failure
 - We believe better outcomes are possible, that would benefit the US both as a home and a host supervisor, and reduce risks to bank resilience
- 4. Market-Making:** Robust liquidity will be critical to supporting a \$4 trillion investor base
- There should be allowance for market-making under the cross-holdings capital deduction framework in order to support market liquidity and ensure breadth of TLAC market.
 - One solution would be to allow own debt trading assets to be offset by <1 year (but otherwise qualifying) TLAC liabilities. Those liabilities are ignored for conservatism– but are still usable.
 - Any deduction should be done on a parallel level, so that TLAC positions >10% of TLAC should lead to a reduction in the trading bank's TLAC position (unfair to do this on a capital basis).

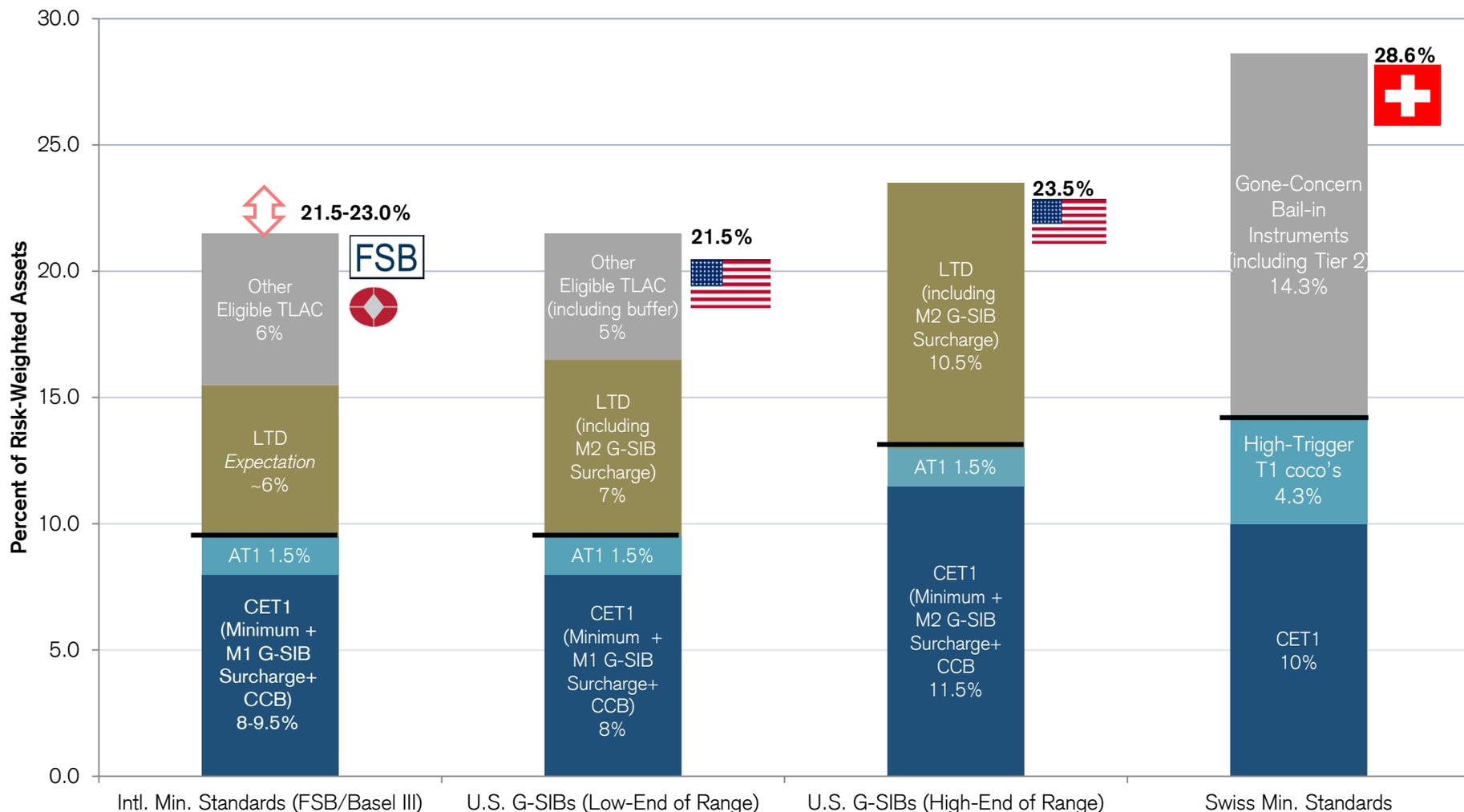
Key Recommendations

- 5. Tax Deductibility for IHC ILAC:** The NPR requires ILAC funding to be deeply subordinated, but the specific terms threaten tax deductibility. It is unfair to subject foreign firms only to such a disadvantage, and not necessary to achieve the desired outcome.
- Internal eligible debt could be regarded as *junior to IHC equity* in the event of a Fed mandated write down of ILAC (or conversion, in cases where old equity is not written-off prior to conversion).
 - This provision is especially problematic from a tax treatment standpoint, as a fundamental characteristic of debt is that it is senior to equity in bankruptcy.
 - Timing is another problematic element from a tax perspective: ILAC debt is required to be subject to Fed mandated bail-in provisions in specified troubled circumstances that might precede the insolvency or resolution of either the IHC or its parent.
- 6. Other comments are set out in the Appendix**

Appendix 1

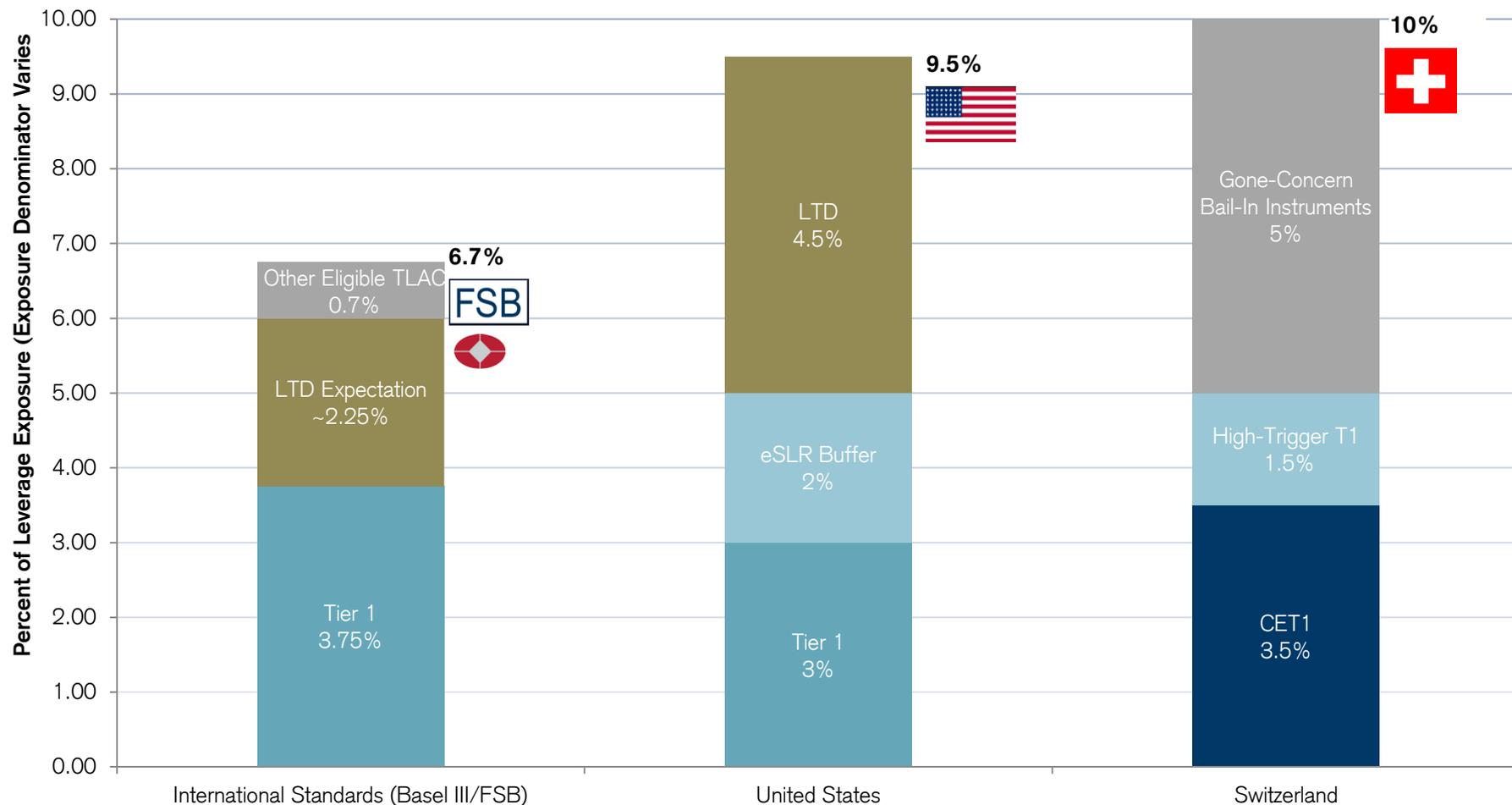
Quantitative Considerations

A Comparison of Minimum Risk-Based Capital Requirements (Full Implementation, No Management Buffer, No Countercyclical Buffer)



- International Standards data based on FSB “Principles on Loss-absorbing and Recapitalization Capacity of G-SIBs in Resolution: Total Loss Absorbing Capacity (TLAC) Term Sheet,” published on November 9, 2015. This chart is RWA based, and ignores the effect of leverage and CCAR which may also bind.
- U.S. data based on Federal Reserve Board Notice of Proposed Rulemaking “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,” published October 30, 2015. Under the Federal Reserve Board’s NPR on Long-Term Debt (LTD) and TLAC, the leverage requirements are higher than FSB proposals and may be binding – (i.e. exceed) – the TLAC requirements for some institutions
- Swiss data based on proposed “Too-Big-To-Fail” capital requirements on 10/21/2015. The Swiss Federal Council has asked the Ministry for Finance to draft the required changes to the Banking Ordinance and the Capital Adequacy Ordinance for formal approval by the Federal Council in Q1 2016.

A Comparison of Minimum Leverage Ratio Requirements (Full Implementation, no Management Buffer)



- Note that the denominators vary across the measures represented here. Each measure accounts for total on-balance sheet assets & exposures, while most measures vary in the off-balance sheet assets and exposures they include..
- International Standards data based on FSB “Principles on Loss-absorbing and Recapitalization Capacity of G-SIBs in Resolution: Total Loss Absorbing Capacity (TLAC) Term Sheet,” published on November 9, 2015.
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Appendix 2

Suggestions on Other Elements

BHC sizing is well-calibrated

Two Key Objectives in resolution

1. Ensure private capital can absorb losses, even in severe crisis, AND
2. Preserve critical functions / support real economy

Back testing of large* banks (CS analysis):

- Rare/extreme events – but most relevant data for the question
- 2008-9 Crisis → “high water mark” (severity > early ‘80s and late ‘90s crises)
- Large gross losses: 8 banks had cumulative write-downs > \$50bn (!)

Key Test: Cumulative CET1 Drawdown over crisis period/ Basel 3 RWA

- Ignore tax shield, goodwill effects (CET1 approach); Ignore “voluntary capital” (equity raises, dividends)
- Adjust denominator to Basel 3 using firm disclosure (where available; otherwise proxy to bankwide data)
 - Loss data may need to be recalibrated for Basel 4 impacts on current trends
- Include acquisition write-downs (where relevant – e.g. Merrill, WaMu, est’d Lehman)
- Maximize loss period (by adjusting quarterly start & end dates to worst case)

Maximum Historic Drawdown: 9% of B3 RWA (WaMu, Merrill)

- 8% drawdown (2 banks), 6% drawdown (1), 5% drawdown (2)
- 30+ other banks had smaller drawdown (or gains)
- CS results are broadly consistent with FSB analysis

**CS Analysis: assessed 37 big banks, incl. all current GSIBs, and other big banks with large (>\$15bn) crisis gross write-downs (per WDCI).*

GSIB data likely to differ considerably vs small banks that are inherently more concentrated in geography/product line

Overall TLAC Scale? NPR is well calibrated for External TLAC

- U.S. NPR implies starting TLAC of 23%-25.5% (incl. statutory buffers & 1.5%-2% mgt. cushion)
- Implies strong capacity to recapitalize post max losses → 14- 16% capital ratio for post bail-in
 - Appropriate to aim towards conservative side (to support LOLR, x-border confidence)
- If US resolution method shifts to liquidation/ solvent wind-down, severity could increase for US BHC

BHC quality tests appear overly strict

The NPR takes an **overly strict view of TLAC quality**. The following exclusions appear unnecessary (as long as other tests are made):

- Instruments with “standard” acceleration clauses (could invalidate much US existing BHC debt)
- Instruments governed by foreign law (could restrict issuance in some markets)
- Structured notes (STNs), a \$600bn market (see STN page for details)
- Convertible or exchangeable securities

The strict **5% cap under the “clean holdco” rules** can have large consequences

- A clean holdco test is a good tool in principle, but current scope is overly restrictive
- However, NPR seems to imply that Excluded Liabilities don’t just disqualify the instruments, they appear to “poison” all debt in that pari passu class from TLAC status.
 - Could invalidate most/ all BHC outstanding debt
 - This approach is not necessary for the instruments above, especially for bridge-style bail-in

Significant implications in the event that significant/ most existing BHC debt is excluded

- Disruptive to existing markets and expensive for BHC corporate finance
- Would also confound hard-won regime credibility in the US markets
 - Investors have been educated by FDIC and others on SPE loss absorption
 - TBTF has been eliminated over time (see GAO study). Reversing this hard won achievement would disrupt market and investor expectations

Qualification - Structured Notes (“STNs”)

Principal-protected long-term STNs provide important loss capacity and should be eligible TLAC/ LTD:

- Furthermore, there is no need to include any STNs in the 5% Clean Holding test
- (assuming the STNs meet the other TLAC requirements)

Exclusion of principal-protected STNs runs reduces the useable LTD and broad burden sharing. It also works against the NPR’s goal of avoiding “undue disruption” by increasing the challenges of the existing debt stack fitting into a tight clean holdco test (along with other excluded liabilities)

The justifications for excluding principal protected STNs from eligible debt instruments are unpersuasive:

- The NPR states that STNs include “features that could make their valuation uncertain, volatile, or unduly complex.” However, the holder’s claim in a principal-protected STN is as certain, fixed & simple to determine as the amount of a holder’s claim on plain vanilla notes with a fixed or floating interest rate
- The NPR also justifies its exclusion of STNs because they are “typically customer liabilities (as opposed to investor liabilities)” (p. 38).
 - However principal-protected STN investors are widely dispersed pool of sophisticated, high-net-worth investors that actively seek a risk-return profile, meaning that they are well suited to evaluate and absorb losses. They are also typically unleveraged. (this can be further ensured by minimum denominations)
 - Moreover, they add scale and diversity to TLAC, and inclusion of principal-protected STNs will avoid cases of an unnecessary buffer breach. The STN market is estimated at ca \$600bn
 - STN exclusion also adds unnecessary definitional challenges, as many vanilla instruments are hedged with swaps.

Potential Solutions:

- Adjust the definition of structured notes as any note or portion of a note, where the principal may be reduced due to a linkage to a derivative index or instrument (plus a clarification that denomination in a foreign currency would not trigger such disqualification). This would permit principal-protected STNs to be eligible.
- Other STNs could still be issued out of the holdco, but would be in the “gray bucket” i.e., not the excluded liabilities /poisonous-to-clean-holdco bucket.

Other Comments

- 1. Qualification and Investor Restrictions:** The final rule should remove unnecessary restrictions on BHC long-term debt (LTD) instruments.
 - Specifically, the restrictions on permissible acceleration clauses, foreign law debt, and principal-protected structured notes (STNs) should be removed or revised. (supervisory requirements should be able to address any underlying concerns in full)
 - At a minimum, legacy LTD should be grandfathered to avoid disruptive liability management requirement and the resurrection of a TBTF uplift in the US for existing debt.
 - In addition, the restrictions on the types of investors in eligible debt are too restrictive (e.g. small BHCs).
- 2. Subsidiary-level Capital Instruments:** The opportunity to include these instruments might be desirable in a future M&A situation (as an FRB crisis option).
 - For example a strong acquiror buying a troubled firm may not be able to finance the full TLAC requirement for a period, which could stymie an otherwise constructive solution.
 - Assuming that such an strategy may be useful in some cases, it may be useful for the FRB to have (significant) transition allowance powers.
- 3. Payout Requirements:** profit tests for dividends & bonus payments are onerous for some cases, especially for one-off extraordinary charges.
- 4. MPE Outcomes:** appear to invalidate much of the MPE strategies used by some banks
 - Technique of differentiation by home country certification looks smart; we believe a larger differentiation in favor of strong SPE oriented parents is warranted
 - Unclear why MPE firms are prohibited from issuing TLAC in the US market in line with US BHC clean holdco standards, assuming that risk disclosure is clear.