CSBS SINCE 1902
CONFERENCE OF STATE BANK SUPERVISORS

February 1, 2015

Robert de V. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551
Docket No. R-1523 RIN 7100 AE-37

Dear Mr. Frierson,

The Conference of State Bank Supervisors ("CSBS")[1] appreciates the opportunity to comment on the Federal Reserve Board's ("Board") Notice of Proposed Rulemaking (proposal or proposed rule) to apply a new "total loss-absorbing capacity" (TLAC) requirement to domestic global systemically important banks (G-SIBs) and U.S. operations of foreign G-SIBs, entitled *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*.[2]

CSBS has actively provided feedback to the federal banking agencies on proposed rules implementing Basel III risk-based capital requirements under Basel III and the Single Point of Entry (SPOE) Resolution strategy under the Orderly Liquidation Authority (OLA). As with these previous rulemaking, state regulators support the Board's efforts to craft a rule which will improve the resiliency of systemically important banking organizations while ensuring that these institutions can be resolved without extraordinary government support, taxpayer assistance, or financial instability. However, CSBS believes that several aspects of the proposed rule require further clarification or modification. Our comments on the proposed TLAC requirements are organized in the sections below.

INTRODUCTION

We support the Board's efforts to improve the resolvability and resiliency of U.S. banking organizations. Large, complex, and interconnected banking organizations pose an outsized risk to the U.S. global banking systems and broader economies, and therefore should be subject to heightened loss-absorbency requirements which minimize the systemic risks accompanying their failure and facilitate their orderly resolution.

In the sections that follow, this comment letter highlights several of our concerns with the proposed TLAC requirements, including the relative proportions of debt and equity in the composition of external TLAC, the consequences of a weaker than anticipated demand for TLAC eligible long-term debt, and the

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[1] CSBS is the nationwide organization of banking regulators from all 50 states, the District of Columbia, Guam, Puerto Rico, and U.S. Virgin Islands. The mission of CSBS is to support the leadership role of state banking supervisors in advancing the state banking system and state financial regulation, benefiting the public by ensuring safety and soundness, promoting economic growth and consumer protection, and fostering innovative state regulation and supervision of the financial services industry.

[2] 80 Fed. Reg. 74,925 (proposed Nov. 30, 2015) [hereinafter Total Loss-Absorbing Capacity Requirements]

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proposed exceptions to the regulatory capital deduction rules. We then propose modifications to further enhance facilitation of the SPOE strategy. Lastly, we emphasize the importance of state-federal supervisory coordination in the implementation and enforcement of the proposed TLAC requirements.

COMPOSITION OF EXTERNAL TLAC

The proposal would require certain top-tier bank holding companies (BHCs) and intermediate holding companies (IHCs) to maintain a minimum level of TLAC, composed of regulatory capital and eligible long-term debt (LTD), and to maintain related buffers consisting of common equity tier 1 (CET1) capital. Top-tier U.S. BHCs identified by the Board as global systemically important bank holding companies (G-SIB BHCs) would be required to satisfy an "external TLAC" requirement mandating minimum ratios of external TLAC and external LTD, plus an external TLAC buffer.

Since the minimum ratios of external TLAC could be met with the Tier 1 capital already used to satisfy existing capital requirements[3], the centerpiece of the proposed rule for G-SIB BHCs is the external LTD requirement. Under the external LTD requirement, the top-tier BHC or IHC must directly issue a minimum amount of structurally subordinated LTD, defined as "eligible debt securities", which will convert to equity during the resolution of the G-SIB to absorb losses suffered prior to the resolution. Nearly half of a G-SIB's required external TLAC will be satisfied by the issuance of eligible LTD.

CSBS has previously supported requiring minimum levels of both equity and unsecured debt at top-tier BHCs to serve a loss-absorption function.[4] Nevertheless, we are concerned that the proposed rule would require the issuance of a disproportionate amount of unsecured debt relative to equity. In line with claims made by the Board in previous rulemakings[5], CSBS believes that Tier 1 equity capital provides a superior form of loss-absorbency over long-term debt.

The loss-absorbency of equity capital can be questioned on the grounds that its intangible components, such as goodwill and deferred tax assets, have a value which will collapse in the context of a resolution. The contingent nature of these intangible assets may engender a degree of uncertainty regarding the accuracy of equity capital valuations. However, external LTD, even with its comparatively definite value, could be a source of still greater uncertainty, since the proposal does not outline clearly defined standards and guidelines for the exercise of supervisory discretion in triggering the conversion of LTD to equity.

Notably, the proposed rule does not address the disparity between, on the one hand, the Financial Stability Oversight Council's finding that for convertible debt instruments with triggers based on supervisory discretion, "observed spreads . . . would likely rise as the financial condition of the firm

[3] The proposed external TLAC and external LTD requirements would complement existing U.S. Basel III capital requirements in that Tier 1 capital would count towards external TLAC, and Tier 2 instruments meeting the proposed definition of "eligible debt securities" would count towards external LTD.

[4] *See* https://www.csbs.org/regulatory/policy/Documents/2014/CSBS_SPOE_Comment_Letter_FINAL.pdf.

[5] *See* Regulatory Capital Rules, 79 Fed. Reg. 24,528, 24,535 (May 1, 2014) (affirming that common equity Tier 1 capital has "the highest capacity to absorb losses" while non-cumulative perpetual preferred stock "has strong loss-absorbing capacity").

worsened", and, on the other hand, the proposal's claim that LTD faces a lower risk of volatility or depletion than does equity in leading up to a resolution.[6]

CSBS requests that the Board more extensively analyze the relative loss-absorbing potential of equity and unsecured debt, and elaborate upon the rationale for the proposed proportions of unsecured debt and equity in the composition of external TLAC. Without further analysis, we would request that the Board require G-SIBs to satisfy the vast majority of their TLAC requirement by issuing additional Tier 1 equity capital rather than long-term unsecured debt.

THIRD-PARTY HOLDERS OF EXTERNAL LTD

Under the proposed rule, the conversion of external LTD to equity during a resolution will be used as a mechanism for passing losses from G-SIB BHCs to third-party private investors. In referring to prospective third-party investors, the proposal states that "it is desirable that the holding company's creditors be limited to those entities that can be exposed to losses without materially affecting financial stability."[7] The success of the proposed rule in bolstering the resiliency of G-SIBs will largely depend on there being sufficient interest in holding external LTD among third-party investors.

Notwithstanding the necessity of strong, sustained investment demand, the proposed rule neither identifies nor gauges the interest of the classes or types of investors it envisions as the primary holders of external LTD. Indeed, other than the disincentive provided by the proposed capital deduction rules discussed below, there are no limits on which investors may hold external LTD. Presumably, the proposed rule envisions that sophisticated institutional investors with long-term liabilities, such as pension funds and life insurance companies, will be the major constituents in the market for external LTD, since these investors are the traditional consumers of bank debt.

CSBS is concerned about the potentially destabilizing consequences if demand for external LTD among institutional investors with long term liabilities is weaker than anticipated by the Board. Weak demand for external LTD among institutional investors could arise as a result of several factors. For instance, the limitations on the eligibility of debt securities to qualify as external LTD may be so restrictive that the instruments will not be flexible enough to tailor to the investment and risk preferences of prospective holders. For instance, requiring that external LTD be "plain vanilla"—although necessary to preserve the LTD's readily ascertainable value and to minimize complexity during a resolution—will reduce the LTD's marketability to certain creditors and thereby stifle overall demand and raise the cost of issuance.

If demand for external LTD among long-term institutional investors is weaker than anticipated, then private funds and banks would likely fill that gap. The significant credit exposure of G-SIBs and their subsidiaries to potentially highly leveraged entities, such as hedge funds and private equity funds could engender spillover and contagion risks among the G-SIBs and the banking system generally leading up to a resolution. Even if the anticipated level of demand for external LTD is met, equivalent spillover and contagion risks will arise if institutional investors designated as "systemically important financial

[6] *Compare* FIN. STABILITY OVERSIGHT COUNCIL, REPORT TO CONGRESS ON STUDY OF A CONTINGENT CAPITAL REQUIREMENT FOR CERTAIN NONBANK FINANCIAL COMPANIES AND BANK HOLDING COMPANIES 15 (2012), *with* Total Loss-Absorbing Capacity Requirements, *supra* note 1, at 74931.

[7] Total Loss-Absorbing Capacity Requirements, *supra* note 1, at 74945.

institutions" (SIFIs) become extensive investors in external LTD, particularly given that SIFIs are exempt from the proposed regulatory capital deduction framework, discussed below.

CSBS requests that the Board elaborate upon the types of third-party investors it envisions as the primary holders of external LTD and explain how these investors in particular can be exposed to losses without materially affecting financial stability. Additionally, the Board should conduct a thorough cost-benefit analysis to measure demand for external LTD among these investors so as to ensure that issuance is neither destabilizing nor unduly costly. In addition, the Board should consider restricting the eligibility of third-party investors to hold external LTD to ensure (1) that private funds to which G-SIBs have significant credit exposures do not hold large quantities of external LTD, and (2) that external LTD is held only by third-party investors that can be exposed to losses without materially affecting financial stability.

REGULATORY CAPITAL DEDUCTION TREATMENT

To limit the risk of contagion, the proposed rule discourages depository institutions and holding companies from investing in TLAC debt through the proposed regulatory capital deduction treatment for a G-SIB investing in the external LTD of another G-SIB. In particular, for its non-significant investments in external LTD of G-SIB BHCs, a G-SIB BHC must deduct the aggregate amount of such investments in excess of 10% of its CET1 capital. The capital deduction requirement provides a very strong incentive for G-SIB BHCs to limit their holdings of the external LTD of other G-SIBs. Nevertheless, CSBS is concerned that certain provisions of the proposed rule will enable the Board to relax the proposed capital deduction rules in a manner which will amplify the systemic importance of G-SIBs and damage the systemic resilience and resolvability of G-SIBs.

Specifically, exemptions from the capital deduction rules are proposed which would enable a G-SIB, with the prior written approval of the Board, to forgo the deduction of investments in external LTD provided "if the financial institution is in distress and if such investment is made for the purpose of providing financial support to the financial institution, as determined by the Board."[8] Since the conditions in which a financial institution is in distress or an investment is made to provide financial support are not clearly defined in the proposed rule, CSBS is concerned that the Board will exempt G-SIBs from the proposed capital deduction requirements to ameliorate any shortfall in investment demand for external LTD and thereby reduce the cost of issuance. This would ensure the smooth implementation and continued functioning of the proposed rule but only by sacrificing the enhanced resiliency and resolvability of G-SIBs. To avoid this outcome, CSBS requests that the Board provide additional guidance on the scope, applicability, and duration of the exemptions to the proposed capital deduction requirements.

FACILITATION OF THE SPOE RESOLUTION STRATEGY

The proposed rule is primarily focused on facilitating the implementation of the SPOE framework by enhancing the resiliency and resolvability of a G-SIB BHC. The SPOE resolution strategy is designed to avoid contagious runs and financial instability by ensuring the continued normal operation of a BHC's operating subsidiaries and passing losses that would otherwise fall on a subsidiary's creditors onto the subordinated creditors of the parent BHC.

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[8] Total Loss-Absorbing Capacity Requirements, *supra* note 1, at 74956 (codified at 12 C.F.R. § 217.22 nn.23-24).

CSBS reaffirms our support for the design of resolution procedures which bolster financial stability and mitigate systemic risks posed by bank failure. In this context, we would like to elaborate on our previous comments on the design of the proposed TLAC requirements to ensure the optimum facilitation of the SPOE resolution strategy.

Internal Domestic TLAC Requirement

In resolving a failed G-SIB, the SPOE resolution strategy requires the transfer of a subsidiary's losses, first, up to the top-tier BHC and, second, to the external TLAC holders. As the proposed rule readily acknowledges, the external TLAC requirements would ensure only that losses are transferred from a top-tier BHC to holders of external TLAC but would not require the creation of mechanisms to transfer losses from the operating subsidiaries to the top-tier BHC. Although the Board notes that they are considering proposing such a domestic internal TLAC requirement, the current proposed rule will contain no such provision.

CSBS is concerned that the omission of an internal domestic TLAC requirement from the proposed rule will create significant uncertainty and result in a disjointed facilitation of the SPOE resolution strategy. State regulators believe it would be prudent to issue a modified proposal for public comment which includes a domestic internal TLAC requirement for G-SIB BHCs. Including an internal domestic TLAC requirement in the proposed rule would ensure both the uniform implementation of the SPOE framework as well as the harmonious operation of the external and internal TLAC requirements.

Facilitation of OLA & SPOE

The adoption of the SPOE resolution strategy marked a turning point in the implementation of the OLA away from its initial liquidation-oriented purpose and towards a "recapitalization-within-resolution" scheme.[9] Given this shift in focus, CSBS requests that the Board, in finalizing the proposed rule, include provisions ensuring that G-SIBs emerge from the resolution process less complex and interconnected. State regulators look forward to continuing to work with the Board to craft a resolution framework which ensures that G-SIBs become less complex and interconnected through resolution, and thereby, bring about an end to the TBTF subsidy.[10]

To ensure the effective facilitation of the SPOE strategy, CSBS believes it is important that all aspects of the interaction between the proposed rule and the SPOE resolution mechanism be made abundantly clear. Several critical details regarding the conversion of external LTD to equity are not specified in either the proposed rule or the notice outlining the SPOE scheme, for instance, the maximum conversion ratio for these debt instruments. As reported by FSOC, it is important for third-party holders to have advanced knowledge of this conversion ratio to avoid excessive downward pressure on a G-SIB's common stock as it approaches a trigger event. For details such as these, CSBS requests that the Board collaborate with the FDIC to jointly issue a proposed rule outlining the precise interaction between the proposed rule and the SPOE resolution strategy.

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[9] *See* Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76614 (Dec. 18, 2013). *Accord* SIFMA and TCH, Letter to Robert E. Feldman, Executive Secretary of FDIC, dated May 23,2011 (FDIC Docket No. 2011-6705), at 2, available at http://www.sifma.org/issues/item.aspx?id=25639.

[10] *See, e.g.*, Kenichi Ueda & Beatrice Weder di Mauro, *Quantifying Structural Subsidy Values for Systemically Important Financial Institutions* (Int'l Monetary Fund, WP/12/128, 2012) (demonstrating that, as of the end of 2007, the bailout expectation for SIFIs lowered their funding costs by 60 basis points).

State Coordination

CSBS encourages the Board to coordinate with state regulators in the finalization and enforcement of the proposed rule. Several aspects of the proposed rule are potentially in conflict with state laws and regulations governing bank holding companies and subordinated debt instruments.

The proposed rule includes clean holding company requirements which would prevent G-SIB BHCs covered by the proposed rule from entering into certain financial arrangement that could impede its orderly resolution. However, state law often places credit exposure limits and investment restrictions on bank holding companies, banks, and their subsidiaries which may limit the extent to which these entities can issue or hold external LTD and internal LTD. CSBS looks forward to working closely with the Board to ensure that the final rule clarifies its relation to these potentially conflicting state laws.

Additionally, the clean holding company requirements place a cap on the "unrelated liabilities" of G-SIBs, including liabilities created by court judgments. CSBS requests that the Board elaborate on the scope of "unrelated liabilities" in terms of which types of court judgments under state law will be included within this category. CSBS requests that the Board provide guidance on whether certain civil suits and administrative fines will be given priority in falling within the proposed cap and the basis for such priority so that State regulators are apprised as to which actions will be subject to limited enforcement by court order.

With respect to the proposed internal TLAC requirements, CSBS requests that the Board maintain extensive coordination with the state banking departments in the supervision of the U.S. branches and agencies of foreign G-SIBs. Since a foreign G-SIB's U.S. branches and agencies operate outside the IHC structure, it will be critical for the Board and state supervisors to closely collaborate in the supervision of branch operations. Likewise, CSBS requests that the Board involve the states in their efforts to coordinate with foreign regulators in order to ensure that, in the resolution of a foreign G-SIB, its branch operations are treated in a manner which is both conducive to an orderly resolution and in compliance with applicable state law.

The positive relationship between the states and the Board has enhanced the supervisory process, reduced duplicative efforts and minimized conflict between federal and state rules. State regulators firmly believe that robust coordination and constant communication between state and federal regulators will ensure the implementation and enforcement of the proposed rule enhances the resiliency and resolvability of G-SIBs.

Conclusion

CSBS appreciates the opportunity to comment on this important initiative and looks forward to continued engagement with the Board as it finalizes the proposed TLAC requirement and continues to enhance the resiliency and resolvability of systemically important banking organizations.

Sincerely,

John W. Ryan
President & CEO