



February 19, 2016

Mr. Robert deV. Frierson  
Secretary  
Board of Governors of the Federal Reserve System  
20<sup>th</sup> Street and Constitution Avenue N.W.  
Washington, D.C. 20551

Re: Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations; Regulatory Capital Deductions for Investments in Certain Unsecured Debt of Systemically Important U.S. Bank Holding Companies, Docket No. R-1523

Dear Mr. Frierson:

Better Markets<sup>1</sup> appreciates the opportunity to comment on the above-captioned rule proposed (“Proposed Rule”) by the Board of Governors of the Federal Reserve System (“Board”). The Proposed Rule establishes “total loss-absorbing capacity” (TLAC), long-term debt, and clean holding company requirements for systemically important bank holding companies and for the intermediate holding companies of systemically important foreign banking organizations.

## **INTRODUCTION AND SUMMARY OF COMMENTS**

Through its Proposed Rule, the Board seeks to improve the resiliency of systemically important bank holding companies by requiring them to maintain minimum amounts of unsecured long-term debt that could absorb losses and be converted to equity if the systemically important bank holding company is resolved under the Dodd-Frank Act’s Orderly Liquidation Authority or the bankruptcy code. The Board’s goal is to ensure that if a systemically important bank holding company or one of its operating subsidiaries fails, the holding company’s long-term debt could be “bailed in” to absorb the losses, such that the

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<sup>1</sup> Better Markets, Inc. is a nonprofit organization that promotes the public interest in the domestic and global capital and commodity markets. It advocates for transparency, oversight, and accountability in the financial markets.

holding company and its subsidiary could be resolved or reorganized without requiring taxpayer support or threatening the stability of the financial system.

Better Markets supports the goal behind the Board's Proposed Rule: the Board and financial regulators should do everything in their power to ensure that taxpayers are never again called upon to choose between bailing out a systemically important bank holding company or its subsidiaries or suffering the economically catastrophic consequences that would result if a systemically important bank holding company fails. However, the Board's Proposed Rule suffers from a number of flaws.

First, the Board's Proposed Rule is the second-best solution to the problem of ensuring that bank holding companies remain resilient and able to withstand losses similar to those they suffered in the financial crisis. As finance professors Stephen Cecchetti and Kermit Schoenholtz put it, "like many academics, we conclude that regulators should focus more on raising requirements for common equity, rather than equity-like debt instruments."<sup>2</sup>

Second, the Proposed Rule is weaker than the earlier TLAC rule proposed by the Financial Stability Board. As a result, the minimum amount of TLAC required under the Board's Proposed Rule is insufficient to ensure that systemically important bank holding companies can withstand the level of losses similar to those they suffered during the financial crisis.<sup>3</sup> While the Financial Stability Board's initial TLAC proposal called for minimum TLAC levels to be between 16% and 20% of an institution's risk-weighted assets, the Board's Proposed Rule sets the minimum TLAC requirement at 16% as of 2019 and 18% as of 2022. The Proposed Rule also allows financial institutions to hold each other's TLAC. The Board should require greater minimum levels of TLAC, ensure that the stability-enhancing attributes of TLAC are not diluted, and require that the long-term debt that

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<sup>2</sup> Stephen Cecchetti and Kermit Schoenholtz, "The Right Direction," *Money and Banking* (Nov. 24, 2014), available at <http://www.moneyandbanking.com/commentary/2014/11/24/the-right-direction>.

<sup>3</sup> For purposes of this letter, Better Markets accepts but does not necessarily agree with the Board's view that the TLAC levels called for in the Proposed Rule are sufficient to "withstand the level of losses similar to those they suffered during the financial crisis." Better Markets believes that an independent and robust analysis of these losses has not been done or publicly disclosed. The Board states that "[t]he calibration of the proposed external TLAC requirement is based in part on an analysis of the historical loss experience of major financial institutions during financial crises. First, a targeted analysis of losses of U.S. financial firms during the 2007–2009 financial crisis was performed. The analysis considered the loss experiences of the 19 bank holding companies that participated in the Supervisory Capital Assessment Program (SCAP). . . . The analysis found that the bank holding company with the most severe loss experience incurred estimated losses and recapitalization needs of roughly 19 percent of risk-weighted assets. The risk-weighted assets component of the proposed external TLAC requirement is consistent with this high-water mark from the global financial crisis." While that may be true, the detailed analysis permitting independent scrutiny and confirmation has not been publicly released. And even if the Board's analysis is accurate, it is not clear that the Board's analysis accounted for the many government bailouts and emergency lending programs that kept the financial system from collapsing during the 2007-2009 financial crisis. Thus, Board's calibration may reflect capital losses that the financial system sustained *after* the government and taxpayers had stabilized the financial system and guaranteed the liabilities of much of the financial system. Without these emergency measures, the capital shortfall would have been significantly greater than 20%.

qualifies as TLAC be of sufficiently long maturity to improve financial stability. The Board should also prohibit financial institutions from holding each other's TLAC to reduce the risk of financial contagion.

Third, the Board's Proposed Rule is incomplete. Even if the minimum level of TLAC set forth in the Board's Proposed Rule were sufficient to absorb the losses that systemically important bank holding companies could be expected to sustain in a crisis, the Proposed Rule does not set forth a mechanism by which this loss-absorbing debt would be converted into equity. As a result, would-be purchasers of this debt have no way to price it. And in the midst of a crisis, the holders of this debt would almost certainly lobby Congress and the regulators to refrain from imposing losses or otherwise impairing the rights of the holders of this debt. To ensure that TLAC will absorb losses, the Proposed Rule should specify the circumstances in which TLAC will be converted into equity. And in light of the recent lawsuits brought by the shareholders of institutions that were bailed out in the 2007-2009 financial crisis claiming that the terms on which their institutions were bailed out were not generous enough, the Proposed Rule should explicitly state that the interests of shareholders will be extinguished if TLAC is converted into equity.

#### **COMMENTS ON THE PROPOSED RULE**

***The Board should raise minimum capital requirements to safeguard financial stability rather than rely on long-term debt that can be converted to equity.***

Thomas Hoenig, the Vice-Chairman of the Federal Deposit Insurance Corporation, recently captured the paradox that lies at the heart of the Board's Proposed Rule: "It is difficult to accept that more leverage solves the destabilizing problem of leverage."<sup>4</sup> The problem that set off the biggest financial crisis and worst recession since the Great Depression was that bank holding companies and financial institutions funded themselves with far too little equity; instead, they funded themselves with too much debt.<sup>5</sup>

In its Proposed Rule, the Board points out that long-term, unsubordinated debt would be a more stable source of funding for systemically important bank holding companies. Because this debt cannot run, it would be available to absorb the losses of the holding company's critical operating subsidiaries. As a result, the creditors and counterparties of these institutions would be less likely to run, knowing that the holders of long-term debt at the holding company level would absorb losses.

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<sup>4</sup> Thomas M. Hoenig, "The Relative Role of Debt in Bank Resiliency and Resolvability," Remarks at the Peterson Institute for International Economics" (Jan. 20, 2016), available at <https://www.fdic.gov/news/news/speeches/spjan2016.html>.

<sup>5</sup> See, e.g., Alan Blinder, *After the Music Stopped: The Financial Crisis, the Response, and the Work Ahead* 271 (2013) ("The crisis exposed numerous flaws in the nation's regulatory system. One painfully obvious one was that banks and other financial institutions had been allowed to operate with too much leverage; that is, with too little capital."); Howard Davies, *Can Financial Markets Be Controlled?* 38-39 (2015). As Professor Davies explains, one of the reasons that banks were undercapitalized in the run up to the financial crisis was that "they were allowed to count as capital a number of instruments (deferred tax assets and convertible instruments, for example) which were not in practice usable when disaster hit."

While the mechanism by which the Proposed Rule would shift losses from the creditors and counterparties of the operating companies may make sense as a theoretical matter, the Proposed Rule's description of the process glosses over the considerable practical difficulties that such a loss-shifting would require. For example, Paul Kupiec, a scholar at the American Enterprise Institute and a former chairman of the Research Task Force of the Basel Committee on Banking Supervision, has highlighted one way to think about the difficulties that arise in the TLAC approach. Mr. Kupiec wrote that for TLAC to eliminate the necessity for taxpayer bailouts and to keep the operating companies of the systemically important bank holding company open and operating, the Board's rule would require

(a) a sufficient volume of parent TLAC; (b) that the proceeds from the parent TLAC issues be used to fund an equivalent amount of TLAC debt issued by critical operating subsidiaries including all depository subsidiaries (back-to-back TLAC); and (c) that the proceeds from subsidiary TLAC debt either (i) replaced insured deposit funding or (ii) be invested in risk-free assets.<sup>6</sup>

Most importantly, Mr. Kupiec points out that this complex arrangement yields the same results as a simpler solution:

A TLAC rule that satisfies these conditions is economically equivalent to increasing the regulatory capital requirement (the required minimum equity-asset ratio) and the [bank holding company's] critical operating subsidiaries and all depository subsidiaries.

And while raising minimum capital requirements and requiring bank holding companies to issue long-term debt that can be bailed in may be functionally equivalent, raising minimum capital requirements is preferable to relying on long-term debt because it is easier, clearer and more likely to work. As Mr. Kupiec put it, "raising minimum equity capital requirements . . . is far simpler and refreshingly transparent" compared to TLAC.

Mr. Kupiec is not alone in his assessment. Many finance experts, academics, and regulators agree that equity is superior to long-term debt as a means of ensuring the stability of large financial institutions and the financial system. For example, when then-Treasury Secretary Timothy Geithner was asked in 2009 how he would address the problem of "too big to fail" banks, he replied, "The most simple way to frame it is capital, capital, capital. Capital sets the amount of risk you can take overall. Capital assures you have big enough cushions to absorb extreme shocks."<sup>7</sup> Stanford finance professor Anat Admati has similarly

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<sup>6</sup> Paul Kupiec, "Is Dodd-Frank Orderly Liquidation Authority Necessary to Fix Too-Big-to-Fail?" AEI Working Paper (Oct. 22, 2015), available at <https://www.aei.org/wp-content/uploads/2015/10/Kupiec-Oct-22-working-paper.pdf>. The Board's Proposed Rule specifies none of these conditions, making it doubtful that the Proposed Rule could in fact eliminate bailouts or ensure the stability of the financial system.

<sup>7</sup> Treasury Secretary Timothy Geithner before the House Financial Services Committee at a Hearing on "Addressing the Need for Comprehensive Regulatory Reform" (March 26, 2009), available at <https://www.gpo.gov/fdsys/pkg/CHRG-111hhrg48875/pdf/CHRG-111hhrg48875.pdf>.

pointed out that long-term debt is inferior to equity as a means for ensuring that large, complex financial institutions can absorb losses without imperiling the financial system or requiring bailouts.

Among other things, TLAC requires that regulators be able to determine when an institution is approaching insolvency and then have the courage to force losses onto the holders of TLAC. As Professor Admati writes,

Designing and enforcing requirements that ensure that TLAC absorbs losses and prevents both bailouts and the collateral damage of failure is very difficult. It is baffling that regulators have taken this complex and unreliable approach to the problem of ‘too big to fail’ banks when a much superior alternative is available. For the purpose of the regulation, a better approach is to insist that financial institutions rely much more on equity funding. In other words, to replace TLAC with equity funding.<sup>8</sup>

In his most recent book, the associate editor and chief economics commentator for the *Financial Times* Martin Wolf draws the same conclusion about the superiority of equity to long-term bail-inable debt as a means of ensuring that governments do not have to bail out large banks or their creditors. Mr. Wolf writes that even if regulators could solve the complex problems of positioning, structuring, and triggering the conversion of long-term debt to equity, “it is not clear” that bail-inable debt is “superior to additional equity. In general, the simple beats the complex if it does the same job. And equity is simpler than complex hybrids.”<sup>9</sup>

Similarly, George Washington University law professor Arthur Wilmarth points out that the regulatory push to allow financial institutions to substitute long-term debt for equity is misguided:

As federal regulators have recently acknowledged, Tier 1 equity capital provides a far superior buffer for absorbing losses. Tier 1 common stock and non-cumulative perpetual preferred stock do not have maturity dates, do not have fixed obligations to pay interest, can suspend dividends to conserve capital. The TLAC proposal is therefore plainly mistaken in arguing that [global systemically important banks] should satisfy nearly half of their TLAC requirement by issuing bail-in debt.<sup>10</sup>

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<sup>8</sup> Anat Admati, “Designing and Enforcing Effective Financial Regulation,” *International Banker* (June 30, 2015) available at <http://internationalbanker.com/banking/designing-and-enforcing-effective-financial-regulation/>.

<sup>9</sup> Martin Wolf, *The Shifts and the Shocks: What We’ve Learned—and Have Still To Learn—from the Financial Crisis* 248-51 (paperback ed. 2015).

<sup>10</sup> Arthur E. Wilmarth, Jr., “The Fed’s TLAC Proposal Would Impose the Costs of Resolving Failed Megabanks on Ordinary Investors and Taxpayers” (Dec. 16, 2015), available at <http://clsbluesky.law.columbia.edu/2015/12/16/the-feds-tlac-proposal-would-impose-the-costs-of-resolving-failed-megabanks-on-ordinary-investors-and-taxpayers/>.

Rather than relying on long-term bail-inable debt to safeguard the stability of the financial system, regulators should instead be raising minimum capital requirements. Capital is simpler and more transparent, and it is far easier to implement and maintain than a system that relies on both capital and bail-inable debt. As Martin Wolf observes, “If, for example, the leverage of a bank were not to exceed, say, four to one, the need for bail-inable debt might disappear, greatly simplifying the regulatory task.” Professor Admati makes the same point:

Using common equity instead of debt-like hybrid securities is a simpler and more reliable approach to making sure systemic institutions are better able to absorb their losses without harming the economy. There is no relevant sense in which hybrid securities, assuming they actually work, are cheaper or better than equity. The fact that the securities become useful in resolution is irrelevant, because if equity were used, resolution would be less likely to be needed at all, which is better.<sup>11</sup>

University of Chicago finance professor John Cochrane also points out that the optimal solution is to require banks to issue more equity, rather than relying on long-term bail-inable debt to recapitalize a failing financial institution:

For commercial banks, the answer is pretty simply: equity, lots more equity. How much? Well, more is better, and “enough so that it doesn’t matter” or “enough so that we never, ever hear again the call ‘recapitalize the banks’ ” are good answers. . . . More is obviously better, because more capital puts banks further from bankruptcy and further from a run to begin with.<sup>12</sup>

For that reason, writes Professor Cochrane, “The larger consensus has shifted away from clever schemes for convertible debt, farsighted benevolent regulators, and any faith in resolution to capital, just more capital.”<sup>13</sup>

And the most recent expert to weigh in on the superiority of capital to long-term debt in protecting financial stability and avoiding bailouts has been Neel Kashkari, the president of the Federal Reserve Bank of Minneapolis. In a recent speech at the Brookings Institution, Mr. Kashkari suggested that perhaps large financial institutions should be required “to hold so much capital that they virtually cannot fail.”<sup>14</sup> During the subsequent question-and-answer period, Mr. Kashkari expressed doubt that bail-inable debt would be effective in absorbing losses because regulators might not be willing to convert this debt into equity in

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<sup>11</sup> Anat R. Admati, “Rethinking Financial Regulation: How Confusions Have Prevented Progress,” in Olivier J. Blanchard et al., eds., *Rethinking Macroeconomics III: Progress or Confusion* (forthcoming), available at <https://www.gsb.stanford.edu/sites/gsb/files/publication-admati-rethinking-financial-regulation.pdf>.

<sup>12</sup> John Cochrane, “Toward a Run-free Financial System,” in Martin Neil Baily and John B. Taylor eds., *Across the Great Divide: New Perspectives on the Financial Crisis* (2014).

<sup>13</sup> John Cochrane, “Challenges for Cost-Benefit Analysis of Financial Regulation,” *Journal of Legal Studies* (2014), available at [http://faculty.chicagobooth.edu/john.cochrane/research/papers/benefits\\_costs.pdf](http://faculty.chicagobooth.edu/john.cochrane/research/papers/benefits_costs.pdf).

<sup>14</sup> Neel Kashkari, “Lessons from the Financial Crisis: Ending Too Big to Fail,” Speech at the Brookings Institution (Feb. 16, 2016), available at <https://www.minneapolisfed.org/news-and-events/presidents-speeches/lessons-from-the-crisis-ending-too-big-to-fail>.

the midst of a crisis. Like other experts, Mr. Kashkari suggested that equity would be a simpler solution.<sup>15</sup>

Yet notwithstanding the consensus that Professor Cochrane describes, the Board's Proposed Rule does exactly the opposite: it relies on convertible debt, it is dependent on regulators doing the right thing in the midst of a crisis, and it depends on an untested resolution mechanism. To resolve a critical operating subsidiary, the Proposed Rule must rely on complex structuring arrangements between holding companies and their operating subsidiaries. Resolving a critical operating subsidiary will also require agreements to shift TLAC among these units. And regulators will have to find the courage to impose losses in the midst of a panic.

Rather than relying on these complex arrangements and discretion of regulators, the Board should instead raise capital requirements at both the holding company level and the operating subsidiary level. Raising capital requirements would make clear that losses will in fact be internalized by these institutions and their creditors rather than by the taxpayer.

Given the superiority of higher capital requirements to a combination of capital and long-term debt as a means of ensuring financial stability, Professors Cecchetti and Schoenholtz ask, "Why, then, did the FSB propose TLAC debt requirements rather than simply raising the requirement for common equity? The answer has to be that banks find debt less costly to issue." Because TLAC is a second-best alternative, Professors Cecchetti and Schoenholtz "encourage the [Financial Stability Board] and national bank regulators to push common equity requirements substantially higher, and to make sure that systemic risks don't migrate from better-capitalized banks to less resilient intermediaries. But, until they can do that, the new TLAC requirement is much better than nothing."<sup>16</sup>

Because the TLAC requirement is a second-best alternative, however, the Board should ensure that it is as robust as possible. Unfortunately, the Proposed Rule should be much stronger than it is.

***The Board should require greater minimum levels of TLAC, ensure that the stability-enhancing attributes of TLAC are not diluted, and require that the long-term debt that qualifies as TLAC be of sufficiently long maturity to improve financial stability.***

The biggest threat to global financial stability is that large, complex financial institutions fund themselves with too little capital to make them resilient in a financial crisis. As a result, unlike other companies that can safely fail and be reorganized in bankruptcy without requiring either bailouts or government-provided emergency lending facilities, large, complex financial institutions that fail cannot absorb their own losses without shifting

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<sup>15</sup> Jaret Seiberg, "More Pressure Rising to Break Up Mega Banks," Guggenheim Securities Policy Bulletin (Feb. 16, 2016).

<sup>16</sup> Stephen Cecchetti and Kermit Schoenholtz, "Bank Resilience: Yet Another Missed Opportunity," Money and Banking (Nov. 30, 2015), available at <http://www.moneyandbanking.com/commentary/2015/11/30/bank-resilience-yet-another-missed-opportunity>.

them to taxpayers. Professors Cecchetti and Schoenholtz have noted that reducing the frequency of financial crises would require banks to fund themselves with equity equal to 20% of their risk-weighted assets, which is twice the standard required under Basel III. They conclude that Basel III's capital requirements should have been set at 20% of risk-weighted assets, but the regulators failed to do this. Instead, Basel III set the minimum capital requirements at half this level.<sup>17</sup>

The world's largest banks thus remain critically undercapitalized and unable to withstand a shock as bad as the 2008 financial crisis. The obvious, simplest, and easiest solution to under-capitalization is to raise capital requirements. But as Professor Wilmarth points out, the Board's Proposed Rule allows systemically important bank holding companies to satisfy half of their TLAC requirements by using long-term debt in place of equity.

Professors Cecchetti and Schoenholtz note that the Proposed Rule further weakens the resilience of large, complex financial institutions in two ways. First, they note that in the Financial Stability Board's initial TLAC proposal, the minimum TLAC level was supposed to be between 16% and 20% of an institution's risk-weighted assets (excluding the additional equity buffers of up to 5% for the world's largest banks). Under the Financial Stability Board's initial TLAC proposal, the combination of equity and long-term debt increased the losses that a bank could withstand by two-and-half times than what a bank could withstand under Basel III. Second, the Proposed Rule allows financial institutions to hold each other's TLAC.

The Proposed Rule is thus significantly weaker than the Financial Stability Board's initial TLAC proposal:

Ignoring the daunting problems of actually using the TLAC debt—whether it will be possible to convert debt to equity without a bankruptcy/resolution proceeding—these numbers didn't look all that bad. Or, as an optimist might think, it could have been worse.

Well, now it is. **The regulators have watered down the new requirement in two ways.** First, the minimum TLAC requirement has been set at 16% as of 2019 and 18% as of 2022. Second, and more disturbingly, banks will be allowed to hold TLAC-eligible debt issued by other banks in an amount up to 10% of their own equity. The effect will be to reduce the effective loss-absorbing equity capital of the most systemic banks by up to 10%. Put

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<sup>17</sup> Stephen Cecchetti and Kermit Schoenholtz, "Bank Resilience: Yet Another Missed Opportunity," *Money and Banking* (Nov. 30, 2015), *available at* <http://www.moneyandbanking.com/commentary/2015/11/30/bank-resilience-yet-another-missed-opportunity>.

differently, a bank with a reported leverage ratio of 5% may have an actual loss-absorbing ratio in a systemic crisis of only 4½%.<sup>18</sup>

The Board should correct both of these problems. First, it should raise the minimum TLAC requirement to ensure that there is sufficient loss-absorbing capacity at systemically important bank holding companies to withstand a financial crisis as severe as the 2008 financial crisis according to the Financial Stability Board calculations. As the former Deputy Governor of the Bank of England and Harvard Professor Paul Tucker wrote,

A necessary condition for [bail-inable debt] to work is that financial groups maintain in issue a critical mass of bonds which can be “bailed-in” to cover losses and recapitalize a firm to the required equity level. In my view, regulators should require group holding companies to issue at least as much long-term debt as their equity requirement, *i.e.*, at least 10 percent of risk-weighted assets for the biggest groups, producing total loss-absorbing capacity (equity plus bonds) of over 20 percent *before* any operating liabilities would need to absorb losses.<sup>19</sup>

Second, the Board should simply prohibit banks from holding each other’s TLAC debt, rather than indirectly encouraging banks from investing in this debt by means of a capital charge. The reason for an outright prohibition is straightforward:

[T]he stability of a financial system requires that banks be barred from holding one another’s loss-absorbing liabilities in the same way that U.S. banks today cannot purchase bank equity. When cross-holdings of this type are allowed, stress will propagate quickly from one institution to the net through links that are unobservable by outsiders. Allowing banks to hold TLAC debt undermines the credibility of their capital buffers and creates a source of contagion.<sup>20</sup>

The Board should also strengthen its Proposed Rule by requiring that TLAC-eligible debt have a maturity of considerably longer than one-year. The former deputy director of the Consumer Financial Protection Bureau Raj Date has pointed out that bail-inable debt of “a finite life”—bonds that must be repaid at some date certain—“do not generate much stability in a crisis of indeterminate duration. Because they must be refinanced upon maturity, the bank’s more senior creditors must be mindful that liquidity will be drained

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<sup>18</sup> Stephen Cecchetti and Kermit Schoenholtz, “Bank Resilience: Yet Another Missed Opportunity,” *Money and Banking* (Nov. 30, 2015), *available at* <http://www.moneyandbanking.com/commentary/2015/11/30/bank-resilience-yet-another-missed-opportunity>.

<sup>19</sup> Paul Tucker, “Regulatory Reform, Stability, and Central Banking,” Hutchins Center on Fiscal and Monetary Policy at Brookings, Working Paper (January 16, 2014), *available at* <http://www.brookings.edu/research/papers/2014/01/16-regulatory-reform-stability-central-banking-tucker>.

<sup>20</sup> Cambridge Winter Center for Financial Institutions Policy, “Now More Absorbent! Five Principles to Make ‘Contingent Capital’ More like Capital, and Less Contingent” (Aug. 25, 2010), *available at* <http://www.bis.org/publ/bcbs174/cambridgewinter.pdf>.

from the firm to meet that repayment obligation.”<sup>21</sup> For that reason, Mr. Date has suggested that bail-inable debt consist of perpetual, non-cumulative bonds.

Martin Wolf makes a similar point: classes of debt with a definite maturity date create the risk of a “funding cliff.” And while debt with a one-year maturity date may meet the accounting definition and some legal definitions of “long-term debt,”<sup>22</sup> the one-year maturity date sets up the same “funding cliff” that occurred during the 2008 financial crisis, albeit with a longer duration. If a firm finds itself in financial distress as the long-term debt that constitutes TLAC comes due, creditors will refuse to roll over that debt as it comes due at the one year mark. The firm could thus find itself facing the same kinds of runs that it saw in the 2007-2009 panic: its creditors may not be able to run immediately, but they will run as soon as they can. Moreover, because the Proposed Rule allows financial institutions to hold the TLAC of other banks, those creditor runs will force these institutions to dump these instruments and sell off other assets, creating the same downward spiral that took place in the financial crisis.

If a bank finds itself approaching a point where the debt might be converted into equity—that is, if there is a chance that this debt will in fact be forced to absorb the institution’s losses—“the willingness to buy such securities might dry up completely.” Mr. Wolf concludes that these “funding cliffs” might be less of a problem if bail-inable debt “had very long maturities.” The irony, however, is this: the longer the maturity on bail-inable debt, the more that debt resembles equity. Mr. Wolf draws the inevitable conclusion: a maturity sufficient long to ensure that TLAC-eligible debt is in fact loss-absorbing and promotes financial stability “would merely make them more like equity. So why not just rely on equity?”<sup>23</sup>

***The Board should specify the circumstances in which TLAC will be converted into equity.***

TLAC—the idea that a financial institution should issue debt that can absorb losses and be converted into equity—is not a new idea. Vice Chairman Hoenig has pointed out that during the last financial crisis, trust-preferred securities were touted as a form of long-term debt that would be available to absorb losses in times of stress; however, during the crisis, these securities failed to serve as a buffer.<sup>24</sup> Like TLAC, regulators believed that these long-term debt instruments relieved the firms of having to fund themselves with capital, because these instruments provided an additional cushion against loss. Similarly, preferred stock was supposed to serve as a form of bail-inable debt, protecting senior creditors and

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<sup>21</sup> Cambridge Winter Center for Financial Institutions Policy, “Now More Absorbent! Five Principles to Make ‘Contingent Capital’ More like Capital, and Less Contingent” (Aug. 25, 2010), available at <http://www.bis.org/publ/bcbs174/cambridgewinter.pdf>.

<sup>22</sup> See Morgan Ricks, *The Money Problem: Rethinking Financial Regulation* 38-40 (2016).

<sup>23</sup> Professor Cochrane makes a similar point: “If bankruptcy-remote, [long-term bank debt] can become information-insensitive and hence potentially more liquid than equity. But current long-term debt is not long-term enough for either purpose. By having fixed maturities rather than perpetual coupons, it raises a rollover risk.” Cochrane, “Toward a Run-Free Financial System.”

<sup>24</sup> Thomas M. Hoenig, “The Relative Role of Debt in Bank Resiliency and Resolvability,” Remarks at the Peterson Institute for International Economics” (Jan. 20, 2016), available at <https://www.fdic.gov/news/news/speeches/spjan2016.html>.

depositors from losses. But as Mr. Date points out, preferred stock failed to absorb losses during the financial crisis:

[T]he availability of that hybrid-debt-equity layer of preferred stock should have added to senior creditors' and depositors' confidence that they would get their money back in a downturn, and thereby forestalled any panic-driven runs on the banks. In reality, though, hybrid capital did nothing of the kind. The preferred market failed in every important way: its pricing mechanism failed to discipline banks' risk-taking behavior (preferred stock tended to price relatively close to more senior debt, under the tacit assumption encouraged by the issuers and Wall Street alike, that banks would protect investors); it did not adequately absorb losses (banks continued to pay preferred dividends well after the magnitude of the crisis was clear); it created instead of mitigated systemic contagion between firms (because banks held large quantities of each other's hybrid's securities).<sup>25</sup>

Or as Better Markets Senior Fellow Robert Jenkins more succinctly put it, "TLAC is potentially a sound building block, but it is one that rests on a shaky foundation. . . . [V]arious forms of bank debt are deemed to be loss absorbing. Here the presumption is . . . that the authorities will have the guts to force losses on debt holders—they didn't last time."<sup>26</sup>

To ensure that TLAC truly is loss absorbing, the Proposed Rule should specify the conditions under which it will be converted into equity. As written, the only thing that the Proposed Rule has to say about the conditions in which long-term debt will absorb losses is the admonition that systemically important bank holding companies would be required to disclose that "their unsecured debt would be expected to absorb losses ahead of other liabilities."

However, unless the Board specifies the circumstances and mechanism by which this unsecured debt will absorb losses, the mere disclosure of this "expectation" that this debt will absorb losses will be insufficient to force would-be buyers of this debt to take this expectation seriously and price for risk accordingly. Avinash Persaud, nonresident senior fellow at the Peterson Institute for International Economics, has made this point:

During boom years when short-term risks appear low and this assessment is repeatedly validated over short periods of time, [short-term] investors will demand more bail-in securities, driving down their yield, encouraging their issuance, and enabling banks to expand their balance sheets and loan portfolios. Short-term investors, aware that they are not in a position to be

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<sup>25</sup> Cambridge Winter Center for Financial Institutions Policy, "Now More Absorbent! Five Principles to Make 'Contingent Capital' More like Capital, and Less Contingent" (Aug. 25, 2010), *available at* <http://www.bis.org/publ/bcbs174/cambridgewinter.pdf>.

<sup>26</sup> Robert Jenkins, "When Timidity Triumphs," Speech on the Occasion of the Annual Finance Watch Conference (Nov 17, 2015), *available at* [http://www.finance-watch.org/iframe/Events/151117\\_FW-conf/Robert\\_Jenkins\\_speech\\_to\\_Finance\\_Watch\\_Conf\\_When\\_timidity\\_triumphs\\_17\\_Nov\\_2015\\_FINAL.pdf](http://www.finance-watch.org/iframe/Events/151117_FW-conf/Robert_Jenkins_speech_to_Finance_Watch_Conf_When_timidity_triumphs_17_Nov_2015_FINAL.pdf).

converted into long-term equity investors, will try to preempt any change in the environment that suggests what was previously safe is no longer so.<sup>27</sup>

In other words, just because regulators “expect” that the holders of this debt will bear losses is no reason to think that the holders of this debt believe that they will. And experience has shown that they will, in times of crisis, aggressively lobby Congress and the regulators to avoid taking these losses. Compounding this problem, debtholders will often be pushing on open doors because too many regulators and policymakers agree that creditors should not take losses. For example, former Treasury Secretary Tim Geithner has made clear his view that creditors should not be required to suffer losses or a financial panic will be precipitated or exacerbated.<sup>28</sup>

As Joshua Rosner, a managing director with Graham Fisher & Company, testified to Congress:

Equity is Equity and there is no substitute. As long as the Federal Reserve retains any 13(3) emergency powers, one must expect that when a [too-big-to-fail] institution is imperiled or required to convert their contingent debt to contingent equity, the “too big to fail” institution will hold legislators and regulators hostage to the notion that such a conversion would cause a market panic and lead counterparties to pull secured lines and withdraw liquidity. This is not a hypothetical argument. It is a reality we suffered in the last crisis.<sup>29</sup>

One solution to this problem would be for the regulators to require that TLAC-eligible debt be converted into equity upon the occurrence of some objective trigger, rather than relying on the regulators’ discretion to require such a conversion. Doing so would allow regulators to credibly commit to imposing losses on this debt, and it would allow the would-

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<sup>27</sup> Avinash D. Persaud, “Why Bail-In Securities are Fool’s Gold,” Peterson Institute for Economics Policy Brief (Nov. 2014), available at <https://www.piie.com/publications/pb/pb14-23.pdf>.

<sup>28</sup> See generally, Timothy F. Geithner, *Stress Test: Reflections on Financial Crises* 518 (2014). Cf. Steve Randy Waldman, “Discretion and Financial Regulation,” *Interfluidity* (Nov. 13, 2009), available at <http://www.interfluidity.com/posts/1258156478.shtml> (“An enduring truth about financial regulation is this: Given the discretion to do so, financial regulators will always do the wrong thing. . . . Bad times, unfortunately, follow good times, and regulatory incentives are to do the wrong thing yet again. When bad times come, overoptimistic valuations have been widely tolerated. In fact, they will have become very common. . . . The miracle of competition ensures that many of the most important and successful banks will have balance sheets like helium balloons at the end of a boom. Then, like a pin from outer space, somebody somewhere fails to repay a loan. When this happens, bankers beg forbearance. They argue that the rain of pins will eventually pass and most of their assets will turn out to be fine. They ask regulators to allow them to write down assets gently, slowly, so that they can let ongoing earnings support or increase their regulatory capital. If that doesn’t work, they suggest that capitalization thresholds be temporarily lowered, since what good is having a buffer against bad times if you can’t actually use it in bad times?”)

<sup>29</sup> Joshua Rosner, Statement before the House Financial Services Committee Subcommittee on Oversight and Investigations, “Who Is Too Big to Fail: Does Title II of the Dodd-Frank Act Enshrine Taxpayer Funded Bailouts?” (May 14, 2013), available at <http://financialservices.house.gov/uploadedfiles/hhrg-113-ba09-wstate-jrosner-20130515.pdf>.

be buyers of this debt to better price it so that it reflects the risk that this debt would in fact bear losses.<sup>30</sup> But the Board's Proposed Rule says nothing about the trigger, or the conditions under which TLAC-eligible debt would be converted into equity. As a result, would-be investors have no way to price this debt and they have no reason to believe that it would be bailed in to absorb the losses of a failing financial institution. And there is nothing to constrain the regulators' discretion on whether to bail-in this debt or to find other ways to avoid imposing losses on these bondholders.<sup>31</sup>

In addition, regulators should specify that if this debt is converted, that the interests of the equity holders will be extinguished. The recent lawsuit by AIG shareholders against the U.S. government demonstrates both the unfairness and uncertainty that results when shareholders are left with a residual option on the assets of a recapitalized entity.<sup>32</sup> As Martin Wolf has pointed out, even though regulators cannot credibly commit to the no-bailout approach of liquidationism, "liquidationism is still quite correct on one thing: *shareholders should never be rescued*. There should also be a clear order of conversion of debt into equity in a well-defined resolution regime that allows financial institutions to continue to function."

The Proposed Rule should be explicit that shareholders will not be rescued. And it should also provide for a "clear order of conversion of debt into equity." These are crucial elements necessary to make the TLAC regime workable, but they are both missing from the Proposed Rule.

Even with these elements, the Proposed Rule still creates the possibility that rather than ending bailouts, it will shift them from one group to another. The Board contemplates that the long-term debt that will count towards TLAC will be held by pension funds and life-insurance companies. The problem is that in a democracy, asking pensioners to bear the losses from impaired long-term bank debt may prove to be politically unacceptable. As Mr. Persaud put it,

If pension funds suffered losses [on the long-term bonds they hold,] taxpayers would very likely be pressured into bailing them out. Given the greater

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<sup>30</sup> As analysts at Goldman Sachs have pointed out, debt that can be converted into equity "has emerged as possible solution to the 'too big to fail' problem. . . . While the underlying recapitalization function of contingent capital is relatively straightforward, 'why,' 'when,' and 'how' it operates can vary substantially." They also point out that "[t]he core feature" of convertible debt is "the 'trigger' that determines whether and when the debt converts to equity, or is written down, to recapitalize the financial firm." Goldman Sachs Global Markets Institute, "Contingent Capital: Possibilities, Problems, and Opportunities" (March 2011), available at <http://www.goldmansachs.com/our-thinking/public-policy/regulatory-reform/contingent-capital.pdf>. The "trigger" can be set up in several ways; however, the Proposed Rule is silent on the subject, which makes it impossible to assess its adequacy.

<sup>31</sup> See generally Alex Pollock, *Boom and Bust: Financial Cycles and Human Prosperity* 51-52 (2011) ("The standard pattern of bailouts is to protect the depositors, bondholders, and other creditors of the failing firm, while punishing the equityholders. . . . But shouldn't the lenders to failed firms have to share in the losses? . . . In principle, yes, investors in debt definitely should have to share losses, but government intervention usually means that they do not.")

<sup>32</sup> See, e.g., Matt Levine, "AIG Shareholders Still Want a Nicer Bailout," *BloombergView* (Oct. 10, 2014), available at <http://www.bloombergvew.com/articles/2014-10-10/aig-shareholders-still-want-a-nicer-bailout>.

fragmentation of the savings markets such a bailout will probably be even more complicated, messy, and politically sensitive than bailing out a handful of banking institutions.

The *Financial Times* painted the matter even more starkly: “Many investors in these [bail-inable securities] will be pension funds and insurers, so imposing losses on them could be politically uncomfortable. Imagine the headlines: My pension was wiped out to rescue greedy bankers.”<sup>33</sup> It is not a sign of progress to have traded one problem for an even more intractable one.

The solution is simple: if failure cannot be made tolerable, then banks must be made so that they cannot fail. Douglas Flint, the Chairman of HSBC, testified to the U.K. House of Lords that bail-in debt is

about *distribution* of the burden of failure; they are not about *avoiding* the burden of failure. At the end of the day, the burden of failure rests with society. Whether you take it out of society’s future income through taxation or whether you take it out through their pensions or savings, society is bearing the cost. . . . To say to people, “Never again will the taxpayer be called upon, because we will have hard-wired it into the pension system,” does not feel very comfortable.<sup>34</sup>

The way out of this dilemma is to realize that the Proposed Rule should be less about the “distribution of the burden of failure” and more about “avoiding the burden of failure.” The best, most direct way to avoid failure is to raise capital requirements.

## **CONCLUSION**

Better Markets supports the goals that underlie the Proposed Rule: large bank holding companies should be more resilient and better able to withstand crises so that taxpayers are never called upon to bail them out. Unfortunately, the Proposed Rule forgoes the simplest and most direct way of accomplishing that goal and instead relies on the same leverage, complexity, and regulatory discretion that helped bring about the financial crisis.

The Board should focus on raising minimum capital requirements rather than requiring the issuance of long-term debt. But if the Board believes that bail-inable long-term debt holds the solution to financial instability and crisis, it should make its long-term debt requirements stronger and clearer. It should raise the minimum TLAC level to at least 20% of risk-weighted assets. It should prohibit banks from holding each others’ TLAC-eligible

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<sup>33</sup> Martin Arnold, “The doubts that linger over solution to ‘too big to fail,’” *The Financial Times* (Dec. 8, 2014), available at <http://www.ft.com/intl/cms/s/0/3f0d8832-7edf-11e4-b83e-00144feabdc0.html>.

<sup>34</sup> Douglas Flint, Unrevised transcript of evidence taken before the Select Committee on the European Union Sub-Committee A (Economic and Financial Affairs), “Inquiry on Review of the EU Financial Regulatory Framework” (Oct. 21, 2014), available at <http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/eu-sub-a-economic-and-financial-affairs-committee/review-of-the-eu-financial-regulatory-framework/oral/14795.html>.

Mr. Robert DeV. Frierson

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debt. And it should specify the conditions and order in which long-term debt will be converted into equity.

Sincerely,



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