

The Systemic Risk Council

Secretariat of the Financial Stability Board
c/o Bank for International Settlements
CH-4002
Basel, Switzerland
fsb@bis.org

BY ELECTRONIC MAIL

February 2, 2015

Re: Consultative Document: Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in Resolution

Dear Financial Stability Board:

The Systemic Risk Council (the Council or we)¹ appreciates the opportunity to comment on the consultative document recently issued by the Financial Stability Board (the FSB) on the adequacy of the total loss-absorbing capacity (TLAC) of global systemically important banks (G-SIBs) in resolution (the Consultative Document).²

The Council has consistently supported requirements for G-SIBs to maintain robust levels of high-quality capital, whether in the United States or overseas.³ We have also supported efforts to strengthen the mechanisms available for the resolution or orderly liquidation of large, complex financial institutions should the need arise,⁴ pursuant to Title II of the Dodd-Frank Wall Street

¹ The independent, non-partisan Systemic Risk Council (www.systemicriskcouncil.org) was formed by the CFA Institute and the Pew Charitable Trusts to monitor and encourage regulatory reform of U.S. and global capital markets, with a focus on systemic risk. The statements, documents, and recommendations of the private sector, volunteer Council do not necessarily represent the views of its supporting organizations. The Council works collaboratively to seek agreement on each of its recommendations. This letter fairly reflects the consensus views of the Council but does not bind its individual members.

² Financial Stability Board, *Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in Resolution—Consultative Document* (Nov. 10, 2014), available at <http://www.financialstabilityboard.org/wp-content/uploads/TLAC-Condoc-6-Nov-2014-FINAL.pdf>.

³ See, e.g., Comment Letter of the Council to Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, et al. (Oct. 15, 2013), available at <http://www.systemicriskcouncil.org/wp-content/uploads/2013/10/Final-SRC-Comment-Letter-re-Leverage-Ratio-10-15-13.pdf> (October 2013 Letter); Comment Letter of the Council to Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, et al. (Oct. 4, 2012), available at <http://www.systemicriskcouncil.org/wp-content/uploads/2013/06/SRC-capital-comment-letter-10-3-12.pdf>.

⁴ See, e.g., Comment Letter of the Council to the Financial Stability Board (Dec. 1, 2014), available at <http://www.systemicriskcouncil.org/wp-content/uploads/2014/12/FSB-Cross-Border-Letter.pdf> (December 2014 Letter); Comment Letter of the Council to Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, (Jun. 7, 2013), available at <http://www.systemicriskcouncil.org/wp-content/uploads/2013/06/SRC-Ltr-Re-LTD-6-7-2013.pdf>, at 1 (June 2013 Letter).

Reform and Consumer Protection Act in the United States⁵ and comparable resolution regimes elsewhere. We commend the FSB for its attention to addressing the causes of financial instability and developing effective methods to combat the perception that certain large, complex financial institutions are “too big to fail.”

In the interest of facilitating the resolution of failed or failing G-SIBs, the Consultative Document proposes a strategy focused on four primary components:

- A proposed range for the size of the minimum TLAC requirement of 16-20% of risk-weighted assets and 6-8% of total assets or at least twice the Basel III leverage capital requirement, excluding any Tier 1 common equity used to meet any applicable capital buffer requirements;⁶
- Detailed criteria for the types of equity or debt instruments eligible to fulfill the minimum TLAC requirement;⁷
- Requirements relating to the “pre-positioning” of TLAC among the resolution entities and material operating subsidiaries within a G-SIB group;⁸ and
- Strong disincentives against the holding of G-SIB TLAC by internationally active banks, in order to contain the potential contagion effects of a G-SIB’s failure.⁹

We applaud these first steps toward the introduction of a global baseline TLAC requirement, and we write to highlight three key considerations that the FSB and financial regulators around the world should continue to bear in mind as they develop and refine methods of G-SIB resolution.

1. Sufficient Layer of “Thickness”

First, we encourage the FSB to insist that G-SIBs at all times maintain a layer of TLAC that is of sufficient “thickness” and accessibility to reassure financial markets, regulators, and the public that orderly resolution mechanisms for G-SIBs are credible. As we noted in our recent letter to the FSB, “important work remains to be done before financial markets, policymakers, and the public can feel confident that large, globally active financial institutions will be able to fail without destabilizing markets or needing taxpayer support.”¹⁰ An appropriately designed TLAC requirement in terms of both capital structure and size would reassure all constituencies that G-SIBs are resolvable without disruption or reliance on public funding and, consequently, are no longer “too big to fail.”

⁵ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 201 et seq., 124 Stat. 1376, 1442 (codified at 12 U.S.C § 5381).

⁶ Consultative Document, at 6.

⁷ *Id.*, at 7.

⁸ *Id.*

⁹ *Id.*, at 12.

¹⁰ December 2014 Letter, *supra* n. 4, at 1.

As we advocated in our June 2013 letter to the Hon. Ben S. Bernanke, then Chairman of the Board of Governors of the Federal Reserve System, the success or failure of a G-SIB resolution regime based on a “single point of entry” strategy, as proposed by the U.S. Federal Deposit Insurance Corporation, depends on the ability of the top-level holding company within a banking organization to absorb losses associated with the failure and fund the recapitalization of the surviving operating entities.¹¹ Thus, where resolution plans rely on single point of entry, it is essential that G-SIBs issue and maintain a substantial amount of long-term, unsecured debt at the holding company level and that investors clearly understand that such debt is at risk of loss or conversion in the event of failure. It is essential for investors to understand that these debt instruments are at risk of loss, just as is the case for Tier 1 common equity. Only in this way will regulators be able to secure the benefits of increased market discipline and appropriate pricing of risk from a robust TLAC requirement. At this time, no regulation or international guideline addresses the need for G-SIBs to maintain adequate levels of senior debt to allow for the rapid and complete resolution or liquidation of a G-SIB. We thus encourage the FSB to work closely with U.S. and other regulators to finalize the TLAC proposal and pursue its adoption in all relevant jurisdictions as soon as possible.

2. Non-Risk-Weighted TLAC Requirement

Second, we note that the FSB has proposed a hybrid approach to TLAC that would set minimum requirements based on both risk-weighted assets and total assets. As we stated in our letter to then Chairman Bernanke, “loss absorption and recapitalization capacity . . . should be based on total (non-risk-weighted) assets.” The Council has elsewhere discussed the severe shortcomings of excessive reliance on risk-based capital requirements. Risk-weightings are complex, rife with exceptions and carve-outs, retrospective, tainted by various biases, and subject to the inherent difficulty of economic forecasting. Over time, favored asset classes become dramatically over-represented and over-leveraged on financial institutions’ balance sheets. During financial crises—precisely when the greatest need exists for confidence in the loss-absorbing capacity of financial institutions—the risk models supporting favorable risk weightings routinely fail. So-called “advanced approach” risk weighting, which relies on large financial institutions to perform their own risk modeling, magnifies the problem by reducing transparency and comparability among institutions. By contrast, simpler leverage ratios based on total assets are more easily understood, comparable among financial institutions, market-oriented, and more difficult to “game.” We therefore urge the FSB to base the TLAC requirement primarily on a substantial leverage ratio based on non-risk-weighted total assets.

3. A Floor, Not a Ceiling

Third, we remind the FSB that the Consultative Document, when finalized, should be a floor and not a ceiling for the TLAC requirements that national regulatory authorities around the world ultimately set for their own countries. We encourage national regulatory authorities, including the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance

¹¹ June 2013 Letter, *supra* n. 4, at 1.

Corporation in the United States, to consider imposing minimum leverage and risk-based capital requirements above and beyond the levels set forth by the FSB. Those requirements should reflect the level of equity losses incurred by G-SIBs during the 2008 financial crisis and the potential realization of “tail risk” in the future.

Respectfully submitted,

A handwritten signature in blue ink, reading "Shate C. Bai". The signature is enclosed in a thin black rectangular border.

The Systemic Risk Council
www.systemicriskcouncil.org

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