



February 2, 2015

Financial Stability Board
Attn: Secretariat to the Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Re: Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in Resolution, Consultative Document, November 10, 2014.

Ladies and Gentlemen:

Better Markets¹ appreciates the opportunity to comment on the above-captioned consultative documents (the “Consultative Document”) of the Financial Stability Board (“FSB”).

INTRODUCTION AND SUMMARY OF COMMENTS

On September 2, 2013, the FSB prepared a report to the G-20 on “Progress and Next Steps Towards Ending ‘Too-Big-To-Fail.’”² The report noted that the “G-20 Leaders called on the FSB to propose measures to address the systemic and moral hazard risk associated with systemically important financial institutions (“SIFIs”). SIFIs are institutions of such size, market importance, and interconnectedness that their distress or failure would cause significant dislocation in the financial system and adverse economic consequences.”³

The report outlined a broad range of actions that must be taken by the G-20 authorities for ending the problem of too-big-to-fail financial institutions. The report “identified a number of issues that remain to be addressed for authorities and market participants to have confidence that resolution strategies and plans can be implemented in practice.”⁴ The FSB noted what it considered key issues, which included “the availability of GLAC (“gone concern loss absorbing capacity”) in sufficient amounts and at appropriate locations; the ranking of claims in the creditor hierarchy and implications for resolution; the cross-border

¹ Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking processes associated with domestic and international financial reform.

² Financial Stability Board, *Progress and Next Steps Towards Ending “Too-Big-To-Fail”* (Sept. 2, 2013).

³ *Id.*

⁴ *Id.* at 13.

enforceability of resolution actions, including on “bail-in”⁵; . . . [and] the operational continuity of critical services and market access of firms in resolution.”⁶

This comment letter addresses four categories of issues raised by the FSB: the availability of TLAC “(total loss-absorbing capacity)” for loss absorption and recapitalization in the resolution of cross-border groups; transparency; limitation of contagion; and market impact and other aspects.

With respect to the availability of TLAC for loss absorption and recapitalization in the resolution of cross-border groups, the comment letter raises questions about who determines the criteria for TLAC availability, how they do so, and the binding nature of those solutions vis-à-vis domestic bankruptcy frameworks. The letter lists eight missing elements in the global coordination process that need to be addressed by global regulators. The comment letter also discusses the urgent need for reform in the structure and operations of Crisis Management Groups to ensure inclusiveness, transparency, and global acceptance of the TLAC agreements.

The FSB proposal on transparency and disclosure of TLAC instrument details is a welcome step to facilitate overall banking industry transparency and accountability. The comment letter makes practical recommendations on the focus of the disclosure requirements and technical aspects of disclosure dissemination. In particular, that includes public disclosure of the corporate structure of global systemically important banks (“G-SIBs”)⁷ as a prior and necessary step to fulfill the useful public disclosure of TLAC instrument hierarchy.

With respect to the risk contagion that TLAC might give rise to, the comment letter analyzes the potential holders of the TLAC instruments and presents cases of potential global, regional, and domestic risk contagion that the current TLAC proposal may facilitate. The comment letter proposes that executive compensation structures be linked to TLAC instruments to help to mitigate the moral hazards associated with this instrument.

Finally, the comment letter addresses considerations of liquidity versus loss-absorption capacity in the context of G-SIBs recovery and resolution. Liquidity capacity should be an integral part of the TLAC framework if TLAC is to be a credible instrument for G-SIBs recovery and resolution. Whether liquidity capacity is achieved via some version of TLAC resolution and recovery liquidity buffers or Lender of Last Resort liquidity assistance to solvent entities, this topic needs to be discussed in public forums. This letter provides an overview of both approaches to liquidity provision to facilitate public discussion on this regulatory policy question.

⁵ *Id.* The FSB provided a footnote regarding “bail-in” stating that “legal certainty around the cross-border enforceability of bail-inable instruments is a condition to support market acceptance and interest for international issuance of this type of instruments, thereby facilitate the consideration of the issuance of sufficient amounts of GLAC for institutions that operate on a global scale.”

⁶ *Id.*

⁷ The FSB identified as global SIFIs (“G-SIFIs”) an initial group of global systemically important banks (“G-SIBs”), using a methodology developed by the Basel Committee on Banking Supervision.

BACKGROUND

Origin and evolution of the loss absorbing capacity concept

The discussion of availability of funds to firms in resolution was initially introduced in an FSB policy discussion in October 2011 in the document “Key Attributes of Effective Resolution Regimes for Financial Institutions.”⁸ In September 2013, the concept of sufficient funding emerged under the term “gone concern loss absorbing capacity” (“GLAC”).⁹ The FSB committed to G-20 in that report to prepare proposals on the adequacy of G-SIFI loss absorbing capacity in resolution. In the FSB report of November 2014 to the G-20, the GLAC definition has been converted into the new “total loss-absorbing capacity” (“TLAC”) concept.¹⁰

TLAC is conceptually different from the previous GLAC approach. The TLAC objective is to provide sufficient resources for both reducing the probability of insolvency as well as supporting orderly resolution of insolvent entities, while GLAC was targeted to ensure “going concern” capital requirements only. The idea behind TLAC is to mandate a minimum level of equity and convertible debt that could be used by a G-SIB or its entities for either restructuring activities or bankruptcy. The TLAC funding would assure the capital needs of critical functions of a G-SIB that would allow successful recovery or orderly resolution.

Crisis management groups

Prior to the 2013 G-20 Too-Big-To-Fail report¹¹, and pursuant to the FSB’s “Key Attributes of Effective Resolution Regimes for Financial Institutions,”¹² the FSB set up Crisis Management Groups of home and key host authorities of FSB-designated global, systemically important financial institutions (“G-SIFIs”). The purpose of each Crisis Management Group is to coordinate the development and implementation of recovery and resolution procedures for designated global SIFIs. In the consultative document of October 17, 2014, “Guidance on Cooperation and Information Sharing with Host Authorities of Jurisdictions Not Represented on CMGs Where a G-SIFI has a Systemic Presence,” the FSB noted that for reasons of operational efficiency and effective decision-making, Crisis Management Group membership is limited to key authorities from jurisdictions that are home or host to entities that are material to an effective resolution of the firm. The FSB further noted that as a result, some jurisdictions where the operations of a firm are “locally systemic” may not be represented in the Crisis Management Group.¹³

⁸ Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions* (Oct. 2011).

⁹ Financial Stability Board, *Progress and Next Steps Towards Ending “Too-Big-To-Fail”* at 5 (Sept. 2, 2013).

¹⁰ Financial Stability Board, *Towards full implementation of the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions*, Report to the G20 on progress in reform of resolution regimes and resolution planning for global systemically important financial institutions (G-SIFIs) (Nov. 12, 2014).

¹¹ Financial Stability Board, *Progress and Next Steps Towards Ending “Too-Big-To-Fail”* (Sept. 2, 2013).

¹² Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions* (Oct. 2011).

¹³ The FSB Cross-Border Crisis Management Group is chaired by the Federal Reserve Bank of New York First Vice President, Christine Cumming.

The current FSB Consultative Document on TLAC states that “the calibration and composition of firm-specific TLAC requirements should be determined in consultation with Crisis Management Groups and subject to review in the Resolvability Assessment Process (RAP).”¹⁴ RAP’s are conducted by the home authority and coordinated within the Crisis Management Groups. At the same time, in its report to the G20 on progress in reform of resolution regimes and resolution planning for global systemically important financial institutions of November 12, 2014, the FSB noted that “to implement an orderly resolution, host jurisdictions need to be confident that there will be sufficient loss-absorbing and recapitalization capacity available to material subsidiaries in their jurisdictions. This requires legally enforceable and operationally workable mechanisms to be in place to facilitate the passing of losses incurred by material subsidiaries up to the entity that enters resolution through the conversion of internal TLAC and to facilitate the write-down and conversion of liabilities at the level of the entity entering resolution in order to generate the funds needed to support the recapitalization of its material subsidiaries for all resolution strategies.”¹⁵

Foreign resolution measures

The FSB consultative document of September 29, 2014, “Cross-Border Recognition of Resolution Action,” presented a number of scenarios “to provide examples of how effect can be given to foreign resolution measures by recognition or support mechanisms.” In particular, the FSB presented the scenarios that include the concept of a bail-in: a bail-in (write-down of liabilities) that imposes losses on creditors by writing down their claims in a distressed bank and a bail-in (conversion of debt-to-equity) that converts the claims of certain creditors into equity. Under the “write-down of liabilities” scenario, “the home resolution authority imposes losses on creditors by writing down their claims in a distressed bank that has a branch in another jurisdiction. The home resolution authority requests the relevant authority in the host jurisdiction to give effect to this measure.”¹⁶ The “conversion of debt-to-equity” scenario envisions that “the home resolution authority implements a bail-in measure in a bank that has a branch in another jurisdiction by converting the claims of certain creditors into equity, including creditors in the host jurisdiction whose claims are reflected on the books of the branch. The home jurisdiction requests the relevant authority in the host jurisdiction to give effect to this measure.”¹⁷

Objectives of loss absorbing capacity

The FSB suggests that “[TLAC requirements] should improve market confidence that each G-SIB can be resolved in an orderly manner, thereby improving the provision of credit globally, including in emerging market economies and those countries that are implementing the Key Attributes that are not home to G-SIBs.”¹⁸

¹⁴ Consultative Document, at 6.

¹⁵ Financial Stability Board, *Toward full implementation of the FSB Key Attributes of Effective Resolution Regime for Financial Institutions* at 7 (Nov. 12, 2014).

¹⁶ FSB, *Cross-border recognition of resolution action, consultative document* (September 29, 2014)

¹⁷ *Id.* at 19.

¹⁸ Consultative Document, at 6.

The TLAC instrument eligibility is limited to “liabilities that can be effectively written down or converted into equity during resolution of a G-SIB without disrupting the provision of critical functions or giving rise to material risk of successful legal challenge or compensation claim.”¹⁹

With respect to the location of TLAC within group structures, the FSB suggests that “authorities have to take into account their preferred resolution strategies and identify the entity or entities within a group to which resolution tools would be applied.”²⁰

Recognizing the risk of asset ring-fencing by authorities of material host subsidiaries, the FSB suggests that “a resolution entity should generally act as a source of loss absorbing capacity for its subsidiaries where those subsidiaries are not themselves resolution entities. The FSB proposes that subsidiaries located outside of their resolution entity’s home jurisdiction that are identified as material and that are not themselves resolution entities are subject to an internal TLAC.”²¹ The Consultative Document does not discuss the status of non-material subsidiaries or the situation when there is a disagreement about subsidiary materiality between the Crisis Management Group and host jurisdictions.

The FSB proposes an exemption to the TLAC requirements for G-SIBs that are headquartered in emerging markets. That suggests that three Chinese banks (Agricultural Bank of China, Bank of China, and Industrial and Commercial Bank of China Limited) among 30 banks designated by the FSB as G-SIBs as of November 6, 2014 will not be subject to the proposed TLAC requirements at least during the initial stage.²²

The FSB also suggests that G-SIBs must publicly disclose “the amount, maturity, and composition of TLAC maintained by each resolution entity and each material subsidiary.”²³

The FSB has invited comment on eight categories of issues raised in the Consultative Document:

- 1) Calibration of the amount of TLAC required;
- 2) Ensuring the availability of TLAC for loss absorption and recapitalization in the resolution of cross-border group;
- 3) Determination of instruments eligible for inclusion in external TLAC;
- 4) Interaction with regulatory capital requirements and consequences of breaches of TLAC;
- 5) Transparency;

¹⁹ Consultative Document, at 7.

²⁰ *Id.*

²¹ *Id.*

²² Financial Stability Board, *2014 update list of global systemically important banks* (Nov. 6, 2014).

²³ Consultative Document, at 21.

- 6) Limitation of contagion;
- 7) Conformance period; and
- 8) Market impact and other aspects

COMMENTS

1. Urgent reforms in the governance and structure of Crisis Management Groups are required to achieve meaningful pre-positioning of external and internal TLACs.

The FSB outlines in the Consultative Document that “a crucial consideration of a resolution strategy’s effectiveness is the availability of sufficient amounts of loss-absorbing capacity at the **right location(s)** within a G-SIB’s group structure.”²⁴ Furthermore, the FSB is cognizant that “a key objective of the new TLAC standard is to provide home and host authorities with confidence that G-SIBs can be resolved in an orderly manner and thereby diminish any **incentives to ring-fence** assets domestically.”²⁵ To provide confidence to the local authorities where G-SIB’s subsidiaries and branches are located, as well as to investors in the local subsidiaries and the holding company, the FSB proposes that authorities where the headquarters holding company is located as well as authorities where material subsidiaries and branches are located should calibrate and compose firm-specific TLAC requirements. Those calculations are proposed to be subject to the FSB Crisis Management Groups consultations and the FSB Resolvability Assessment Process review.

To evaluate the effectiveness of the FSB proposed approach to global authorities who are regulators to G-SIB entities, it is essential to understand the process of how TLAC is calibrated and where it is located and who is involved in the process. The implicit schema outlined by the FSB has the following steps:

- 1) The FSB collects information from the FSB authorities on the size and other economic parameters of their banks.
- 2) The FSB analyzes the data and makes determination of which banks it considers to be Globally Systemically Important Banks.
- 3) The FSB and the authority where a bank’s headquarter is located determine which subsidiaries of a G-SIBs are material.
- 4) The FSB sets up an FSB Crisis Management Group for a G-SIB and invites authorities from the bank’s headquarter location as well as the limited set of key authorities from jurisdictions where material subsidiaries of a bank are located.

²⁴ Consultative Document, at 7 (emphasis added).

²⁵ *Id* (emphasis added).

- 5) Crisis Management Groups are expected to develop an institution specific cooperation agreement on the recovery and resolution planning for a G-SIB and report it to the FSB.
- 6) Crisis Management Groups are expected to have in place a coordination and information-sharing process to facilitate the resolvability of a G-SIB and report the status to the FSB.
- 7) Any authority that is not a member of a Crisis Management Group but believes that a G-SIB subsidiary or branch has systemic importance in its jurisdiction should prepare an assessment of why such a subsidiary is materially important for that jurisdiction and provide such an assessment to an authority where a G-SIB headquarter is located.
- 8) The authority where a G-SIB headquarter is located should also take measures to identify authorities where a G-SIB may have local material presence and local authorities should provide the data for such analysis.
- 9) The authority where a G-SIB headquarter is located will make its own determination of the local materiality.
- 10) A home authority where a G-SIB headquarter is located will share the list of locally material G-SIB subsidiaries with the Crisis Management Group.
- 11) An authority where a G-SIB headquarter is located and authorities where locally material subsidiaries are located agree on arrangements for mutual cooperation and information sharing, which are tailored and appropriate for a particular jurisdiction. They should “reach an understanding of how they might support each other in a resolution and any conditions for that support.”²⁶ Furthermore, “as a prerequisite for the sharing of information, authorities need to demonstrate that they meet the standards set out in the Key Attributes.”²⁷
- 12) An authority where a G-SIB headquarter is located is supposed to make the review of locally material subsidiaries of the G-SIB on a regular basis.
- 13) The FSB conducts a review in the resolvability assessment process.

Despite multiple steps, this overall process has a number of critical gaps that could derail the whole cross-border recovery and resolution schema. With the absence of any dispute resolution or appeal mechanism, the process lacks transparency and inclusiveness,

²⁶ Financial Stability Board, *Guidance on cooperation and information sharing with host authorities of jurisdictions not represented on CMGs where a G-SIFI has a systemic presence* (Oct. 17, 2014).

²⁷ *Id.* at 5.

which are necessary for true global coordination on recovery and resolution of G-SIBS. In particular, the following elements of the global coordination process are missing:

- 1) Application and membership criteria for Crisis Management Groups;
- 2) Process of appeal and dispute resolution for rejected applications to the Crisis Management Group;
- 3) Process for assessment of local materiality of subsidiaries;
- 4) Process for appeal and dispute resolution of a refusal to consider a subsidiary locally material by an authority where a G-SIB headquarter is located;
- 5) Process for appeal and dispute resolution of a negative assesment of compliance with Key Attributes by an authority where a G-SIB headquarter is located;
- 6) Process for challenging a failure to cooperate or share G-SIB/G-SIFI information between authorities of local material subsidiaries and authorities where G-SIB headquarters are located;
- 7) Process for electon of authorities to conduct a G-SIB resolvability assessment process; and
- 8) Process for dispute of resolvability assessment process review by authorities where locally material subsidiaries are located and who are not members of the FSB.

Pursuant to the FSB's "Key attributes of effective resolution regimes for financial institutes," the FSB set up Crisis Management Groups of home and key host authorities of FSB-designated G-SIFIs. The FSB noted that for reasons of operational efficiency and effective decision-making, Crisis Management Groups' membership is limited to key authorities from jurisdictions that are home or host to entities that are material to an effective resolution of the firm. In its 2013 report to the G-20, the FSB recognized that the Crisis Management Group membership may not include "host authorities in jurisdictions where a G-SIFI has a systemic presence."

However, instead of undertaking the reform in the Crisis Management Groups to address a membership gap and include representatives of excluded jurisdictions where the entity has a major presence, the FSB is developing a system of eligibility determinations and types of information sharing for different participants. This is a counterproductive way to promote global agreement and buy-in into the TLAC framework and cross-border resolution actions that Crisis Management Groups were designed for. If some authorities are excluded from the groups because they are deemed not "key" enough to be present at the table to agree on TLAC calibration and cross-border resolution models, it is unlikely they will cooperate with authorities when the crisis event takes place. Instead, they will likely assume that because they are not significant on a global scale, their interests will not be considered in cross-border recovery and resolution activities of "major players." That will promote domestic ring-fencing,

collateral seizure, and similar activities that Crisis Management Groups are designed to prevent. The randomness of the Crisis Management Groups structure does not mitigate the probability of cross-jurisdictional legal disputes but likely increases them by harboring unsupported expectations.

Making matters worse, the current insufficiency or lack of cooperation and information sharing agreements between “key” and “non-key” authorities that oversee G-SIFIs also raises concerns regarding cross-border TLAC transferability in recovery, and it creates legal uncertainties in resolution activities. The efficiency of recovery and resolution activities is undermined when not all authorities overseeing a SIFI are engaged in the discussion and committed to the cross-border resolution agreement.

An international agreement for the TLAC global agreement and cross-border resolution is necessary to provide legal certainty to cross-border resolution actions and to ensure that all authorities have an opportunity to engage with and commit to the international resolution initiative. Moreover, without authorities from non-home and non-key host jurisdictions being engaged in the calibration of TLAC requirements and the development of the cross-border resolution regimes and coordinating resolution activities, the effectiveness of the cross-border resolution activities would be jeopardized. To achieve truly global cooperation and coordination of authorities in resolution and recovery of G-SIBs, an urgent reform to the framework of the Crisis Management Groups is needed. That reform should contain the following elements:

- 1) A formal legally binding international agreement must be developed for Crisis Management Groups with legally enforceable rights and responsibilities of their members..
- 2) Membership in Crisis Management Groups should be open to any authority that has any subsidiary/branch of a G-SIB in its jurisdiction (irrespective of its FSB membership) and who agrees to the requirements for Crisis Management Group membership.
- 3) Each Crisis Management Group should have an opportunity to set up a steering group composed of a smaller number of authorities to promote work efficiency. All members of the Crisis Management Group should have access to the documents and discussions of any steering group.

These immediate reforms to the inclusiveness and transparency of the FSB’s global coordination of authorities on recovery and resolution of G-SIBs is a prerequisite for meaningful discussions about the amount and location of the loss-absorbing capacity of G-SIBs.

Pre-positioning of internal TLAC by national authorities

As the FSB acknowledges in its October 17, 2014 document, “host authorities should be best placed to assess the systemic importance of a G-SIFI’s local operations in their own

jurisdictions.”²⁸ Consequently, all authorities which express interest in engagement on cross-border coordination initiatives should have the right and an opportunity to do so. The minimum condition for any authority to be accepted into the global resolution and recovery process should be the binding nature of its commitment to information sharing and coordination with other authorities, members of the Crisis Management Group. That will both limit the risk of a home country not fulfilling its commitments to host countries during a crisis and mitigate the risk of ring-fencing of local assets by host authorities.

One of the commitments of the members of the international recovery and resolution group should be an agreement on the process for calculating an internal TLAC for local or regional subsidiaries. The agreement should be accompanied by a framework for assessment of expected required liquid and capital assets necessary for a recovery and resolution of an entity at local or regional levels. Such an agreement will provide a basis for local authorities to decide the most efficient and effective way to structure local recovery and resolution regimes and to decide where the resolution entity should be located and what the minimum amount of TLAC capital should be.

An inclusive approach to such discussions will develop a framework for local authorities to decide whether they prefer to have local TLAC and associated costs or whether they have sufficient confidence in their partners to rely on TLAC assets on a regional basis. That will also allow local authorities to evaluate the advantages and disadvantages of locating TLAC assets at the local level or regional level and will allow reliance on already existing bilateral and regional agreements of regulators in determining the optimal size and location of internal TLAC.

Reliable approach to calibrated external TLAC

The most important aspect of this inclusive process is that it will allow a home authority to obtain a relatively reliable picture of the funding requirements for global recovery and resolution activities for a whole G-SIB and to accurately calibrate the size of the external TLAC. Adding up the locally validated amounts of required funding for various subsidiaries and branches of a G-SIB would appear to be the most reliable approach to calculating the total amount of TLAC required for the whole G-SIB group. At the same time, that will allow the home authority to evaluate how much bailing in will have to take place at the headquarter level if any of the subsidiaries experience a stress event. That would be the most accurate way to calibrate the external TLAC, supported by the “living wills” of G-SIBS in terms of execution of a recovery and resolution.

An additional benefit of this approach is that it allows for a complete legal analysis of the probability of legal outcomes of various recovery and resolution actions on various levels and identifies issues on local levels that need to be addressed for an effective and efficient resolution on either local, regional or global levels. That way the identification of a legal obstacle on each individual level will inform both local authorities and global authorities about

²⁸ *Id.*, at 2.

issues in resolution and recovery plans and lead to a set of solutions for overcoming each problem.

2. **TLAC instruments public disclosure must include G-SIB corporate structure and off-balance sheet exposures in addition to convertible debt creditor hierarchy.**

The transparency principle proposed by the FSB “requires disclosure of information on the hierarchy of liabilities on a legal entity basis for, at a minimum, all material legal entities, so that there is as much clarity as possible ex-ante about how losses are absorbed and by whom and in which order.”²⁹ This is a welcome step in advancing investor confidence and market discipline for the G-SIBs. However, in order to achieve the stated objective, first the FSB and global regulators need to ensure the transparency and public disclosure of the corporate structure of G-SIBs. It is hard to see how the transparency of the hierarchy of liabilities can be achieved if there is no transparency as to the corporate structure of G-SIBs.

The practical way to address this shortcoming is to require the public disclosure of the complete corporate hierarchy of a G-SIB that includes disclosure of not only all legal entities within the structure of a G-SIB but also all unincorporated entities such as branches that have separate books or similar economic conditions that are important in resolution. Additionally, such corporate hierarchy disclosure should include reporting of all on-balance sheets, off-balance sheets, and master agreements guaranteed by any G-SIB entity irrespective of the ranking in a guarantee. This is the first necessary step to establish an infrastructure where investors and regulators can see the ownership, control, and inter-relationships of each entity in a G-SIB group.

The next critical element of a public disclosure will be disclosure of the amount, maturity, and composition of all TLAC by any entity of a G-SIB as well as the ranking of each TLAC in a scenario of local, regional, and global resolution and recovery. Such public disclosure should be a required element for G-SIB annual reports and regulatory reporting. The FSB and global regulators should develop a standard set of terms and definitions to describe various relationships between G-SIB entities and require G-SIBs to disclose their corporate hierarchy as well as TLAC insolvency creditor hierarchy using the globally agreed and approved terms and definitions.

3. **TLAC contagion risk can be mitigated when executive management is required to hold those instruments as part of their non-salary compensation.**

The holders of bail-in debt could be very likely the exact parties that regulators are attempting to protect

There are three types of bank creditors:³⁰

1) Banking creditors – such as retail and wholesale depositors;

²⁹ Consultative Document, at 12.

³⁰ Emiliios Avgouleas and Charles Goodhart, *A Critical Evaluation of Bail-Ins as Bank Recapitalization Mechanisms* (July 2014).

- 2) Investment business creditors – such as swap counterparties, trading counterparties, and those with similar claims; and
- 3) Financial creditors – long-term creditors of the bank such as bondholders and other long-term unsecured finance providers.³¹

Under U.S. and UK models of bail-in, the financial creditors are the ones who will be exposed to potential write-downs. Jeffrey Lacker, the President of the Federal Reserve Bank of Richmond, remarked on this:

[I]t seems regrettable to have to identify one class of creditors that is eligible for losses, with the presumption being that all other receive support, rather than the usual approach of providing explicit government guarantees, such as deposit insurance, to some creditors and presuming that all others are at risk. Broad protection for many subsidiary creditors seems likely to weaken market discipline and exacerbate the too-big-to-fail dynamic that led to the crisis.³²

From the standpoint of public policy in the U.S. and UK, the ultimate ownership of the bail-in debt would determine the certainty and effectiveness of the bail-in process. Global regulators do not want banks to hold each other's bail-in debt by placing a limit on how much TLAC-eligible debt banks can hold. The preferred outcome for financial regulators is the holding of the bail-in instrument by the long-term holders, such as pension funds and life insurance companies. Those businesses have the balance sheet structure that makes them natural holders of long-term assets due to the inherent long-term liabilities they carry. The general sentiment is that short-term investors are the least preferred investor in this asset class because they do not have a long-term horizon for the investment and consequently will have no incentives to exercise the necessary due diligence and oversight of the banking operations, contributing to the escalation of the capital 'flight' and the spread of the contagion risk.

Contagion risk could be the result of a large number of potential simultaneous bail-ins by short-term holders of the bail-in debt.

The currently available data on ownership of the bail-in debt instrument, although scarce, sheds doubts on the certainty of the envisioned regime. Avinash Persaud, in the brief "Why bail-in securities are fool's gold,"³³ cites the BIS quarterly review and notes that "in the absence of the scrutiny that will come when one of these instruments is 'converted,' there is little information on who is buying them. Early indications suggest it is investors focused on

³¹ *Id.*

³² Jeffrey Lacker, Speech at 2014 National Conference of Bankruptcy Judges Annual Meeting, *Rethinking the Unthinkable: Bankruptcy for Large Financial Institutions* (Oct. 10 2014), available at https://www.richmondfed.org/press_room/speeches/president_jeff_lacker/2014/lacker_speech_2014_1010.cfm.

³³ Avinash D. Persaud, *Why Bail-In Securities are Fool's Gold* (Nov. 2014).

short-term gains, namely retail investors, private banks, and hedge funds, not the buyers regulators want.”³⁴

He further cautions that this short-term nature of the bail-in debt holdings could undermine the underlying idea of market discipline that bail-in tries to introduce. “Because they [short-term investors] are short-term in focus they will not, as it was hoped of holders of these instruments, invest in monitoring long-term developments and emerging concentration of risk. They will assume that they are not holding these instruments long enough for it to matter to them and anyway someone else is doing that.”³⁵ Angel Ubide confirms this argument by explaining that when an event changes perception of risk, short-term investors in these bail-in securities will trample over each other to reach the exit before bail-in.³⁶ This, in turn, will lead to the spread of the contagion risk.

The regulators may want to promote the bail-in debt to long-term investors but that also contains disadvantages. Charles Goodhart notes that “with a purely domestic bank, the effect of shifting from bail-out to bail-in will, therefore, primarily transfer the burden of loss from one set of domestic payers, the taxpayers, to another, the **pensioners and savers**.”³⁷ The same argument of shifting the losses from taxpayers to households was raised by Arthur Wilmarth, Professor of Law, George Washington University Law School, during the “Financial Stability After Dodd-Frank: Have We Ended Too Big To Fail?” conference in November 2014 in Washington DC.³⁸ This concern was only elevated when Moody’s and Fitch gave an investment grade rating to the bailable-in debt issued by HSBC.³⁹ This highlights the consequence of such a classification: the ability by pension fund and strict mandate asset managers to hold those securities when pursuing a reach-for-yield strategy.

Gregory Turnbull-Schwartz, a fixed income manager at Kames, cautions that “the rating agencies would have effectively colluded in getting yet another unsound investment product stuck into people’s retirement funds. Let’s hope that regulators are doing their job behind the scenes and that these do not end up in indices despite the rating agencies’ current lax approach to the matter.”⁴⁰ Ironically, this concern was echoed by the Chairman of HSBC, Douglas Flint, who told the House of Lords in October that:

“These [bail-in rules] are 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

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.*; see also Angel Ubide, *Anatomy of a Modern Credit Crisis*, Banco de Espana (2008).

³⁷ Emiliios Avgouleas and Charles Goodhart, *A Critical Evaluation of Bail-Ins as Bank Recapitalization Mechanisms* (July 2014) (emphasis added).

³⁸ Arthur Wilmarth, panel discussion at George Washington University *Financial Stability after Dodd Frank: Have We Ended Too Big to Fail?* Conference (Nov. 5, 2014), available at http://www.law.gwu.edu/News/2014_15_Events/Pages/FinancialStabilityafterDoddFrank.aspx.

³⁹ Nick Reeve, *Bond Manager Questions Rating Agencies Over “Unsound” Judgment*, CHIEF INVESTMENT OFFICER (Oct. 9, 2014), available at http://www.aio.com/channel/NEWSMAKERS/Bond_Manager_Questions_Rating_Agencies_Over_Unsound_Judgement.html.

⁴⁰ *Id.*

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."⁴¹

That starkly presents the public policy and public interests here.

When distribution of losses is analyzed in the cross-border context, the uncertainty concerns only get amplified due to "public policy grounds," as identified by the FSB in the Consultative Document. The experience of the Argentinian debt-restructuring provides a glimpse of potential issues that may unexpectedly appear during the restructuring process. Building on the IMF observation⁴² that a significant proportion of the costs of bank resolution could involve settling conflicts of interest among creditors, Charles Goodhart speculates that "this is particularly likely to be so in so far as bail-in will concentrate ownership amongst 'vulture' hedge funds, whose métier is the use of legal means to extract large rents."⁴³ In addition, one commentator pointedly warned that, "while the TLAC proposals contain sensible mechanisms to encourage cross-border co-operation in a banking crisis, the fact that the Chinese authorities are thus far sitting out the reforms does not bode well for global harmony."⁴⁴

The political viability of non-legally binding cross-border resolution cooperation is highly doubtful when pensioners and savers of the bail-in debt in the home country (most likely in the U.S. and UK) will take significant losses for failure of a subsidiary in a host country (which could be anywhere in the world). However, a re-designed incentives structure within the SIFI – where executives are required to hold the bank holding company equity and bail-in debt – might act as a mechanism to increase both internal policing and market discipline. Consequently, a regulatory requirement that any non-salary executive compensation at any part of the SIFI group should be awarded in the form of the bank holding company equity and bail-in debt should be considered.

4. Liquidity considerations deserve more attention for purposes of G-SIB recovery and resolution.

The objective of the Consultative Document is to define the sufficient level of loss absorbing and recapitalization capacity that is available to authorities "to implement an orderly resolution that minimizes any impact on financial stability, ensures the continuity of critical functions, and avoids exposing taxpayers to loss."⁴⁵ However the document seems to focus on the **sufficient capital** capacity necessary for a G-SIB recovery and resolution without also addressing the **liquidity** capacity necessary for effective recovery and resolution. Irrespective of whether the objective is to continue a banking group as a going concern or to

⁴¹ James Titcomb, *Mark Carney: No More Bank Bail-Outs*, TELEGRAPH (Nov. 10, 2014), available at <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/11220192/Mark-Carney-No-more-bank-bail-outs.html>.

⁴² Daniel C. Hardy, *Bank Resolution Costs, Depositor Preferences, and Asset Encumbrance*, IMF Working Paper 13/172 (July 2013).

⁴³ *Id.*

⁴⁴ Sam Flemming, *Ancient Regime of Bank Bailouts is Not Yet Confined to History Books*, FINANCIAL TIMES (Nov. 11 2014), available at <http://www.ft.com/cms/s/0/bf974972-6993-11e4-9f65-00144feabdc0.html>.

⁴⁵ Consultative Document, at 1.

maintain the critical operations of a group to allow orderly liquidation, material subsidiaries of a G-SIB will require immediate cash funding to continue operations.

Charles Goodhart, Emeritus Professor in the Financial Markets Group at London School of Economics, outlined in his recent article “Bank Resolution under T-LAC: The Aftermath” why sources of liquidity capacity will be an essential element for a G-SIB recovery and resolution:

“The overall strength of the banking group will have become undoubtedly impaired when the hold-co [headquarter holding company] is liquidated or drastically written down. The name and reputation of the bank will have been brought into question. The likelihood is that the initial reaction of both informed and uninformed investors (as with Northern Rock) will be to flee. In advance, no one can guarantee that this will not happen. Without protection from that eventuality in the guise of an associated commitment by the relevant Central Bank to provide sufficient lender of last resort (LOLR) support, the whole exercise stands at risk of failing disastrously in the first hurdle.”⁴⁶

Building a liquidity capacity provision into the TLAC framework could be an effective way to address the currently ambiguous situation about who will provide liquid assets to maintain critical operations of G-SIB entities and how they will do so. History demonstrates that markets (and regulators) frequently underestimate or misunderstand the liquidity risk and liquidity premiums of assets. The IMF December 2014 paper, “A Simple Macroprudential Liquidity Buffer,” noted that

[T]he liquidity properties of assets and liabilities can change abruptly during crisis periods; information amplifiers may render illiquid assets that are normally to be close substitute for cash, or subject even notionally long-term liabilities to ‘runs’.”⁴⁷

As Associate Professor at University of Notre Dame, Colleen Baker, addresses the same question from a liquidity pricing angle:

“Liquidity is not free. Liquidity risk is one of the fundamental risks in financial markets. All else being equal, liquid financial assets are less risky than illiquid ones and, therefore, worth more. Financial investors generally expect to receive a “liquidity premium” for illiquid financial assets. In the past, however, both economic and financial theories have sometimes treated liquidity as costless. And **international financial institutions have long mismanaged and mispriced liquidity risk.**”⁴⁸

That suggests that despite the best efforts to establish solid bail-in capital capacity and supply additional capital to a G-SIB through the conversion of bail-in debt into equity, this may

⁴⁶ Charles Goodhart, *Bank Resolution under T-LAC: the Aftermath* (Dec. 24, 2014).

⁴⁷ Daniel C. Hardy and Philipp Hochreiter, *A Simple Macroprudential Liquidity Buffer* at 5, IMF Working Paper (Dec. 2014).

⁴⁸ Colleen Baker, *The Federal Reserve as Last Resort*, 46 U. MICH. J. L. REFORM 69, 78 (2012) (emphasis added).

not be sufficient to ensure that the G-SIB has sufficient access to liquidity. In a traditional scenario of a bank run, a G-SIB may find that it has a shortage of cash and that liquidity premiums increase so much that immediate liquidation of its assets will challenge the institution's vitality. That suggests that liquidity availability should be addressed by the TLAC framework. There are two non-mutually exclusive approaches to mitigating the risk of lack of liquid assets in G-SIB during recovery and resolution.

Lender of Last Resort (LOLR)

The single point of entry bail-in mechanism for recovery and resolution of a G-SIB creates a structure where subsidiaries will be solvent irrespective of whether the original holding company remained or whether a bridge company assumed the role of a holding company. Given the solvency of G-SIB subsidiaries, it may be appropriate to develop an LOLR system that allows those subsidiaries to seek liquidity support from either central banks or reserve funds if there are complications in the cross-border recovery and resolution of a G-SIB or some operational problem. Such access to liquidity would be subject to collateral and claw-back requirements to ensure that public funds are not lost.

Providing assurances to the market that the solvent subsidiaries will have needed liquidity from a bank holding company, a bridge company, or an LOLR will allow both a G-SIB and regulators to focus on restructuring of a company and addressing cross-border coordination challenges and legal issues while subsidiaries have the necessary cash to maintain operations. Because cross-border coordination will be the primary issue in emergency liquidity provision to subsidiaries, there should be a clear framework among regulators on where liquidity will be provided during the recovery and resolution event. This pre-agreement on how short-term liquidity will be provided to different parts of a G-SIB during the transition period could be one of the most important steps to ensure that a viable restructuring can take place without permanent or long-term commitment of public money.

Paul Tucker from Harvard Kennedy School and Business School suggests that transparent stress testing and resolution regimes should provide for a credible lending policy via LOLR to solvent institutions:

"In the past, central banks faced a dilemma if the condition of an initially solvent firm deteriorated after LOLR support had been extended. Faced with that situation in the future, galvanized by the knowledge that the firm's plight will be revealed by a forthcoming stress test, central banks should withdraw support and put the firm into resolution. With termination of liquidity assistance credible, there will be stronger incentives for borrowers to use the time provided by LOLR support to fix their problems.

Conversely, once a fatally wounded firm has gone into resolution, the central bank should be prepared to grant access to its discount window provided it is satisfied that the resolution is delivering a reconstructed business that is sound. Post-resolution provision of liquidity assistance by the central bank can, therefore, be a more powerful signal that solvency and basic viability are being restored.

Central banks need to make that clear in public statements of their LOLR principles.”⁴⁹

This TLAC liquidity discussion also presents an opportunity to the evaluate pros and cons of an international lender of last resort as outlined by Stephen Cecchetti, Professor of International economics at the Brandeis International School of Business. Professor Cecchetti is explicit that foreign currency liquidity needs must be met and that management of shortages in foreign currency is needed.

“[T]he facilitation of cross-border transactions and the allocation of the associated risks inevitably require that banks provide liquidity insurance in foreign currency. In the vast majority of cases, this means dollar liabilities. Ensuring financial stability in such circumstances requires that, when they face a liquidity crisis, bank outside the United States have access to dollars. So long as the global financial system runs on dollars, something that is likely to be the case for some time to come, it is to the benefit of the United States that the Federal Reserve funds a way to provide such access.”⁵⁰

While it must be further discussed how best to deliver the necessary domestic and foreign currency liquidity support, such discussions need to take place now.

Liquidity buffers and reserve requirements

Professor Baker recommends a different approach to bank recovery and resolution liquidity capacity assurance, which is focused on minimizing pricing distortions via reforms that “reprice” relevant financial transactions.”⁵¹ She explains her reluctance to follow the LOLR route because of the inherent moral hazard problems:

“By providing a staggering amount of emergency liquidity to financial markets during the financial crisis, governments potentially contributed to further mismanagement and underpricing of liquidity risk. This is because such actions reinforced financial market expectations of central bank intervention. Title VIII’s [referring to the Dodd-Frank Act] new last resort lending authority risks similarly reinforcing financial markets’ anticipation of Federal Reserve assistance, especially if it is not an emergency authority. Few financial market participants likely believe that a too-big-to fail bank would be allowed to fail. Even fewer likely believe this in the case of a systemically important CCP. Therefore, given the inescapable tension between financial market stability and the creation of moral hazard, the best solution is likely to implement measures to minimize pricing distortions.”⁵²

An IMF December 2014 paper offers two approaches for liquidity capacity that promote the establishment of some version of macroprudential liquidity buffers or reserve

⁴⁹ BIS Papers No 79, *Re-thinking the lender of last resort* at 22 (Sept. 2014).

⁵⁰ *Id.* at 136.

⁵¹ Baker, *supra* note 48, at 120.

⁵² *Id.* at 119.

requirements. The rationale for using either of those two methods is illustrated by the IMF staff through the cross-border resolution and recovery process and spill-over effects:

“Supposed first that both home and host supervisors are confident that neither will ever ‘ring fence’ local liquidity, that is, that no authority would restrict the flow of liquidity, and also that no functioning parent bank would cut off funding to a subsidiary abroad. In that case, the coordination and mutual recognition of required MPLBS [Macroprudential Liquidity Buffer] would be unproblematic: the MPLB held by a subsidiary in jurisdiction A can count towards the fulfillment of the group requirements because all SLA [systemically liquid assets] are available to act as a buffer through the group.”⁵³

The IMF staff suggests that the holding company as well as its subsidiaries and branches should be subject to a liquidity ratio, by currency. Ensuring the availability of liquidity capacity for recovery and resolution of a G-SIB, and reaching explicit agreement among global regulators about how that liquidity will be provided to failing or critical entities, are essential steps for ending too-big to-fail in accordance with the single point of entry bail-in TLAC regime favored by the FSB.

Further discussion and analysis is necessary to determine which of the approaches outlined above is the most viable for liquidity assurance for recovery and resolution of a G-SIB within the TLAC framework. It is nonetheless vital that liquidity provision be an integral part of the international standard on total loss-absorbing capacity for global systemic banks and it should be addressed in the final proposal.

The liquidity capacity during resolution and recovery of G-SIBs should also be an essential part of the cross-border recovery and resolution actions of Crisis Management Groups and other international recovery and resolution bodies. Those bodies can analyze whether multilateral arrangement of central banks or a single international structure is most efficient when undertaking liquidity provision in a cross-border recovery and resolution. What is essential is that there is a clear understanding of the rights and responsibilities of central banks and financial regulators around the world as to when, how, and under what circumstances, if ever, they will provide liquidity support to recovering G-SIB and how this liquidity provision will be secured by them to ensure repayment.

CONCLUSION

This comment letter addressed four categories of issues raised by the FSB: the availability of TLAC for loss absorption and recapitalization in the resolution of cross-border groups; transparency; limitation of contagion; and market impact and other aspects.

With respect to the availability of TLAC for loss absorption and recapitalization in the resolution of cross-border groups, the comment letter identifies eight missing elements in the global coordination process that need to be addressed by global regulators. The comment letter also discussed the urgent need for reform in the structure and operations of the Crisis

⁵³ Hardy and Hochreiter, *supra* note 47, at 18.

Management Groups to ensure inclusiveness, transparency, and global acceptance of the TLAC agreements.

The FSB proposal on transparency and disclosure of TLAC instrument details is a welcome step to facilitate overall banking industry transparency and accountability. The comment letter recommends greater public disclosure of corporate structures, internal relationships, and hierarchies in G-SIBs.

With respect to the risk contagion that TLAC might give rise to, the comment letter analyzed the potential holders of the TLAC instruments and outlined the potential global, regional, and domestic risk contagion that the current TLAC proposal may facilitate. The comment letter proposed an executive compensation structure linked to TLAC instruments to mitigate the moral hazard associated with this instrument.

Finally, the comment letter addressed the focus on liquidity versus loss-absorption capacity in the context of G-SIB recovery and resolution. Liquidity capacity should be an integral part of the TLAC framework if TLAC is to be a credible instrument for G-SIBs recovery and resolution. Whether it is done via some version of TLAC resolution and recovery liquidity buffers or Lender of Last Resort liquidity assistance to solvent entities, this topic needs to be discussed in public forums.

We hope these comments are helpful.

Sincerely,



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