

The Systemic Risk Council

Submitted electronically

July 16, 2019

The Honorable Jerome H. Powell
Chair, Board of Governors of the Federal Reserve System
20th St. and Constitution Ave. NW
Washington, DC 20551

The Honorable Jelena McWilliams
Chair, Federal Deposit Insurance Corporation
550 17th St. NW
Washington, DC 20429

COMMENT BY SYSTEMIC RISK COUNCIL ON FEDERAL RESERVE AND FDIC PROPOSALS TO RELAX RESOLVABILITY REQUIREMENTS FOR US REGIONAL BANKS

Dear Chair Powell and Chair McWilliams,

In April 2019, the Federal Reserve Board and the Federal Deposit Insurance Corporation published proposals to relax resolution-planning requirements for the large regional US banks that are not globally systemic. These proposals followed as yet unfinalized plans from the Federal Reserve and the other US bank regulators to relax equity and liquidity requirements for essentially the same group of regional banks.

This letter sets out the Systemic Risk Council's main concerns about this package of proposals.

In a nutshell, the Systemic Risk Council (SRC) is concerned that these proposals are misdirected. The priority should not be relaxing resolution planning but,

rather, strengthening preparations for ensuring that all large regional banks could be resolved in an orderly way, minimizing spillovers to the economy and losses to the Deposit Insurance Fund. That is especially important at this phase of the business and credit cycle.

Summary of the April 2019 proposals to relax resolvability planning for large regional banks

There are two sets of proposals on resolution planning requirements. One, issued jointly by the Federal Reserve (Fed) and the Federal Deposit Insurance Corporation (FDIC), concerns the application of powers under Title I of the Dodd Frank Act to large banking groups. The other, issued solely by the FDIC, concerns resolution planning for large insured depository institutions (IDIs) (collectively, the “April 2019 Proposals”).

The joint Fed/FDIC proposals for large banking groups

The 2010 Dodd Frank Act initially required resolution planning for all banking groups with at least \$50bn of total consolidated assets. In 2018, the Economic Growth, Regulatory Relief, and Consumer Protection Act (Crapo Act) increased that threshold to \$250bn, but gave the authorities discretion to require resolution planning from banking groups with total consolidated assets of between \$100bn and \$250bn. Exercising that discretion, the banking regulators announced in October 2018 that they plan to tailor the application of prudential oversight, including resolution planning, according to a banking group’s size and scope. Specifically, US-domiciled banking groups with total consolidated assets of at least \$100 billion (large banks) would be divided into four categories:¹

- Category 1: US global systemically important banking groups (G-SIBs) and their subsidiary depository institutions;²

¹“Proposed Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements,” see below note 12, at 66,028.

² The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) granted the Fed the authority to identify and regulate U.S. banking organizations as G-SIBs (Globally Systemically Important Bank Holding Companies). See 12 U.S.C. § 5365. Pursuant to this authority, the Fed has developed a framework to determine whether a U.S. banking group that holds at least \$250 billion in total consolidated assets should be

- Category 2: at least \$700 billion in total consolidated assets (or at least \$75 billion in cross-jurisdictional activity);
- Category 3: at least \$250 billion in total consolidated assets (or at least \$75 billion in weighted short-term wholesale funding, nonbank assets, or off-balance sheet exposures);
- Category 4: all other large banking organizations with total consolidated assets between \$100 billion and \$250 billion.

In a memorandum accompanying the October 2018 consultation, the Fed reported that there are, respectively, eight, one, four, and eleven banking groups in those four categories.³

In April 2019, the Fed and FDIC jointly issued a notice of proposed rulemaking applying this framework to resolution planning requirements.⁴ The proposal is to reduce required resolution planning by banking groups in Categories 2, 3, and 4 compared to the current requirement that they file full resolution plans every year. In particular, a banking group in Category 2 or 3 would be required to file a full resolution plan only once every six years, with a thinner review every three years.⁵ As for Category 4 groups, the authorities propose to exercise their discretion, under the Crapo Act, not to require any filing of resolution plans at all.

designated as a G-SIB, which assesses the systemic importance of the group in question pursuant to five categories – size, interconnectedness, cross-jurisdictional activity, substitutability, and complexity. 12 CFR part 217, subpart H; *see also* “Regulatory Capital Rules: Implementation of Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Final Rule,” 80 FR 49,082 (August 14, 2015).

³ Memorandum from Vice Chairman for Supervision Randal K. Quarles to Board of Governors, “Notices of Proposed rulemaking to Tailor Prudential Standards” (October 24, 2018), at 16, available at <https://www.federalreserve.gov/aboutthefed/boardmeetings/files/board-memo-20181031.pdf>.

⁴ “Resolution Plans Required,” 84 Fed. Reg. 21,600 (proposed May 14, 2019). The proposal was publicly announced on April 8, 2019.

⁵ Under the proposal, Category 2 and 3 groups would be treated identically for resolution-planning purposes. They would formally file a resolution plan every three years, but those filings would alternate between full resolution plans and new “targeted resolution plans.” The Fed and the FDIC note in the release accompanying the proposal that they are “proposing the creation of the targeted resolution plan submission to strike the appropriate balance between providing a means to continue receiving updated information on structural or other changes that may affect a firm’s resolution strategy while not requiring submission of information that remains largely unchanged since the previous submission.” *Id.* at 21,608. A “targeted resolution plan” submission would include (i) the information that is required to be in a full resolution plan on capital, liquidity, and the filer’s plan for executing any contemplated recapitalizations; (ii) information on any sections of the full resolution plan where there have been material changes since the filer’s last full plan filing; and (iii) any other areas of interest identified by the Fed and the FDIC. *Id.* at 21,608-21,609.

The FDIC proposals for insured depository institutions

At roughly the same time, the FDIC issued an advanced notice of proposed rulemaking (ANPR) seeking views on whether it should relax its resolution planning requirements under the Federal Deposit Insurance Act for large IDIs (“IDI Rule”).⁶ This more cautious approach to reconfiguring the IDI regime allows public debate before FDIC decides whether or not to proceed with any notice of proposed relaxations.

At present, reflecting the original Dodd Frank threshold for the parallel banking-group regime, the FDIC requires IDIs with more than \$50 billion in total assets to submit resolution plans to it every year.⁷ In its ANPR, the FDIC seeks views on whether it should raise the threshold for IDI resolution planning obligations given the Crapo Act changes for banking groups. The FDIC also seeks views on whether it should move to requiring covered IDIs (CIDs) to submit full resolution plans only occasionally (every four or six years).⁸ More broadly, the FDIC asks whether it should substantially revise the IDI Rule to incorporate a risk-based approach to resolution planning, in which resolution planning requirements for each covered IDI would vary depending on the size, complexity, and risk profile of the organization.

SRC concerns, and proposals

The Systemic Risk Council (SRC) agrees with the general proposition that, so far as possible, the prudential requirements applied to individual firms, including resolution planning, should be tailored to the social costs that would be incurred by the economy and the public if a particular firm fails or becomes

⁶ Advanced Notice of Proposed Rulemaking, “Resolution Plans Required for Insured Depository Institutions with \$50 Billion or More in Total Assets,” 84 Fed. Reg. 16,620 (proposed April 22, 2019).

⁷ In practice, over the past few years the FDIC has extended the deadlines for plans to be filed, so that plans typically have been filed on a biennial basis. *See id.* at 16,627.

⁸ The FDIC does not propose a specific filing schedule in the ANPR, but seeks views on whether it should shift to a system in which individual CIDs are assigned to a biennial or triennial filing schedule based on size, complexity, or other characteristics. The FDIC also indicates in the ANPR that it is “considering a schedule in which the filing cycle would alternate between Resolution Plan submissions and further streamlined content submissions (focusing, for example, on a subset of informational requirements).” Taken together, these proposals would result in a schedule in which an IDI would – depending on whether it was classified as a biennial or triennial filer – only need to file a full resolution plan every four or six years. *See id.* at 16,627.

distressed.

Those social costs are incurred through the wider disruption caused by, for example, suspension of payments services, cuts in the supply of credit, and a heightened sense of risk, each of which can depress economic activity, jobs and asset values. They can occur when a banking business fails in a disorderly way, with spillovers either directly into the economy or indirectly via contagion through other firms that are similar to or inter-connected with the distressed firm (or both). Special resolution regimes exist to contain those spillovers to third parties and the wider economy (regionally or nationally) by preserving the continuity of essential services and delivering an orderly wind down of parts of the business that are not maintained *without taxpayers providing solvency support*.

The SRC is concerned that the Fed and the FDIC propose to ease resolution-planning requirements for some large regional banking groups and IDIs without first addressing whether all such firms could be resolved in a safe and orderly way with current techniques. Especially at this point of the “credit cycle,” the banking authorities should be more concerned about whether they could handle the failure of any of the affected institutions without contagion, regional economic disruption, and avoidable losses to the Deposit Insurance Fund.

Ensuring the resolvability of large banking groups that are not globally systemic

During the 2008/09 crisis, the FDIC deployed the resolution technique known as “purchase and assumption”, which involves transferring the insured-deposit liabilities of a failed depository institution, often with most other (uninsured) liabilities and assets, to a healthy third-party bank, and with any unsold liabilities and assets going into receivership.

Since the crisis, however, the FDIC itself has signaled material uncertainty about whether the same approach would work today:⁹

⁹ See *id.* at 16,622.

“The FDIC’s sole experience with resolving a failed institution over the current asset size threshold for a CIDI [Covered IDI], Washington Mutual Bank, involved an all-deposit P&A transaction that resulted in no losses to the DIF [Deposit Insurance Fund]. The availability of this low-risk, efficient resolution strategy cannot be assumed for future CIDI failures. The largest bank failure resolved by the FDIC without use of a P&A transaction was that of IndyMac Bank, a complicated resolution that caused significant losses for the DIF and posed considerable operational challenges. The overall risk profile associated with the size, complexity, and funding structure of some CIDs reduces the likelihood that they could be resolved through a P&A transaction, whether an all-deposit transaction or an insured deposit only transaction. Further, these factors also present significant challenges to conducting a resolution involving use of a bridge bank.”

That uncertainty is shared by experts in this field.

In contrast to the largest and most complex banking groups, the large regional banks have *not* been subject to new resolvability requirements imposed at the level of groups rather than IDIs.¹⁰ They have not been required to structure themselves to enable a group-level resolution; and, in particular, have not been made subject to formal requirements on Total Loss Absorbing Capacity (TLAC), which in effect mandate the issuance of a minimum amount of bonded debt (by the group holding company) that can absorb losses, in resolution, by being written down or converted into equity. That can be used to recapitalize a bridge structure and, so, maintain the business of operating subsidiaries, including IDIs.

If, by contrast, a large regional bank failed and could not be resolved in an orderly way, there could plausibly be a run on similar banks. If that occurred, the supply of credit and other services would be impaired, with wider costs to the regional or even national economy. Separately, in those circumstances, the losses to the FDIC’s Deposit Insurance Fund would likely be materially larger than would be incurred under an effective resolution of the IDI.

This is why the SRC is concerned about the Fed and FDIC proposals to relax resolvability-planning and testing requirements for large regional banks (at

¹⁰ Since the 2008/09 crisis, new plans have been developed by authorities in the US and internationally to resolve the largest and most complex banking groups (and some other financial groups) via what is generally known as single-point of entry (i.e. top-down) *bail-in* of bonds issued from group holding companies. Notice, *Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy*, 78 Fed. Reg. 76,614 (Dec. 18, 2013).

both group level and for IDIs), and to completely lift them for Category 4 banking groups. While there is now no statutory obligation to conduct resolution planning for banking groups with total assets below \$250bn, there is no statutory bar on doing so for groups with assets of at least \$100bn, and no statutory restrictions apply, crucially, to the FDIC's resolution-planning requirements for IDIs. In explaining how they plan to exercise their discretion, the authorities do not say whether (or how) they have satisfied themselves as to the resolvability of each affected banking group and IDI, or how they have satisfied themselves that there would not be socially costly contagion or other spillovers if, in the event of distress or failure, any such group or insured bank could not be resolved in an orderly way. The SRC is clear that the priority should be to enhance resolution planning, and that risks should not be taken with its effectiveness.

SRC proposal

The SRC recommends that the Fed and FDIC should not go ahead with their proposals to relax resolution planning for some large regional banks and to cease resolution planning for others unless both authorities are satisfied that the affected IDIs and banking groups could be resolved in an orderly way with a high degree of probability. Ideally, the authorities would give a public assurance of this, in respect of each affected banking business.

Second, SRC recommends that the FDIC and Fed should review whether new requirements are needed to ensure the resolvability of some IDIs and banking groups. Specifically, given the uncertainty about whether the purchase and assumption resolution technique could be used to resolve some large regional banks, SRC recommends that the banking regulators seriously consider applying the equivalent of TLAC requirements to such businesses, either at the level of the IDI or its holding company. If that were done, those IDIs could, if necessary, be resolved by bailing-in their subordinated debt securities.¹¹

¹¹ If the TLAC requirement were set at holding company level, a failing regional bank that could not be resolved in an orderly way via purchase and assumption could instead be resolved at the level of their holding companies, and so without the IDI going into resolution or bankruptcy. Among other options for effecting such a TLAC policy for large IDIs, firms could be incentivized to issue bonds that can be bailed-in through discounts on their deposit-insurance premiums.

The October 2018 Proposals to relax capital and liquidity requirements

Against this background, the SRC is also concerned about the proposals to relax capital and liquidity requirements for certain banking groups.

Summary of the proposals

Under the October 2018 Proposals, the prudential standards for US-domiciled banking groups would be tailored according to the four-category classification summarized above.¹² The regulatory capital and liquidity requirements for banking groups in Categories 1 and 2 would not change. Quantitative liquid-asset requirements would be relaxed for Category 3 banks, and abolished for Category 4 banks, which would be subject only to qualitative standards (even though such measures proved useless during 2007 and 2008). For capital regulation, a highly technical change is proposed which, in effect, would permit Category 3 and 4 banks to include certain types of unrealized gains in loss-absorbing equity for purposes of complying with minimum capital requirements.¹³

In a release that accompanied the October 2018 Proposals, the Fed estimated that the proposals would lead to a fall of 2.5% in the liquid assets held in aggregate by banks with total assets of \$100 billion or more.¹⁴ That implies that there would be a larger fall in the liquid assets of the Category 3 and 4

¹² There are two proposed new rulemakings. The first was jointly issued by the Fed, the Office of the Comptroller of the Currency (OCC), and the FDIC. "Proposed Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements," 83 Fed. Reg. 66,024 (proposed Dec. 21, 2018). The second proposed rule was issued by the Fed alone. "Prudential Standards for Large Bank Holding Companies and Savings and Loan Holding Companies," 83 Fed. Reg. 61,408 (proposed Nov. 29, 2018). Both proposals were announced on October 31, 2018.

¹³ Category 3 and 4 banks would be permitted to opt out of the requirement to incorporate most of the elements of "accumulated other comprehensive income" (AOCI) into regulatory capital. The incorporation of AOCI into capital calculations was done in large part to ensure that such calculations reflected an institution's unrealized gains and losses. Permitting Category 3 and 4 institutions to opt out of most of the elements of AOCI therefore would allow them to exclude their unrealized gains and losses from their capital calculations.

¹⁴ See "Proposed Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements," see above note 12, at 66,038-66,039.

banks affected by the proposals.¹⁵

SRC concerns

Other things being equal, reduced capital and/or liquidity requirements make the distress or failure of a bank or banking group more likely, and more costly when failure occurs.¹⁶ The SRC is concerned, therefore, that the Fed's consultative paper does not address whether the firms benefiting from the proposed deregulation could be liquidated without social costs and, if not, whether each of them is resolvable in an orderly way without government (taxpayer) solvency support.¹⁷

For the reasons given above, there is some doubt about this. SRC urges the Fed (and, where relevant, the other banking regulators) not to proceed with these deregulatory proposals unless they are fully satisfied that the authorities will be able to achieve an orderly resolution of the affected banks if they were to fail.

Conclusions

One of the biggest lessons of the great financial crisis of 2008/09 was that it is insufficient for the banking authorities to rely entirely on policies aimed at reducing the probability of individual firms failing. Since failure cannot be ruled out, it is also vital to be able to cope with failing firms in ways that contain social costs without resorting to taxpayer bailouts.

The Fed and the FDIC are proposing or contemplating relaxations of regulatory policy and, in particular, resolution planning when it is unclear that the

¹⁵ It was somewhat strange for the effect of the proposals to be reported in terms of all large banks rather than the two categories of banks that the Fed says will enjoy lower regulatory requirements. We infer that the percentage falls in liquid assets would be larger for such banks.

¹⁶ For those reasons, SRC has opposed the proposals to reduce the enhanced supplementary leverage ratio for the largest banks. See Letter from Sir Paul Tucker, Chair, Systemic Risk Council to Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System, and Joseph Otting, Comptroller of the Currency (Aug. 8, 2018), available at <https://4atmuz3ab8k0glu2m35oem99-wpengine.netdna-ssl.com/wp-content/uploads/2018/08/SRC-Comment-Letter-on-eSLR-and-Volcker-Rule-Aug-8-2018.pdf>.

¹⁷ Nor as far as we can tell, do any of the published responses to the October 2018 Proposals address this important issue.

affected banks and banking groups could be resolved in an orderly way. If ever a large regional bank failed and could not be resolved, the authorities might well face a choice between, on the one hand, material losses to the Deposit Insurance Fund and disruption of the regional or national economy and, on the other hand, a taxpayer bailout.

Given the uncertainties about whether the purchase-and-assumption resolution tool could be used effectively on large regional banks, the SRC urges the authorities not to relax their resolution-planning requirements, and not to relax capital and liquidity requirements. Further, the SRC recommends that the authorities should seriously consider introducing TLAC requirements, and also group-level resolution planning, for any regional bank where there is a material risk that the purchase-and-assumption resolution technique could not be applied effectively.

With so much focus on the very largest institutions since the crisis, it is unclear whether the banking authorities have planned and prepared adequately for the failure of large regional banks. A recent internal reorganization in FDIC might help with this. We also welcome the announcement that the banking regulators plan to look at whether there should be restrictions on regional banks investing in the bail-in able bonds of the largest banks.¹⁸

Plainly the authorities must maintain utmost vigilance on the globally systemic firms, but the SRC urges regulators also to focus on the resolvability of regional banks rather than on relaxing the prudential requirements applied to them.

Cc: Randal K. Quarles, Vice Chair for Supervision, Board of Governors of the Federal Reserve System
Joseph Otting, Comptroller, Office of the Comptroller of the Currency

¹⁸ See “Regulatory Capital Treatment for Investments in Certain Unsecured Debt Instruments of Global Systemically Important U.S. Bank Holding Companies, Certain Intermediate Holding Companies, and Global Systemically Important Foreign Banking Organizations,” 84 Fed. Reg. 13,814, 13,818 (proposed Apr. 8, 2019) (“While the systemic risk associated with banking organizations’ investments in covered debt instruments is greatest for large banking organizations, it is relevant for all banking organizations. . . . In order to strongly discourage smaller banking organizations from investing in covered debt instruments, the agencies intend to give further consideration on how to address these risks with respect to investments in covered debt instruments, as defined below, by non-advanced approaches banking organizations.”).

Systemic Risk Council Membership

Chair: Sir Paul Tucker, Fellow, Harvard Kennedy School and Former Deputy Governor of the Bank of England

Chair Emerita: Sheila Bair, Former Chair of the Federal Deposit Insurance Corporation

Senior Advisor: Jean-Claude Trichet, Former President of the European Central Bank

Senior Advisor: Paul Volcker, Former Chair of the Federal Reserve Board

Members:

Brooksley Born, Former Chair of the Commodity Futures Trading Commission

Baroness Sharon Bowles, Former Member of European Parliament and Former Chair of the Parliament's Economic and Monetary Affairs Committee

Bill Bradley, Former U.S. Senator

William Donaldson, Former Chair of the Securities and Exchange Commission

Peter Fisher, Tuck School of Business at Dartmouth, Former Under Secretary of the Treasury for Domestic Finance

Jeremy Grantham, Co-Founder and Chief Investment Strategist, Grantham May Van Otterloo

Richard Herring, The Wharton School, University of Pennsylvania

Simon Johnson, Massachusetts Institute of Technology, Sloan School of Management

Jan Pieter Krahen, Chair of Corporate Finance at Goethe-Universität in Frankfurt and Director of the Centre for Financial Studies

Sallie Krawcheck, Chair, Ellevest, Former Senior Executive, Citi and Bank of America Wealth Management

Lord John McFall, Former Chair, UK House of Commons Treasury Committee

Ira Millstein, Senior Partner, Weil Gotshal & Manges LLP

Paul O'Neill, Former Chief Executive Officer, Alcoa, Former U.S. Secretary of the Treasury

John Reed, Former Chairman and CEO, Citicorp and Citibank

Kurt Schacht, Managing Director, Standards and Advocacy Division, CFA Institute

Chester Spatt, Tepper School of Business, Carnegie Mellon University, Former Chief Economist, Securities and Exchange Commission

Lord Adair Turner, Former Chair of the UK Financial Services Authority and Former Chair of the Financial Stability Board's Standing Committee on Supervisory and Regulatory Cooperation

Nout Wellink, Former President of the Netherlands Central Bank and Former Chair of the Basel Committee on Banking Supervision

* Affiliations are for identification purposes only. SRC members participate as individuals and this statement reflects their own views and not those of the organizations with which they are affiliated.