The Systemic Risk Council

The Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Dear Chairman Bernanke:

The Systemic Risk Council\(^1\) has consistently supported stronger and higher quality capital requirements for our largest banking organizations. We also support the implementation of Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) that gives the Federal Deposit Insurance Corporation (FDIC) the authority to resolve a large complex financial institution (LCFI) should the need arise. Capital requirements and the orderly liquidation authority are powerful tools that address key aspects of “too big to fail.”

The FDIC, working in consultation with the Federal Reserve Board and international regulators, has developed an innovative strategy for the orderly resolution of a large, internationally active bank which involves seizing control of its holding company. In the event of an LCFI failure, the FDIC would use its authority as receiver to form a bridge financial company. The holding company’s shareholders and creditors would absorb losses associated with the failure, while some of their claims would be converted to equity to recapitalize the new enterprise.

However, the success of the FDIC’s orderly liquidation authority using this “single point of entry” strategy depends on the top level holding company’s ability to absorb losses and fund recapitalization of the surviving operating entities. Currently, we have no regulation that addresses the need for these firms to hold sufficient senior debt to meet this need. We agree with the increasing number of financial regulators at the Federal Reserve and FDIC and other experts that we need to address this gap in regulatory reform.

As you noted in your recent speech before the Federal Reserve Bank of Chicago, eliminating too big to fail is essential and regulators have a broad range of tools available to them, including requiring bank holding companies to have a “certain amount of senior debt.”\(^2\) Similarly, Vice

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\(^1\) 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. capital markets focused on systemic risk. The statements, documents and recommendations of the private sector, volunteer Council do not necessarily represent the views of the supporting organizations. The Council works collaboratively to seek agreement on all recommendations. This letter fairly reflects the consensus views of the Council, but does not bind individual members.

Chair Janet Yellen said recently that she “is not convinced that the existing SIFI regulatory work plan, which moves in the right direction, goes far enough” and that the Federal Reserve “is considering the merits of a regulatory requirement that the largest, most complex U.S. banking firms maintain a minimum amount of long-term debt outstanding.” Governor Daniel Tarullo has also recommended “ensuring the loss absorbency needed for a credible and effective resolution process” and suggested that “there is a clear need for a requirement that large financial institutions should have minimum amounts of long-term unsecured debt that could be converted to equity and thereby be available to absorb losses in the event of insolvency.”

Earlier this year FDIC Chairman Martin Gruenberg testified on its progress in implementing the Dodd-Frank orderly liquidation authority saying, “… the approach we have been looking at would impose losses – actually wiping out shareholders, imposing losses on creditors, and replacing culpable management. In regard to creditors, it would be important to have a sufficient amount of unsecured debt at the holding company level in order to make this approach work.”

We strongly support your efforts to eliminate too big to fail and urge you to move forward with a rulemaking to require LCFIs to issue a minimum amount of long-term, unsecured debt at the top holding company level which investors will clearly understand is at risk of loss in the event of a failure. Even with tougher capital standards -- which we strongly support -- there is no guarantee that a large bank failure can be prevented in the future. Thus, it is imperative that losses incurred with the failure of an LCFI be absorbed by the firm’s own shareholders and creditors, and not be forced on other firms through special assessments, or worse, on taxpayers.

The senior, unsecured long-term debt must be issued at the top level holding company to eliminate the banking organization’s ability to game the requirement by redirecting its debt issuance to its insured depositories or other operating subsidiaries. The redirection of debt issuance to subsidiaries would impede the effectiveness of single point of entry resolution. The loss absorption and recapitalization capacity must reside at the top-level holding company and should be based on total (non-risk weighted) assets. In addition, to limit the contagion or domino effect of a LCFI insolvency, the debt must not be an eligible investment for any other LCFI or any other bank, nor should other LCFIs be permitted to write credit protection for, or have other real or synthetic exposure to, that debt.

A properly sized long-term debt cushion that meets these parameters would support the FDIC’s single point of entry resolution strategy and assure the markets that the LCFI is indeed resolvable and not too big to fail. The debt cushion could include a minimum subordinated debt.

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3 “Regulatory Landscapes: A U.S. Perspective,” remarks by Janet L. Yellen, Vice Chair, Board of Governors of the Federal Reserve System at the International Monetary Conference, Shanghai, China, June 2, 2013.


5 Testimony of FDIC Chairman Martin Gruenberg before the Senate Committee on Banking, Finance and Urban Affairs, Washington, DC, February 14, 2013.

6 Some experts have proposed a ratio of 30 percent of equity, subordinated debt, and unsecured long-term debt to total consolidated assets. See comment letter on the Federal Reserve Board’s Notice of Proposed Rulemaking to implement Sections 165 and 166 of the Dodd-Frank Act, signed by Sheila Bair, Senior Advisor, Pew Charitable Trusts; Simon Johnson, MIT Sloan School of Management and Senior Fellow, Peterson Institute for International Economics; Anat Admati, Graduate School of Business, Stanford University; and Richard Herring, Co-Director of the Wharton Financial Institutions Center, Wharton School, University of Pennsylvania; March 20, 2012.
requirement to offer some protection for senior bondholders. This would potentially provide a
more stable funding structure and greater market discipline as creditors would have the incentive
to closely monitor the riskiness of their respective investments. As investors would likely
require these LCFIs to pay somewhat higher premiums for the added debt, this approach could
have the added benefit of providing a strong incentive to reduce complexity, interconnectivity
and growth of these large, complex financial institutions through market forces.

Respectfully submitted,

[Signature]

The Systemic Risk Council
www.systemicriskcouncil.org

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Fellow, Brookings Institution
John Rogers, CFA, President and Chief Executive Officer, CFA Institute
Chester Spatt, Tepper School of Business Carnegie Mellon University, Former Chief Economist
of the Securities and Exchange Commission

cc: The Honorable Thomas J. Curry, Comptroller of the Currency
    The Honorable Martin Gruenberg, Chairman of the Federal Deposit Insurance Corporation