



February 17, 2016

Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Re: Consultative Document – TLAC Holdings

Ladies and Gentlemen:

The Clearing House Association, the Securities Industry and Financial Markets Association, the Financial Services Roundtable and the Institute of International Bankers (collectively, the “**Associations**”)¹ welcome the opportunity to comment on the Basel Committee on Banking Supervision’s (the “**Basel Committee**”) November 2015 *Consultative Document – TLAC Holdings* (the “**Proposal**”) addressing the treatment under the Basel III capital framework² (“**Basel III**”) of internationally active banks’ holdings of “total loss-absorbing capacity” (“**TLAC**”) instruments of global systemically important banks (“**G-SIBs**”). The Proposal addresses Section 15 of the term sheet included in the Financial Stability Board’s (“**FSB**”) *Principles on Loss-absorbing and Recapitalization Capacity of G-SIBs in Resolution and Total Loss-absorbing Capacity (TLAC) Term Sheet*, dated November 9, 2015 and prepared in consultation with the Basel Committee.

The Associations appreciate the importance of fashioning rules to reduce contagion risk³ that could arise from failures of large financial institutions. We also appreciate that excessive holdings by banks of G-SIBs’ TLAC, as contemplated by the FSB term sheet, could be a source of contagion risk

¹ See Annex 1 for a description of each of the Associations.

² Basel Committee, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (December 2010, rev. June 2011).

³ Although this comment letter follows the terminology of the Proposal and uses the term “contagion”, we submit that the more appropriate term in explaining the relevant risk is “interconnectedness”. As is the case here, “interconnectedness” risk occurs when Party B has a direct exposure to Party A. “Contagion” risk occurs when Party B has the same type(s) of risk, or is perceived as having the same type(s) of risk, as Party A.

and, accordingly, should be addressed. However, as the Basel Committee moves from the Proposal to its final approach to TLAC holdings after considering comments of interested parties (the “**Final Approach**”), it is important to recognize that the Final Approach’s treatment of holdings and cross-holdings of TLAC is only one of a number of tools that international regulators have implemented, including through the Basel Committee, to address contagion risk. Among the other tools are large exposure limits, reforms addressing derivatives (including requirements that most derivatives be cleared through central counterparties), and Basel III’s existing limitations on cross-holdings of regulatory capital instruments. The contribution of these other tools to addressing contagion risk should give the Basel Committee some comfort that a Final Approach incorporating modifications to the Proposal that we and others recommend will still be a robust and sufficient contribution to containing contagion risk.

We believe the Proposal is overly-broad in four main respects that should be corrected in the Final Approach, namely:

- The Proposal does not include an exemption for market-making activities. The Final Approach should. Failure to recognize an exemption for market-making activities works at cross-purposes with the self-evident need to ensure there is a sufficiently deep and liquid market in G-SIBs’ TLAC, particularly TLAC in the form of long-term debt securities (“**TLAC debt**”) that does not qualify as regulatory capital. The absence of an exemption for market-making activities will negatively impact the liquidity and (from the issuing G-SIBs’ perspective) price of TLAC debt, market efficiency, and G-SIBs’ ability to issue TLAC debt quickly, including in times of stress. Moreover, addressing holdings of TLAC debt by simply pulling them into Basel III’s required deductions for holdings of capital instruments is likely to impact the liquidity and marketability of regulatory capital instruments as well, particularly if holdings of TLAC debt are deducted from Tier 2 capital without an adjustment to the 10% of Common Equity Tier 1 (“**CET1**”) limitation in paragraphs 80-83 of Basel III on investments in the capital of banking, financial and insurance entities (collectively, “**financial institutions**”) that are outside the scope of regulatory consolidation and where the bank does not own more than 10% of the issued common share capital of the entity (“**non-significant investments in the capital of unconsolidated financial entities**”).
- The cross-holdings deduction should conform to the symmetric “like-for-like” principle of the Basel III capital framework’s corresponding deduction approach. Requiring G-SIBs and other banks to deduct holdings of G-SIBs’ TLAC debt from Tier 2 capital is unnecessarily punitive, particularly taking into consideration the fact that the Proposal is just one of a number of regulatory initiatives addressing contagion risk.
- In order to facilitate certainty for banks as to which of their holdings of G-SIBs’ debt instruments are subject to deduction, the Final Approach should eliminate the Proposal’s inclusion within deductible debt of instruments that rank *pari passu* with TLAC debt but themselves are not eligible for inclusion in TLAC debt.
- If the Final Approach retains the Proposal’s asymmetric approach to the TLAC holdings deductions, deducting holdings of TLAC debt that are not regulatory capital against Tier 2 capital, and particularly if it fails to include a broad market-

making exemption as recommended in the first paragraph above, Basel III's 10% CET1 threshold for non-significant investments in the capital of unconsolidated financial institutions should be increased.

We address below in Part I the importance of including a market making exemption, in Part II the importance of retaining Basel III's principled and symmetric like-for-like approach to deductions, in Part III the scope of G-SIBs' debt subject to deduction, and in Part IV the need to adjust Basel III's 10% CET1 threshold if the Final Approach does not take a symmetric like-for-like deduction approach or does not include a broad market-making exemption.

I. The Final Approach to deductions by holdings of other banks' securities – both TLAC debt and regulatory capital instruments – should include an exemption for *bona fide* market making. This is important to support the ability of G-SIBs to issue these securities as well as liquid markets in these securities.

The Associations believe the Proposal should be modified, and related amendments to Basel III should be made, to provide for a separate and specific exemption to permit banks, including G-SIBs, to engage in market-making activities in other bank's TLAC debt capital instruments. Although the Proposal is specifically focused on TLAC instruments, we urge the Basel Committee at the same time to re-consider Basel III's approach to market-making more broadly and not just limit its consideration to market-making in TLAC instruments.

Moreover, if notwithstanding our comments in Part II the Final Approach retains the Proposal's approach of deducting G-SIBs' TLAC instruments from Tier 2 capital, we urge the Basel Committee, when it re-considers the impact of Basel III's deduction provisions on market-making, to provide an exemption for G-SIBs' net holdings in a market-making capacity of their own TLAC. G-SIBs' securities affiliates are often the major market-makers in their own securities, including benchmark senior debt that qualifies as TLAC. Although we agree that net "own holdings" (including for market-making purposes) of TLAC should not count as eligible TLAC under national regulators' TLAC rules, the disqualification of own holdings from eligible TLAC is a given because such holdings are not external. It is excessively punitive to require G-SIBs to deduct own-holdings of TLAC from regulatory capital when they have already, albeit appropriately, been deducted from eligible TLAC.

Without a broader market-making exemption, the Associations are concerned that Basel III and the Proposal's amendments to Basel III would work at cross-purposes with one of the key, self-evident objectives of the Proposal, which must be to ensure that there is a sufficiently deep and liquid market in TLAC debt and capital instruments of G-SIBs to allow them to satisfy their respective capital and TLAC requirements. Recent market developments demonstrate the potential for substantial volatility and even disruption when markets become less liquid. Although the reasons for the current decline in liquidity may be debatable, there appears to be an increasing consensus that regulation has been a contributing factor. This makes it all the more important that regulators not create any additional restraints on the liquidity of these instruments. A broader market-making exemption for capital instruments and other securities of entities that are financial institutions within the meaning of paragraph 80 of Basel III in any event is necessary because, without a market-making exemption, what limited room there is for this sort of activity within Basel III's current deduction provisions will become increasingly constrained.

Currently Basel III provides that the aggregate net holdings of non-significant investments in the capital of unconsolidated financial institutions are not subject to any deductions from capital, provided that they represent less than 10% of CET1 of the relevant bank, net of certain required deductions and adjustments (the “10% threshold”).⁴ The calculation is made based on the net long position in each underlying exposure, although the ability to net exposures is limited. Any excess above the 10% threshold must be deducted from capital. The Basel Committee itself noted in the Proposal that “[o]ne of the aims of the Basel III deduction threshold is to permit a limited level of activity, such as market making, to occur without banks being subject to a deduction. Therefore, an issue that the Committee will consider as part of the consultation process is whether any adjustment to the existing threshold, set at 10% of a bank’s own common equity, is warranted.”⁵

Under the Proposal, however, an entirely new category of instruments – any TLAC debt – is subject to deduction. In the case of own instruments, the deduction is absolute, applying to 100% of holdings recognized as assets under applicable accounting principles. In the case of net holdings of TLAC debt of other banks that are G-SIBs, the deduction is subject to the 10% threshold.⁶ To avoid a deduction from capital under the Proposal, both a bank’s aggregate net holdings of capital instruments in the equity of unconsolidated financial institutions and its aggregate net holdings of TLAC debt must, together, still fit within the same 10% threshold.

Absent an exemption for TLAC debt or an expansion of the 10% threshold, G-SIBs’ and other banks’ current market-making activity in capital instruments would likely be curtailed in order to free up capacity under the 10% threshold for market-making activity in TLAC debt or *vice-versa*. Either way, without (i) a broader market-making exemption or (ii) an expansion of the existing deduction threshold and/or a more appropriate approach to netting, the Proposal’s inclusion of net holdings of TLAC debt in the aggregate amount of holdings subject to the 10% threshold will have the effect of either constraining market-making capacity in the very same eligible TLAC debt that G-SIBs must issue and maintain outstanding to meet their TLAC requirements or in the capital instruments of a broader range of financial institutions.

The Associations note that the Basel Committee’s recent final standard addressing capital requirements for market risk specifically contemplates that national banking supervisors may establish a market-making exemption for holdings of other firms’ capital instruments held in the trading book: “Where a bank demonstrates that it is an active market-maker, then a national supervisor may establish a dealer exception for holdings of other banks’, securities firms’, and other financial entities’ capital instruments in the trading book.”⁷ In light of the critical need for deep and liquid markets in not

⁴ Basel III ¶¶ 80-83.

⁵ Proposal at p.3.

⁶ Although under Basel III in its current form for cross-holdings of capital instruments, holdings of capital securities of other banks where the investing bank owns more than 10% of the investee bank’s common equity are subject to a 100% deduction for the investing bank, we are not specifically addressing market-making in that context in this letter because of the unlikelihood that any bank (particularly a G-SIB) would own more than 10% of the common stock of another G-SIB.

⁷ Basel Committee on Banking Supervision, Final Standard, *Minimum capital requirements for market risk* ¶ 5 (Jan. 2016).

just TLAC debt of G-SIBs, but also the capital instruments of a broad array of regulated and even unregulated financial institutions, the Associations support the modification of Basel III to provide for a blanket exemption for dealing and market-making activities. The benefit of a market-making exemption would be to preserve (rather than hinder) the liquidity for both TLAC debt as well as regulatory capital securities, all of which are important loss-absorbing instruments.

II. The Final Approach to TLAC holdings should conform to the symmetric like-for-like principle of Basel III's corresponding deduction approach.

Basel III's corresponding deduction approach is symmetric and sound as a matter of principle – an investing bank deducts covered investments in capital securities of an investee bank from the corresponding components of the investing bank's own capital stack. The Final Approach's treatment of TLAC debt should take an equally symmetric and principled approach. Required deductions of net holdings of an investee's debt should be deducted from corresponding components of the investor's debt – that is, TLAC debt in the case of G-SIBs, not Tier 2 capital.

The Basel Committee proposes an asymmetric approach that would apply deductions to Tier 2 capital and comments on the considerations that led to its proposal. The Proposal's approach forces banks to treat holdings of TLAC debt as worthless assets – a write-off – for regulatory capital purposes. That approach is excessively punitive and unnecessary to address contagion risk.

The Basel Committee identified as its core concern with a true symmetric corresponding deduction approach – that is, one that would deduct investments in TLAC debt from the investing bank's issuances of TLAC (or, for non-G-SIBs, "TLAC-equivalent") debt – that "such an approach does not work well for non-G-SIBs, which will not be subject to the TLAC regime and so may not have sufficient TLAC resources available from which to apply deductions." The Basel Committee then goes on to list four factors that it identifies as benefits of its approach. Neither the Basel Committee's core sufficiency concern for non-G-SIBs, nor any of the four factors discussed in the Proposal, warrants the Proposal's asymmetric approach of deducting TLAC debt from Tier 2 capital.

First, we do not believe the Basel Committee's concern with the sufficiency of the amount of non-G-SIBs' TLAC-equivalent debt warrants an asymmetric approach. It is the case, of course, that, if a true corresponding deduction approach were applied (that is, debt-to-debt), a non-G-SIB would not suffer a regulatory consequence or sanction to the extent it had TLAC-equivalent debt against which it could deduct such net holdings because it is not required to maintain a specific amount of TLAC (whether as TLAC debt or otherwise) in the first place. But to the extent that a non-G-SIB's net holdings exceed its actual outstanding TLAC-equivalent debt, the excess would be required to be deducted in the ordinary sequence – first from Tier 2 capital, then from Additional Tier 1 capital, and then from CET1 – from the non-G-SIB's regulatory capital. Moreover, as noted in the introductory paragraphs to this letter, the Proposal is only one of a number of regulatory initiatives that address contagion risk; the Final Approach to cross-holdings does not need to eliminate any concerns by itself.

If the Basel Committee is concerned that that approach does not sufficiently disincentive non-G-SIBs from holding G-SIBs' TLAC debt, the Basel Committee should consider, as an alternative to a deductions approach for non-G-SIBs, requiring them to apply an appropriately conservative risk-weight to holdings of G-SIBs' TLAC debt, as contemplated by Section 3.2 of the Proposal. In Section 3.2, the Basel Committee seems to discount that alternative when it notes that "unless set at a level that is equivalent to a deduction, such an approach will not remove the double

counting of TLAC.” We do not understand the comment. There would be a double counting of required loss-absorbency for G-SIBs, which is what TLAC is, only to the extent TLAC is held by entities subject to a TLAC requirement—that is, other G-SIBs. In the case of non-G-SIBs, we believe the only concern is contagion risk. As noted in the introduction to this letter, the Proposal is only one of a number of regulatory tools that address contagion risk. Requiring a non-G-SIB to deduct net holdings of G-SIBs’ TLAC from its regulatory capital to the extent such holdings exceed the non-G-SIB’s TLAC-equivalent debt, or applying a higher risk-weight to holdings of G-SIBs’ TLAC debt, are, in our view, appropriate and more proportionate responses to the risk the Proposal should be addressing – contagion risk.

Second, addressing each of the Basel Committee’s four factors:

The first factor is that, because Tier 2 capital is normally more costly for an issuer than debt, “the approach can be expected to provide sufficient disincentive for banks to invest in TLAC, thus reducing potential contagion from the failure of a G-SIB.” We support reasonable measures to limit contagion risk. However, we do not believe this measure is necessary. As to non-G-SIBs, the potential for a deduction from Tier 2 capital if the non-G-SIB’s own debt is less than the deductible holdings, or a higher and appropriately conservative risk-weight, should act as a sufficient disincentive to a non-G-SIB from holding excessive amounts of covered BHCs’ covered debt securities. Moreover, the amount of covered BHC debt they can purchase in any event is limited by investment and lending limits in applicable laws and regulations. If national regulators are concerned that non-G-SIBs may nevertheless hold excessive amounts of G-SIBs’ TLAC debt, we encourage them to consider more apt and less regimented alternatives, such as explicit supervisory guidance on appropriate amounts of holdings of such securities. As to G-SIBs, a true corresponding deduction approach that requires deductions of an investee G-SIB’s TLAC debt securities against the investing covered G-SIB’s debt securities, with its direct consequence on the investing G-SIB’s ability to satisfy minimum LTD and TLAC requirements, should in itself act as a sufficient disincentive to excessive holdings of other G-SIBs’ covered debt instruments.

The second factor is that “[e]ven in cases where banks do invest in TLAC, the Tier 2 they will need to maintain to absorb the deduction will help to reduce contagion from the failure of a G-SIB.” In other words, banks will be required to maintain more Tier 2 capital, reducing contagion once a failure occurs as opposed to facilitating orderly resolution of failed institutions. Required capital levels have increased dramatically compared to pre-crisis requirements, particularly for larger institutions, and the robustness of the instruments that qualify as regulatory capital has been substantially improved. We strongly believe that TLAC should not be used as an indirect or “back-door” approach to further increases in required capital levels.

The third factor is that the asymmetric approach “can be applied consistently by both G-SIBs and non-G-SIBs, thus avoiding the creation of any level playing field issues.” The core level playing field issue, of course, is that G-SIBs are subject to the TLAC requirement and non-G-SIBs are not. Given the importance of TLAC in facilitating orderly resolution of systemically important institutions and ending too-big-to-fail, we agree that the benefits of a properly fashioned TLAC requirement outweigh the burdens on G-SIBs of that non-level-playing field issue. We do not believe, however, that applying a true symmetric corresponding deduction approach, as we believe national regulators should, creates additional level playing field issues that warrant the asymmetric approach. G-SIBs are regulated differently in many important respects from other institutions; that is simply a given—the regulatory playing field is tilted against them. Addressing a secondary issue that results from that different regulation, and doing it as a level playing field issue in a way that results in undesirable albeit different

impacts on both G-SIBs and non-G-SIBs, in our view, does not correctly balance the considerations relevant to this issue.

The fourth factor is that the asymmetric approach “utilizes the current provisions of Basel III, meaning it can be implemented with minimal changes.” The symmetric approach that we believe the Basel Committee and national regulators should adopt also, of course, utilizes the current provisions of Basel III. Although its implementation would require more changes to Basel III than the Proposal’s asymmetric approach (essentially (i) the definition of a “TLAC debt” category in the capital rules that is not a component of capital but is used to implement a symmetric cross-holdings deduction approach, and (ii) a provision in national regulators’ TLAC rules requiring that a G-SIBs own eligible TLAC is reduced by its net holdings of TLAC debt), we do not believe they are extensive. They would merely involve expanding and supplementing the Proposal’s definition for TLAC debt to encompass equivalent securities for non-G-SIBs and use it in the waterfall of instruments against which deductions are applied.

III. Only holdings of TLAC debt included in G-SIBs’ reported eligible TLAC should be subject to deduction.

The Proposal, in language that it would add to Basel III as a new paragraph 77a, would apply Basel III’s deduction approach to a broad concept of TLAC holdings, defined as “direct, indirect and synthetic investments in the instruments of a G-SIB that qualify as TLAC (but that do not otherwise qualify as regulatory capital for the issuing G-SIB,” subject to specified inclusions and exclusions. One of the inclusions, in proposed clause (ii), is for instruments that rank *pari passu* with eligible TLAC (that is, *pari passu* with what we have defined as TLAC debt for purposes of this letter). Clause (ii) is responsive to the 5% exceptions allowance in the third paragraph of Section 11 of the FSB’s TLAC term sheet.

We believe clause (ii)’s inclusion of *pari passu* instruments should be deleted from the Final Approach, with the consequence that TLAC debt subject to deduction would exactly equal the TLAC debt G-SIBs include in and count (and we expect will report) as a component of their eligible TLAC, plus an equivalent amount for G-SIBs in emerging market jurisdictions that under the FSB term sheet are not yet subject to a TLAC requirement. We have three reasons for this view, as follows:

First, because eliminating clause (ii) will have the consequence of a G-SIB’s qualifying TLAC in the form of debt exactly equaling the amount subject to deduction, maintaining that equivalency will make it much easier to implement the principled, symmetric like-for-like deduction approach that we address in Part III of this letter. Somehow all banks – and not just G-SIBs – will need to know which of their holdings of G-SIBs’ debt are subject to deduction. The appropriate Pillar 3 approach to TLAC will be to require G-SIBs to publicly disclose their eligible TLAC and TLAC ratios, similar to Pillar 3 reporting of regulatory capital information. It would not be difficult for each G-SIB to disclose as part of that process a listing (including potentially by CUSIP) of TLAC debt instruments that as of the reporting date are included in its eligible TLAC.

Second, the amount of *pari passu* instruments affected by the deduction would be relatively small once TLAC rules in individual jurisdictions become fully effective. This is because of the specific requirement of Section 11 of the FSB’s TLAC term sheet, limiting liabilities within the exception to 5% of “the resolution entity’s eligible external TLAC”, and the fact that the exception is likely to be filled largely with operating liabilities. And again, as previously noted several times in this letter, the Final Approach to cross-holdings is only one of a number of regulatory initiatives that address contagion risk. Any exposure of a financial institution to another financial institution, including a non-G-SIB’s

holdings of G-SIBs' *pari passu* instruments, entails some degree of contagion risk. The Final Approach to cross-holdings does not need to eliminate any concerns by itself. The benefit of a certain and straightforward reporting regime, with G-SIBs disclosing as a Pillar 3 matter their eligible TLAC debt and other banks relying on those reports to implement the Final Approach to cross-holdings, meaningfully outweighs, in our view, the potential contagion risk not captured by the Final Approach if, as we recommend, *pari passu* instruments are not covered.

Third, with respect to a bank's investments in a G-SIB's *pari passu* debt that does not qualify as eligible TLAC debt, it is unclear why the bank should be subject to the same potential partial or full deductions to "remov[e] the double counting of capital, which can act as a significant source of contagion in the banking and financial sectors."⁸ If the issuing G-SIB cannot recognize these *pari passu* debt securities as eligible TLAC debt because they are deemed to be insufficiently loss-absorbing, the corollary is that the investing bank is less exposed to the risk of being bailed in and having to absorb losses of the issuing G-SIB that if it had invested in a capital instrument issued by the G-SIB. Yet the Proposal's deduction is the same, as if the bank had made an investment in a G-SIB's Tier 2 capital. The Associations believe that investments in *pari passu* debt of G-SIBs that do not qualify as eligible TLAC debt for G-SIBs pose no more than normal credit and market risk and thus should not be addressed by a new capital deduction but instead should be addressed by the existing Basel III rules' provisions for calculating risk-weighted assets for credit and market risk.

IV. If the Final Approach retains the Proposal's asymmetric treatment of holdings of TLAC debt, deducting holdings of TLAC debt that are not regulatory capital against Tier 2 capital, and particularly if it fails to include a broad market-making exemption as recommended in Part I of this letter, Basel III's 10% CET1 threshold for non-significant investments in the capital of unconsolidated financial institutions should be increased.

Basel III's 10% CET1 threshold for deductions of non-significant investments in the capital of unconsolidated financial institutions was derived and calculated premised on a symmetric corresponding deductions approach, where the only instruments giving rise to deductions were regulatory capital securities. Because Basel III does not currently include a market-making exemption, its 10% CET1 threshold did not take into account holdings by banks of any non-regulatory capital instruments of financial institutions, including TLAC debt. If the Final Approach retains the Proposal's asymmetric approach to the cross-holdings deduction, deducting net holdings of covered debt instruments that are not regulatory capital against Tier 2 capital, and particularly if it fails to include a broad market-making exemption as recommended in Part I of this letter, then the Basel Committee and national regulators should increase the 10% threshold and/or allow greater netting of long and short positions. As noted in the language from Section 2 of the Proposal concerning market-making that we quoted in Part I of this letter, the Basel Committee contemplated the need for re-visiting the 10% threshold in the context of market-making. We believe revisiting that threshold is necessary in any event, even absent the addition to Basel III's deduction provisions of a market-making exemption.

⁸ Proposal at p. 2.

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The Associations thank the Basel Committee for its consideration of our comments. If you have any questions, please do not hesitate to call John Court at 202-649-4628 (e-mail: john.court@theclearinghouse.org) or Carter McDowell at 202-962-7327 (e-mail: cmcdowell@sifma.org).

Sincerely,



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Annex 1 The Associations

The Clearing House

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Securities Industry and Financial Markets Association

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Financial Services Roundtable

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Institute of International Bankers

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