Imposition of SPOE and TLAC Requirements on Large Regional Banks is Unnecessary to Promote Financial Stability

Lauren Anderson, Katie Collard and Gonzalo Fernandez Dionis

June 30, 2022

Introduction

U.S. and global regulators emerged from the global financial crisis with a mission to solve the problem of global banking institutions that were "too big to fail." In response, jurisdictions across the globe enacted major financial regulatory reforms. In the U.S., the Dodd-Frank Act overhauled the prudential regulation of global systemically important banks (GSIBs) and provided regulators with new resolution powers. Through the Financial Stability Board (FSB) and Basel Committee, international regulators designed a new prudential framework to fortify banks against stress and developed new resolvability requirements to limit risk to the broader financial system in the unlikely event a GSIB did fail. The development of resolution planning requirements, the "single point of entry" (or SPOE) resolution strategy, and new total loss-absorbing capacity requirements (or TLAC) were key elements of the resolvability framework, ensuring that if a bank failed, it could do so in a safe and orderly way. These reforms were extremely costly, but regulators and the banking industry alike almost universally agreed they were both appropriate and necessary.[1]

As part of the post-crisis reforms, U.S. regulators also intensified resolution planning and other prudential requirements for non-GSIBs, including regional banks, but determined that GSIB-specific resolution requirements like TLAC and an SPOE resolution strategy were neither appropriate nor necessary for these banks.

Yet now, certain U.S. regulators are nevertheless suggesting that large regional banks should have to meet these GSIB-specific resolvability requirements. A key assumption underlying this suggestion seems to be that the only practical means of resolving a large regional bank would be to sell it to a U.S. GSIB.[2] This assumption is wrong. In reality, there would be several resolution options available to resolve a failing large regional bank. In fact, over the last decade, large regional banks and their holding companies have developed robust resolution plans demonstrating the feasibility of a range of resolution options and practically equipping the federal banking regulators to pursue them should it be necessary. To date, no federal banking regulator with resolution planning responsibility has determined that these plans are not credible.

The GSIB resolvability framework was built specifically for GSIBs to address the unique challenges and risks that would arise if one failed. This framework has stood unchallenged for the past decade with no intervening events that would suggest it should be extended more broadly to smaller, less systemic institutions lacking a significant global footprint. Imposing GSIB-specific resolvability requirements on domestic regional banks—the failure of which would not present the same financial stability issues—is unwarranted and would be unnecessarily costly.

THE RESOLUTION PLANNING AND PRUDENTIAL FRAMEWORK FOR LARGE REGIONAL BANKS GIVES REGULATORS APPROPRIATE AND REALISTIC FLEXIBILITY TO DETERMINE HOW TO RESOLVE THESE INSTITUTIONS.

The assumption that large regional banks could only be resolved through a sale to or a merger with another large institution is unfounded and contradicts longstanding agency practice.

The existing resolution plans of large regional banks and their holding companies demonstrate the feasibility of a variety of resolution options and practically equip the federal banking regulators to pursue them should it be necessary. Any assumption that the only option for resolving such an institution would be to sell it to a U.S. GSIB is unfounded and contradicts longstanding agency practice with respect to evaluating resolution plans.

[1] BPI's predecessor organization, The Clearing House Association, along with several other financial industry trade associations, supported the Financial Stability Board's efforts to create a TLAC requirement for GSIBs.
[2] *See* Acting Comptroller Hsu remarks in a May 16, 2022 speech at Brookings in which he stated: "The issue for large regional banks can be boiled down to a simple question: 'If one were to fail, how would it be resolved?' If the answer is: It would have to be sold to one of the four megabanks, then, I would posit, we have a financial stability problem." *See also* Acting Comptroller Hsu remarks at an academic conference at Wharton on April 1, 2022: "we have a problem" because "if a large regional bank were to fail today, the only viable option would be to sell it to one of the GSIBs," which could, over time, add to financial stability risk.

Under Title I of the Dodd-Frank Act, banking organizations with $250 billion in assets or that are otherwise in regulatory tailoring Categories I, II or III are required to submit plans for their orderly resolution under traditional insolvency regimes, including principally the U.S. Bankruptcy Code for nonbank companies and the Federal Deposit Insurance Act for insured banks. The FDIC and the Federal Reserve have responsibility for reviewing these plans, identifying any deficiencies and ultimately deciding whether a determination of "not credible" is to be made.

Similarly, banks with $100 billion or more in total assets must submit resolution plans to the FDIC separate and apart from the Title I plans under the FDIC's IDI (Insured Depository Institution) Rule. The plans submitted to the FDIC are for the resolution of the bank under the FDIA. Under this IDI Rule, the FDIC reviews the plans in consultation with the appropriate federal banking regulator for the covered IDI and its parent company. If, after consultation with the appropriate federal banking regulator, the FDIC determines that the resolution plan is not credible, the FDIC must notify the bank of the deficiencies and the institution must then submit a revised plan addressing such deficiencies.

The Title I resolution plans of top-tier BHCs with large regional banks generally provide for liquidation of the holding company through Chapter 11 bankruptcy and placement of the insured bank into a FDIC-led receivership. In many cases, the IDI resolution plans for the large regional banks themselves provide for at least two options: the sale of the bank to another institution, *or* the separation of parts of the bank's business and sales of those parts to multiple buyers.

Fundamentally, either of the IDI resolution options is viable, for two primary reasons. First, the vast majority of large regional banking organizations' assets and activities are typically concentrated in the insured bank subsidiary itself, meaning that the resolution proceeding would be concentrated in the FDIC receivership with few—if any—regulatory or judicial coordination issues that would typically result from multiple proceedings across different entities and jurisdictions. For example, the primary bank subsidiary accounts for more than 97% of the assets of each of the top three large regional banking institutions (U.S. Bancorp, Truist Financial Corporation, and The PNC Financial Services Group). Second, if a large regional bank were to fail, it is unlikely that losses would be so pervasive that there would not be discrete value packages that acquirers other than other large institutions would be interested in acquiring. Given regulatory and supervisory improvements since the global financial crisis, broad systemic failure of underwriting and risk management throughout a large regional bank's diversified portfolios is unlikely. Losses would more likely be concentrated in a particular portfolio, making it possible to isolate and effectuate a sale of the bank's valuable assets.

Separability analysis requirements built into resolution planning requirements demonstrate the feasibility of this option to combine or disaggregate portfolios and discrete "objects of sale" or "franchise components" as needed to allow the FDIC to dispose of various components in different ways. The FDIC could execute these options over the timeframe it deemed appropriate, whether a "resolution weekend" or a longer period after establishing a bridge bank or by leaving certain assets in the receivership to be packaged and sold at a later date while still being serviced.

Furthermore, the FDIC would be practically equipped, via the bank's resolution plan, with the information necessary to pursue this breakup option or whatever other resolution strategy was most appropriate given the cause of failure and prevailing market conditions. For example, the relevant resolution planning regulations and guidance include requirements relating to planning for operational continuity, mapping of business lines to critical functions, and separability analysis, among other topics. Firms must also provide detailed information on organizational structure, key personnel and management information systems so the FDIC would be able to meaningfully evaluate options and operate the bank as long as necessary to execute the chosen resolution strategy.

The prudential and resolution planning requirements implemented since the 2008 financial crisis have resulted in more resolvable institutions and have provided the information to execute a range of options in the event of a large bank failure. The suggestion that the only viable option would be a whole bank purchase and assumption transaction executed by a U.S. GSIB acquiror is inaccurate and should not serve as a basis for a major revision of the resolution framework applicable to these institutions. Those calling for the imposition of regional bank TLAC and SPOE requirements baselessly disregard the viability of options other than a whole bank sale and, in doing so, directly counter the judgments that the FDIC and Federal Reserve have repeatedly made over many years after detailed analysis of the resolution plans of these organizations.

Imposing GSIB-like resolvability requirements on large regional banking institutions would* de facto *move them to an SPOE resolution strategy, thereby contradicting the resolution optionality statutorily granted to these institutions.

Imposing the specific SPOE resolution strategy and GSIB-like TLAC requirements on large regional banks would effectively limit them to a single resolution strategy and, in so doing, upend the statutorily based framework that the federal bank regulators themselves developed, which has been operating smoothly for the past decade with institutions continually improving their resolution planning capabilities.

As noted above, the Dodd-Frank Act charges large BHCs with crafting their own resolution plans, thereby implicitly acknowledging that different strategies may be appropriate for different institutions and granting institutions optionality in identifying the most appropriate solution. Although not as explicitly contemplated in the FDIA, the FDIC's IDI rule grants similar optionality to IDIs. The FDIC's Statement on Resolution Plans for Insured Depository Institutions issued on June 25, 2021, explicitly acknowledges that "the appropriate overall resolution strategy for an IDI depends on the facts and circumstances when the FDIC is appointed receiver." [3] This is a key reason why resolution planning requirements have focused on a firm's ability to provide critical information in a timely manner to help inform strategic options, which may include any number of options. The resolution planning process is not designed to presuppose a specific reason for failure or a specific outcome, but rather to give the resolution authority all the information it needs to execute in a variety of situations.[4] As noted above, the current large regional bank resolution plans do exactly that, and, to date, no large regional banking institution's plan has been found to be "not credible".

Forcing all large regional banks to adopt an SPOE strategy, supported by TLAC, would reject the resolution optionality provided by the Dodd-Frank Act and should not be undertaken without a clear statutory mandate.

The GSIB Resolution Framework, Including The International Tlac Standard, Addresses Gsib-Specific Resolution Challenges; And It Is Unlikely That Extending Its Application To Non-Gsibs Would Enhance Financial Stability.

In the immediate aftermath of the 2008 financial crisis, policymakers recognized that resolving a troubled global banking organization in an orderly way was extremely challenging for two key reasons: 1) those organizations had material, systemically important operations in multiple jurisdictions, and officials in those jurisdictions did not always cooperate with each other in a constructive way; and 2) those organizations, particularly the U.S. ones, had systemically important nonbank affiliates, like large broker-dealer operations, outside of their insured bank subsidiaries, and it was challenging to coordinate the resolution of the insured bank under the FDI Act and the

[3] FDIC, *Statement on Resolution Plans for Insured Depository Institutions* (Jun. 25, 2021), *available at* https://www.fdic.gov/resources/resolutions/resolution-authority/idi-statement-06-25-2021.pdf.

[4] Unlike the case for GSIBs, where activities are not as highly concentrated in the IDI and resolution of the parent is therefore not necessarily as tightly linked to resolution of the IDI, imposing a *de facto* SPOE requirement on institutions with large IDIs effectively dictates the resolution strategy for the IDI regardless of the specific failure scenario.

broker-dealer and other material nonbank affiliates under competing insolvency regimes, like the U.S. Bankruptcy Code.[5]

So, after the financial crisis, the international regulatory community—through the FSB, which includes the Federal Reserve, FDIC and OCC—worked to develop a broad framework to ensure troubled global banking organizations could be resolved in an orderly way as a means of promoting global financial stability. Through its international standard-setting process, the FSB finalized the international TLAC requirements in November 2015. The Fed adopted TLAC requirements for U.S. GSIBs in December 2016. The FSB has cited TLAC requirements as one of the key too-big-to-fail reforms for GSIBs, and the Federal Reserve has explained that its TLAC rule is intended to "help to reduce risks to financial stability" and "address the too-big-to-fail problem" relating to GSIBs.

Concurrent to the development of the TLAC standard, GSIBs and resolution authorities crafted the SPOE resolution strategy as a means to maintain continuity of operations and client services while at the same time simplifying the resolution transaction and ensuring that shareholders and creditors bore losses. The eight U.S. GSIBs, with encouragement from their regulators, have adopted the SPOE strategy as their preferred resolution strategy, as have the majority of GSIBs across the world. SPOE addresses the complexities of executing a multifaceted cross-border resolution transaction involving multiple legal entities across multiple jurisdictions by ensuring only the top-tier holding company enters resolution proceedings. The principal operating subsidiaries, including domestic and foreign bank and broker-dealer subsidiaries, would continue operating without entering receivership, bankruptcy, insolvency or other resolution proceedings. Supported by TLAC requirements at the top-tier holding company, the SPOE strategy is designed to impose resolution-related losses on shareholders and creditors of the top-tier holding company.

Preserving the principal operating subsidiaries of GSIBs as going concerns is intended to minimize risks to financial stability, including by, among other things, supporting the continuation of a GSIB's critical operations and preserving the value of its business lines. Bringing critical global operations to a halt through a series of bankruptcy, receivership or other resolution proceedings directly involving a GSIB's principal operating subsidiaries would create systemic shocks throughout the financial markets and wider economy. The risks of such a confluence include disruptions to critical operations or the provision of other services to third parties, affiliates and customers, loss of franchise value, increased losses through ring-fencing in host countries, and funding and liquidity shortfalls (including due to "trapped" liquidity at one subsidiary being inaccessible to address a funding or liquidity need at another subsidiary)—all of which were witnessed to some degree during the 2008 financial crisis. An SPOE strategy solves for those challenges.

As discussed in greater detail below, because large U.S. regional banks don't share the relevant characteristics that make resolving a GSIB so challenging – namely, large regional banks don't have material, systemically important operations outside the United States and they don't have material broker-dealer or other nonbank affiliates outside the insured bank chain – large regional banks shouldn't be subject to the key resolution techniques developed to address those exact characteristics. In other words, the resolution of a large regional banking organization would not present the same financial stability risks or practical difficulties as would the resolution of a GSIB, obviating the need for an SPOE resolution strategy and the associated TLAC requirement.

[5] A third concern when it came to a GSIB resolution was the fact that they had derivatives contracts with counterparties in a multitude of jurisdictions who would terminate their trades upon resolution, given they were not bound by domestic statutory stay provisions. This would create a cascade of cross-defaults across the GSIB organization and lead to the sort of financial instability that was witnessed when Lehman Brothers filed for bankruptcy in 2008. This problem of enforcing the statutory stays on termination was ultimately fixed through the adoption of the ISDA resolution stay protocols in 2014 and 2015. Again this issue is not relevant for large regional banks given they have limited trading activity and even more limited trading activity with foreign counterparties governed by foreign law.

Large Regional Banks Do Not Pose Systemic Risk Comparable To That Of GSIBs.

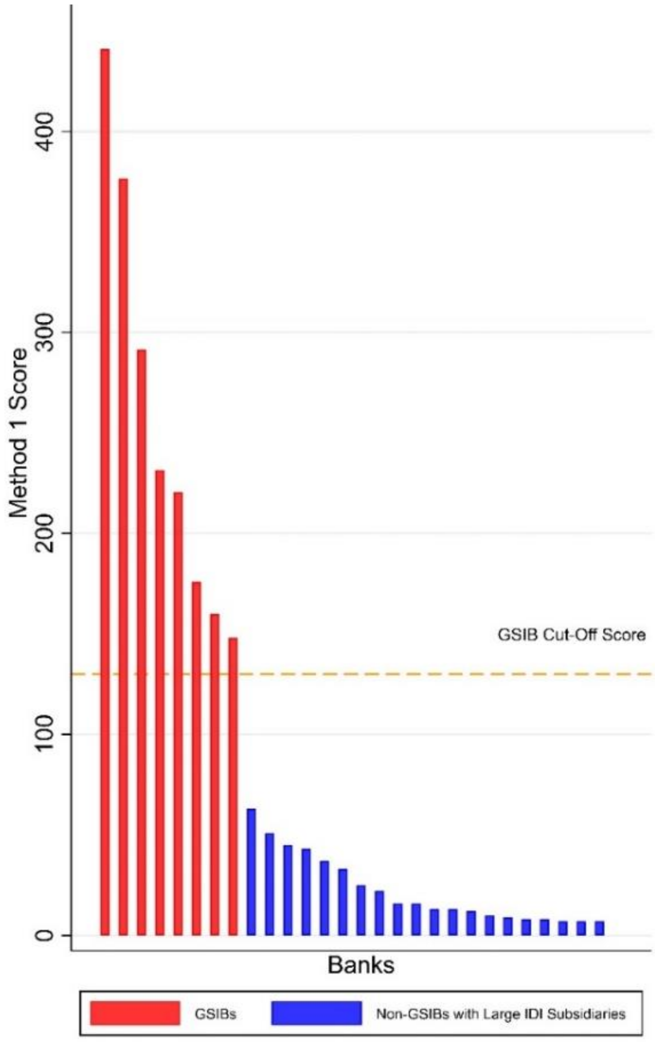
As noted above, one of the issues driving the development of TLAC and SPOE requirements was the financial stability risk that a potential GSIB failure and resolution would create. The Federal Reserve and other federal banking regulators have recognized that large regional banks and their affiliates do not pose systemic risk comparable to that of GSIBs, and this justification for TLAC/SPOE is therefore not present for large regional banking institutions. The Federal Reserve uses the Basel Committee's GSIB assessment methodology to identify U.S. GSIBs. When the Federal Reserve adopted this methodology in 2015, it noted that "across many potential metrics, there is a clear separation in systemic risk profiles between the eight U.S. [GISBs] and other bank holding companies," including "a large drop-off between the eighth-highest score (146) and the ninth-highest score (51)" under the Basel Committee methodology (Method 1 of the Federal Reserve's rule).[6] The threshold for identification as a GSIB is a Method 1 score of 130. The Federal Reserve explained that "[d]rawing the cut-off line within [the range of 51 to 146] is reasonable because firms with scores at or below 51 were much closer in size and complexity to financial firms that had previously been resolved in an orderly fashion than they were to the largest financial firms, which had scores between three and nine times as high and are significantly larger and more complex."[7] In other words, there is a clear, distinguishable line between what is a GSIB and what is not.

Crucially, we are aware of no evidence that this thorough analysis was flawed or that material changes have occurred in the last seven years that would render this analysis obsolete. There should be a heavy burden of proof on those who would advocate for a repudiation of this prior analysis. In particular, the failure of Washington Mutual and the other failures and near-failures of large, non-systemic IDIs that occurred during the 2008 financial crisis were well-known to the policymakers who adopted the GSIB framework and did not prompt them to apply SPOE and TLAC to large regional banks.

The "large drop-off" in GSIB Method 1 scores between U.S. GSIBs and other U.S. banking organizations has persisted, as shown in Figure 1 below. Currently, the lowest GSIB score is 148, while the highest non-GSIB score is only 63.

[6] Federal Reserve, 80 Fed. Reg. at 49084 (Aug. 14, 2015).
[7] *Id*.

Figure 1: Method 1 Scores of GSIBs and Non-GSIBs with a Large Bank Subsidiary[8]



Note: Method 1 scores are calculated using 4Q20 bank-level indicators with 2020 aggregate denominators.
Each bar represents the Method 1 score of a FR Y-15 filer.
Source: Federal Reserve Board, FR Y-15.

In fact, in some ways, the presence of large regional banks and their affiliates in the U.S. banking sector *enhances* financial stability. As discussed above, a firm's probability of failure is a key factor in assessing the risk that the firm poses to financial stability; all else being equal, the lower a firm's probability of failure, the lower the risk it poses to financial stability. Large institutions tend to be more diversified than smaller ones, which has been shown to reduce their risk of failure.[9] In addition, larger institutions tend to be more profitable than smaller ones, and this increased profitability also reduces an institution's probability of failure.[10] Scale also allows larger entities to invest

[8] Population comprised of FR Y-15 filers, which include U.S. BHCs and covered SLHCs with total consolidated assets of $100 billion or more, FBOs with combined U.S. assets of $100 billion or more, including, if applicable, any U.S. IHC of the FBO regardless of the size of the IHC, and U.S.-based organizations designated as GSIBs that do not otherwise meet the consolidated assets threshold.

[9] Joseph Hughes, Loretta Mester and Choon-Geol Moon, Are scale economies in banking elusive or illusive?: Evidence obtained by incorporating capital structure and risk-taking into models of bank production, 25 J. Banking & Fin. 2169 (2001) (finding that large banks achieve a better risk-profit trade-off than smaller banks because diversification reduces their risk).

[10] Numerous studies have found positive returns to scale in the banking industry. *See*, *e.g.*, Guohua Feng and Apostolos Serletis, Efficiency, Technical Change, and Returns to Scale in Large U.S. Banks: Panel Data Evidence from an Output Distance Function Satisfying Theoretical Regularity, 34 J. Banking & Fin. 12 (Jan. 2010).

in technology and other resources to reduce risks, most notably operational risks, including threats to cybersecurity.[11] Thus, all else being equal, larger size may decrease overall risk to financial stability.

In addition, and perhaps more importantly in the case of large regional banks, the presence of many large firms in the market may reduce the system risk presented by *each* large firm. Specifically, large regional banks are likely to offer products and services on a scale and at pricing that enables them to be feasible substitutes for other providers of such products and services—including GSIBs. Therefore, by increasing substitutability for other firms (which is one of the factors considered for purposes of the Method 1 GSIB score methodology discussed above), the presence of large regional banks reduces the financial stability risks posed by their competitors, thereby increasing overall financial stability. In this regard, we note Acting Comptroller Hsu's recent speech in which he observed, "[P]rohibiting [mergers involving large regional banks] could shield the GSIBs from competition, potentially helping to solidify their dominance in various markets."[12] For all these reasons, large regional banks do not present systemic risk and may in fact enhance financial stability.

For large regional banking institutions, an SPOE Strategy Is not necessary to facilitate an orderly resolution.

As described above, the other central driver of SPOE and the associated TLAC requirement for GSIBs was the need to consolidate and coordinate resolution proceedings across various legal entities and jurisdictions in order to ensure the possibility of an orderly resolution and avoid potentially severe disruptions to the global financial system. These challenges and risks do not exist for regional banks, and SPOE and TLAC requirements are therefore not appropriate or needed.

As noted above, the vast majority (typically over 90%) of activities and assets of large regional banks are typically conducted and held through a single U.S. IDI subsidiary. As a result, even in the unlikely event of a failure, a single resolution framework—the receivership provisions of the FDIA—would apply to most of the institution's businesses, assets and liabilities. This centralized resolution means that many of the practical difficulties that an SPOE strategy is meant to address, such as coordination of multiple competing insolvency proceedings or uncertainty as to the distribution of losses and outflows among legal entities—are simply not present in the large regional bank context. In addition, unlike many GSIBs, large regional banking organizations do not house systemically important nonbank entities, such as securities broker-dealers, that could need to continue as going concerns for financial stability purposes. Nor do they engage in significant activities outside the United States, such that ring-fencing and coordination of cross-border resolution proceedings would be problematic.

Applying TLAC and SPOE requirements on large regional banks solely due to their size would contradict the multi-year process of notice-and-comment rulemaking to adopt the GSIB methodology and tailoring framework in which size is not the sole determining factor for whether attributes of the prudential regulatory framework applied to GSIBs should be extended to non-GSIBs. Rather, the application of TLAC and SPOE requirements, like the application of any prudential regulatory requirement, should be based on the risk profile of the applicable firms and whether the particular requirement would be fit for purpose. Given the substantial differences between the significance and potential resolution processes of a GSIB and a large regional bank, the mandatory application of an SPOE strategy and associated TLAC requirement to these institutions would be neither fit for purpose nor commensurate with the risk profiles of those firms, as the federal bank regulators themselves have determined.

[11] In fact, French central bank governor François Villeroy de Galhau recently admonished his EU counterparts for not enacting policies to strengthen the EU banking market by encouraging more mergers of EU banks. François Villeroy de Galhau, Governor of the Banque de France, *Looking up to achieve a Financing Union* (Feb. 23, 2022), *available at* https://www.banque-france.fr/sites/default/files/medias/documents/looking_up_to_achieve_a_financing_union.pdf.

[12] Michael J. Hsu, *Financial Stability and Large Bank Resolvability* (Apr. 1, 2022), *available at* https://www.occ.gov/news-issuances/speeches/2022/pub-speech-2022-33.pdf.

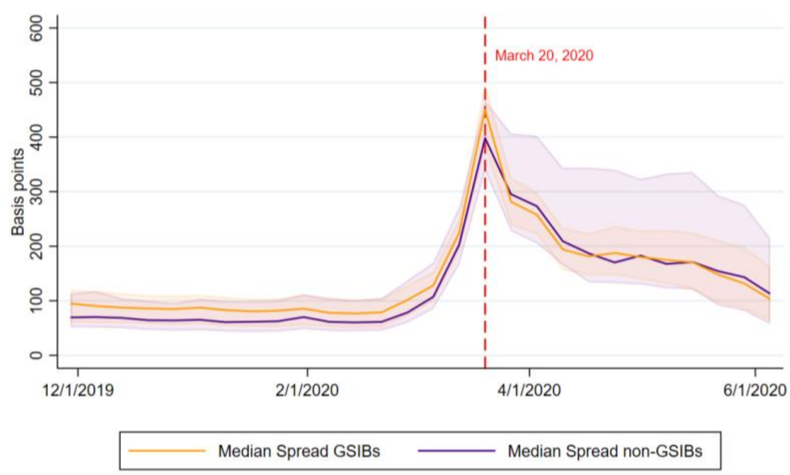
THE COSTS AND DISADVANTAGES OF IMPOSING GSIB-LIKE RESOLVABILITY REQUIREMENTS ON LARGE REGIONAL BANKS WOULD NOT OFFSET ANY BENEFITS.

The GSIB resolvability framework discussed above, and in particular TLAC requirements, carry significant costs and disadvantages for financial institutions, their customers and the broader financial system. Given the extremely low risk that a large regional bank would fail, and the lack of systemic risk associated with any such failure, particularly in light of the myriad post-crisis regulations applicable to this group of institutions, the benefits of imposing such requirements are extremely small and do not outweigh the costs. This differs from the case for GSIBs, where systemic importance and unique resolution challenges arguably do outweigh the costs and disadvantages associated with the framework.

The costs and disadvantages of a GSIB-like resolvability framework are broad and significant.[13] The most apparent and broadly felt cost would be that on the bank and ultimately on its customers. Requiring large regional banks to issue TLAC debt would require these institutions to shift a portion of their funding mix from low-cost deposits to higher-cost borrowing. Large regional banks would need to seek higher returns commensurate with this higher cost of funding, thereby raising borrowing costs for businesses and customers by as much as 40 basis points. Empirical analysis demonstrating these increased lending costs are provided in the Appendix.

Requiring banks to shift a portion of their funding from deposits to debt would also shift their funding from a stable source to a market-dependent source. This increased reliance on a more volatile funding source would weaken the safety and soundness of large regional banks. Indeed, Figure 1 plots the behavior of unsecured bond spreads of all Category I through IV firms around the onset of the COVID-19 pandemic.[14] Going into the pandemic, median bond spreads were about 100 basis points for GSIBs and approximately 80 basis points for non-GSIBs. In March 2020, bond spreads widened suddenly to around 450 basis points for GSIBs and 400 basis points for non-GSIBs. Thus, TLAC requirements increase banks' funding costs not only in normal times, but also upon any deterioration in the economic outlook.

Figure 1: Option-Adjusted Unsecured Bond Spread



Source: Bloomberg.
Note: Sample includes all unsecured senior bonds. The option-adjusted spread is defined as the difference between the yield on the bond and that of the corresponding maturity-matched Treasury bond adjusted for the embedded options in the bond. The shaded area represents the interquartile range.

---

[13] The costs discussed in this section would be equally applicable to IDI-level TLAC requirements in the context of a multiple-point-of-entry or MPOE resolution strategy.

[14] For details on the construction of the time series *see* Francisco Covas and Gonzalo Fernandez Dionis, *Putting "Too Big to Fail" to Rest: Evidence from Market Behavior in the COVID-19 Pandemic* (Sep. 9, 2020), *available at* https://bpi.com/putting-too-big-to-fail-to-rest-evidence-from-market-behavior-in-the-covid-19-pandemic/.

In addition, the imposition of a TLAC requirement could harm financial stability by increasing procyclicality and thereby expediting and intensifying a financial downturn. As we saw during the onset of the COVID-19 event, banks' balance sheets increase in periods of stress due to draws on credit lines from corporate customers and the expansion of the Federal Reserve's balance sheet. This balance sheet growth would reduce banks' TLAC ratios and require them to issue more TLAC—at the same time bond spreads are widening as shown above—during these periods. Unlike any potential benefits of TLAC, which would only be realized with respect to specific banks in the highly unlikely event of their failure, this undermining of financial stability would occur across affected institutions in every period of financial stress.

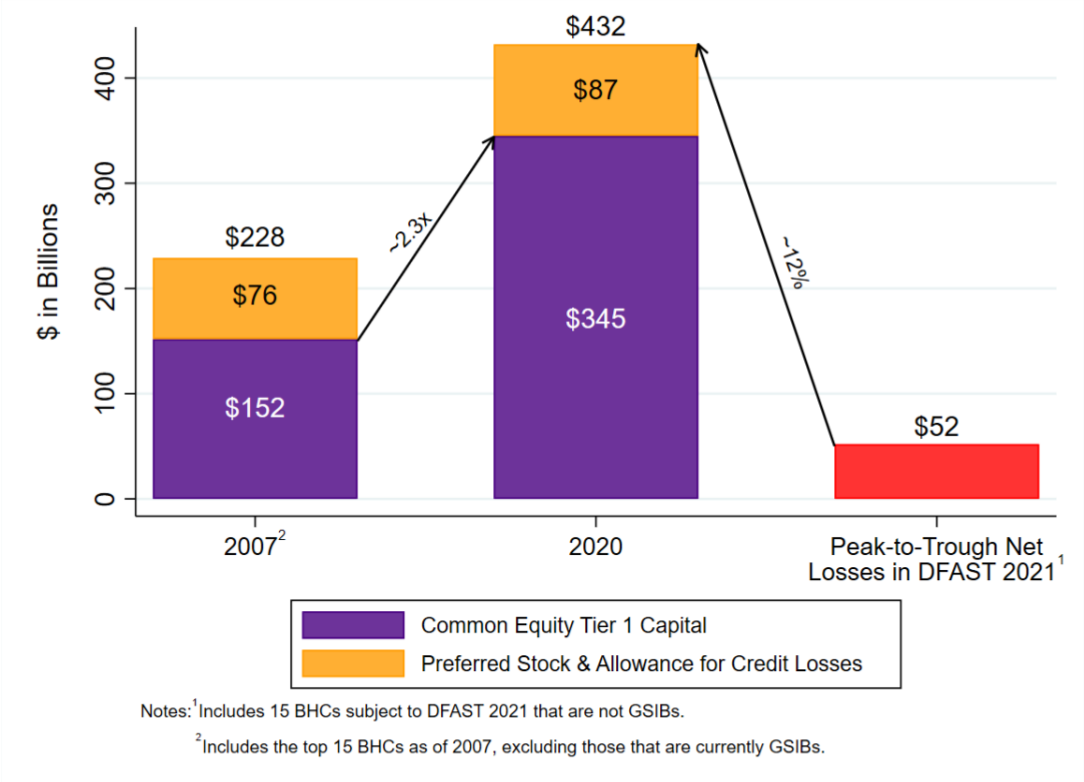
Moreover, imposing a TLAC requirement could further harm financial stability by driving more lending to less regulated nonbank providers rather than heavily regulated banks. Large regional banks—and in fact all banks—are increasingly competing with nonbank providers, which do not face the same level of regulation, to provide core banking products and services. As noted above, increasing banks' funding costs will require them to increase the costs of their products and services, particularly loans. Nonbank competitors, which will not face such funding cost increases, may be able to offer more attractive pricing for core banking products and services, and thereby attract a greater share of customers. Despite engaging in virtually identical activities to banks, these nonbank providers are not subject to the robust capital, liquidity and other prudential standards that mitigate risks to providers' safety and soundness and to the financial system. Nor are they subject to the same type of regular, direct supervision as banks for consumer protection or BSA/AML requirements. As such, they pose risks to the financial system, consumers and national security that our current system and approach does not adequately address.[15] By increasing the costs of bank-provided products and services, imposing a TLAC requirement on large regional banks will likely serve to increase the pervasiveness of these nonbank providers.

There is also an extremely low risk that a large regional bank would fail, particularly in light of the many prudential reforms and increased capital and liquidity requirements implemented over the last decade. Existing capital regulations (most notably the stress capital buffer) require the institutions to have extra capital to account for potential losses from relatively riskier activities (a few BHCs of large IDIs have SCBs above 2.5%, the minimum requirement under the Federal Reserve's regulations). Not surprisingly, as a result of post-crisis reforms, large IDIs have common equity capital levels (the strongest form of capital) and liquidity levels that are sharply above levels prior to the financial crisis. Specifically, large IDIs had average common equity tier 1 capital ratios of 8.3% in 2005, compared with 12.7% in 2020, and had an average ratio of liquid assets to total assets of 10% in 2005, compared with 23.3% in 2020. These capital and liquidity requirements significantly reduce the risk that these firms would fail, even under severely stressful conditions.

Figure 2 shows the combined loss absorbing resources of non-GSIB DFAST participants to demonstrate that those banks would already be able to sustain very severe stress while continuing to make loans to households and businesses. Based on the most recent stress test results, the combined net losses of the largest 15 non-GSIBs that participated in DFAST 2021, over a nine-month period under severely stressed conditions, were $52 billion. At the end of 2020—the jump-off date of the 2021 stress tests—those banks held $432 billion in loss absorbing resources (the sum of common equity, preferred stock and allowances for credit losses). Therefore, the combined net losses of non-GSIBs in the stress tests accounted for only about 12% of the total loss-absorbing capacity of those banks. In addition, those institutions have more than doubled their highest-quality capital relative to the onset of the 2008 financial crisis.

[15] For more detailed discussion of some of the risks associated with certain non-bank providers of core banking products and services, *see* Bank Policy Institute, Comment Letter to the CFPB regarding Notice and Request for Comment Regarding the CFPB's Inquiry Into Big Tech Payment Platforms (Docket No. CFPB–2021–0017) (Dec. 10, 2021), *available at* https://bpi.com/wp-content/uploads/2021/12/BPI-CommentCFPBBigTechInquiry-12-10-21final.forsubmission-CFPB-2021%E2%80%930017.pdf.

Figure 2: Loss Absorbing Resources of Non-GSIB DFAST Participants



In addition to these high levels of capital and liquidity, the multitude of other post-crisis reforms and enhanced prudential standards further reduce the risk that any large regional bank would fail. Generally speaking, intensive regulatory examination and supervision, as well as the stress tests mentioned above, function to discourage banks from accumulating unsafe levels of risk. Single-counterparty credit limits reduce the risk that failure of a major counterparty would trigger failure or any related harms to financial stability. Clearing requirements and swaps margin requirements for uncleared swaps reduce the possibility that contagion and spillover effects of failed derivatives trades would cause bank failure by requiring that collateral be available to offset losses caused by the default of a derivatives counterparty and that parties regularly exchange collateral based on market developments in order to prevent the build-up of uncollateralized exposure. Furthermore, many firms engage in recovery planning, in addition to resolution planning, as part of their business-as-usual risk management processes, which further reduces the risk that a firm would fail, even if it were to incur heightened losses.[16]

Taken together, the capital, liquidity, and other prudential standards applicable to large regional banks, as well as the high level of supervisory scrutiny regulators provide to these institutions, make it extremely unlikely that a large regional bank would fail. In light of this low probability, the benefits, if any, of imposing any GSIB-like resolvability requirements are unlikely to ever be realized, making their expected value fleetingly small and largely uncertain. Any such value is more than offset by the significant, broadly felt and certain costs that would be associated with imposing such requirements.

[16] OCC regulations specifically require national banks with $250 billion or more in total assets to engage in recovery planning. To an extent a firm meets these criteria, it must engage in recovery planning that complies with these regulatory standards.

POLICYMAKERS SHOULD CLEARLY ARTICULATE, PROVIDE REASONABLE SUPPORT FOR AND ENGAGE IN A DELIBERATIVE PROCESS WITH RESPECT TO ANY PERCEIVED WEAKNESSES IN THE RESOLVABILITY FRAMEWORK CURRENTLY APPLICABLE TO LARGE REGIONAL BANKS BEFORE MODIFYING THE FRAMEWORK.

To the extent regulators harbor concerns regarding the resolvability of large regional banks, they have not clearly articulated these concerns or provided specific analysis that would allow for appropriate public scrutiny, consideration and deliberation. If policymakers hold concerns, they should clearly articulate and explain them through either the legislative process or a specific RFI so that all appropriate stakeholders can appropriately consider their merits and, if necessary, assist in crafting solutions specifically and narrowly designed to address any issues in a balanced and cost-efficient manner. As demonstrated in this response, merely transferring requirements designed for a completely different type of institution and to address a different set of policy challenges would be a costly and inefficient—if not entirely ineffective—way to address any concerns.

Appendix

ESTIMATES OF THE EFFECTS OF THE IMPOSITION OF TLAC REQUIREMENTS ON INSTITUTIONS WITH LARGE REGIONAL BANKS ON LENDING RATES

To estimate the costs of TLAC on banks' cost of funding and loan rates, we assume institutions with IDIs with total assets of $100 billion or greater will be subject to the TLAC and LTD requirements as they currently apply to U.S. GSIBs, with two adjustments. First, GSIB-related buffers are set to zero. These include the buffers that sit on top of the requirements based on total leverage exposure. Second, for institutions not subject to the supplementary leverage ratio, total leverage exposure is replaced with total assets. In this instance, we set the requirement at 1 percentage point higher, since total assets do not include off-balance-sheet exposures.

Table 1: Assumed TLAC and Long-Term Debt (LTD) Requirements (%)

		Risk-Weighted Assets (RWA)	Total Leverage Exposure/Total Assets (as applicable) (TLE)
TLAC	Minimum + CCB Buffer	20.5	7.5/8.5
LTD	Minimum	6	4.5/5.5

Table 1 summarizes the TLAC and LTD requirements used in the analysis.[17] There are four requirements, with two ratios calculated with respect to banks' risk-weighted assets, and two other ratios based on banks' total leverage exposure.[18] The TLAC RWA requirement is set at 20.5 percent, the LTD-RWA requirement equals 6 percent. The TLE-based requirements are 7.5 percent and 4.5 percent for TLAC and LTD, respectively.

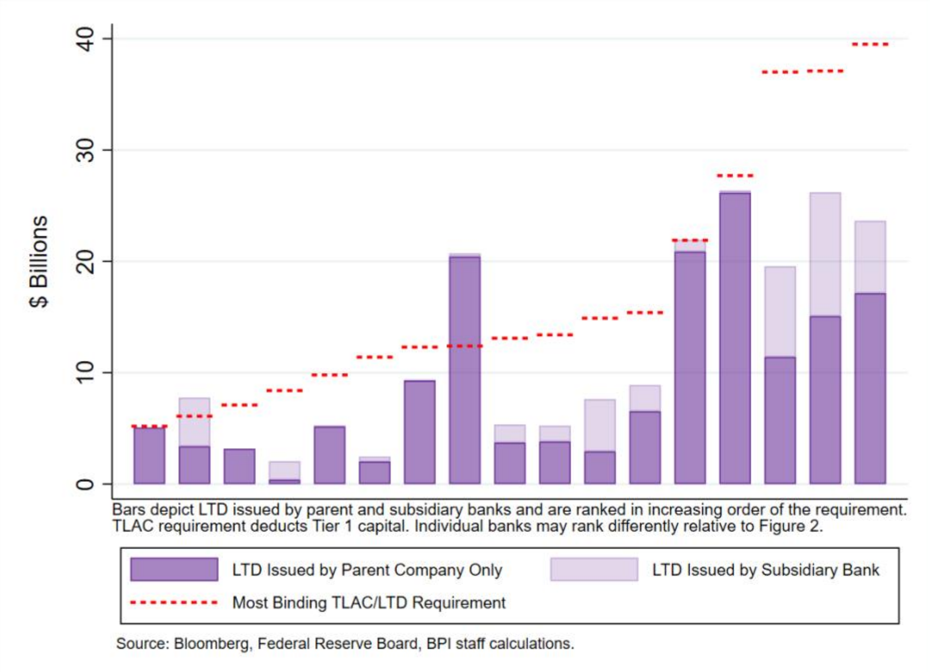
The first step of the analysis estimates the TLAC and LTD shortfalls based on the requirements listed on Table 1. Our sample includes all institutions with IDIs with $100 billion or more in total assets in Categories II through IV for which we were able to find senior unsecured debt outstanding in Bloomberg (17 of 28 banks). The baseline analysis uses senior unsecured debt issued only by the parent company. We also report the results assuming senior unsecured debt amounts issued by its subsidiary bank are also TLAC-eligible. In both cases, the definition of TLAC-eligible liabilities excludes long-term debt amounts maturing in 2022 and 2023.

TLAC shortfall amounts are reported in Figure A-1. For each institution, we estimate two shortfall amounts, one assuming only the LTD issued by the parent company is TLAC-eligible and the other including the LTD issued by both the parent company and its subsidiary bank. The shortfalls are calculated as the minimum amount of additional LTD necessary to meet each of the four requirements listed in Table 1. The TLAC-RWA requirement is the most likely to bind across all banks in our sample, followed by the LTD-TLE requirement.

[17] TLAC consists of Tier 1 capital other than minority interests and the unpaid principal of eligible debt securities, adjusted for a 100 percent haircut for amounts due to be paid within 1 year. LTD represents the unpaid principal of eligible debt securities, adjusted for a 100 percent haircut for amounts due to be paid within 1 year and 50 percent haircut for amounts due to be paid between year 1 and year 2.

[18] When total leverage exposure amounts are not available because the firm is not subject to the supplementary leverage ratio requirement (i.e., Category IV bank), we use total assets instead and increase the requirement by 1 percentage point.

Figure A-2: Bank-Specific Shortfalls



The aggregate TLAC shortfall across all banks in our sample is $94.2 billion assuming all TLAC-eligible LTD issued by the parent company and its subsidiaries is available to meet the TLAC and LTD requirements. The average (median) shortfall is $5.5 billion and ranges between a shortfall of 0 and a shortfall of $15.9 billion. The aggregate shortfall increases by 50% to $143.9 billion when only the LTD issued by the parent company is TLAC-eligible. The average (median) shortfall increases to $8.5 billion and ranges from a shortfall of 0 to a shortfall of $25.5 billion.

The differences in bank-specific TLAC shortfalls between the two possibilities considered in Figure A-1 are significant. In practice, for the LTD issued by a bank subsidiary to be considered TLAC-eligible, the institution would have to convert the bank-level debt to parent-level debt. The costs of the conversion would likely be significant because the parent companies typically have lower credit ratings than their subsidiary banks.

Overcoming these shortfalls to meet TLAC requirements would result in higher funding costs for institutions because, as noted above, they would have to issue more expensive TLAC-eligible liabilities in lieu of cheaper sources of funding like retail deposits. To estimate the cost of meeting the TLAC requirements, the analysis assumes banks would fill their bank-specific shortfalls by issuing unsecured LTD. The additional TLAC-eligible liabilities would replace each bank's current liabilities on a pro-rata basis.

We proxy the cost of TLAC-eligible securities with the weighted average z-spread[19] of each senior unsecured bond plus the yield of government bonds with the same maturity. We set the cost of the liabilities being replaced as equal to each bank's average funding costs as of the fourth quarter of 2021. Under these assumptions, and when the shortfall is measured using LTD held by the parent company only, the cost of complying with the TLAC requirements would average 5 percent of net interest income across all banks in our sample and reach a maximum cost of 11 percent.

We further evaluate the overall costs of TLAC by estimating how the increase in institutions' cost of funding would affect lending rates. The analysis assumes lending rates would increase to offset the rise in interest expenses. This

[19] The z-spread measures the difference between the bond yield and the yield of a risk-free bond with the same maturity.

is a similar assumption to the one used in prior studies conducted by the BCBS.[20] The main determinants of the size of the increase in lending rates are the size of the bank-specific TLAC shortfall and the share of interest income on loans in total interest income.

Figure A-3: Estimated Impact on Lending Rates

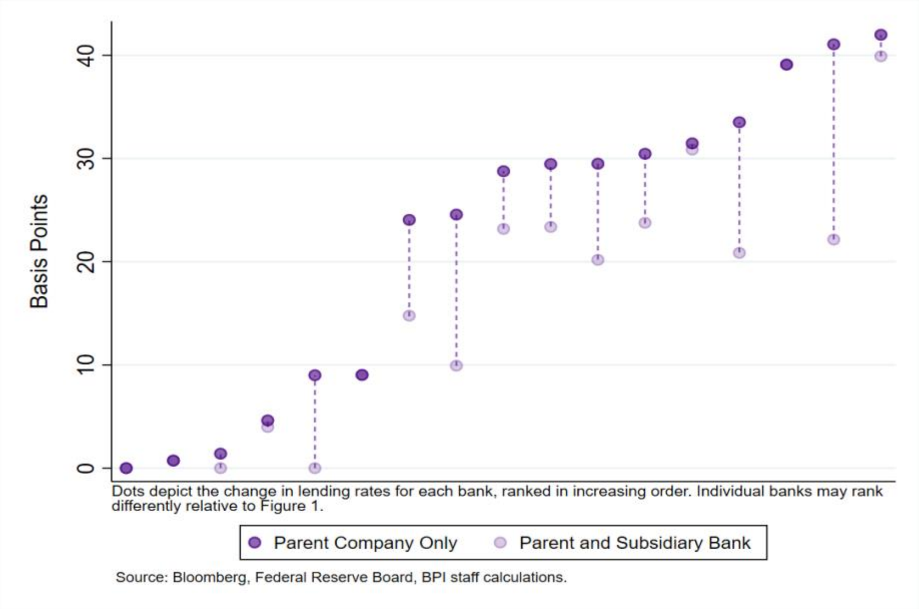


Figure A-2 shows the estimated effect on lending rates across all banks in our sample. When only the LTD issued by the parent company is TLAC-eligible, our results show a median increase in loan rates of 29 basis points. For a few banks, we estimate the increase in lending rates is at or above 40 basis points. When all LTD issued by the parent company and the subsidiary bank is TLAC-eligible, the median increase in lending rates is still about 20 basis points. Notably, the estimated increase in lending rates is significantly higher than the increase to lending rates estimated by the BCBS as a result of the introduction of TLAC requirements for GSIBs. For instance, in 2015, the BCBS estimated that the median increase in lending rates varied between 5 and 10 basis points, which is significantly lower than the estimates shown in Figure A-2. This is because the banks in our sample are mainly deposit-funded, and the cost of replacing deposits with LTD is more costly relative to the replacement costs faced by the GSIBs in the BCBS study that were already more likely to be using wholesale funding when TLAC was adopted.

_____

Disclaimer:

[20] *See* Basel Committee on Banking Supervision, *An assessment of the long-term economic impact of stronger capital and liquidity requirements* (Aug. 2010), *available at* https://www.bis.org/publ/bcbs173.pdf; Basel Committee on Banking Supervision, *TLAC Quantitative Impact Study Report* (Nov. 2015), *available at* https://www.bis.org/bcbs/publ/d341.pdf.