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January 16, 2024

Ms. Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551
Docket No. R–1815 and RIN 7100–AG66

Mr. James P. Sheesley
Assistant Executive Secretary
Attention: Comments/Legal OES
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429
RIN 3064–AF86

Mr. Benjamin McDonough
Chief Counsel
Office of the Comptroller of the Currency
400 7th Street, NW
Suite 3E-218
Washington, DC 20219
Docket ID OCC–2023–0011

Re: Long-term Debt Requirements for Large Bank Holding Companies, Certain Intermediate Holding Companies of Foreign Banking Organizations, and Large Insured Depository Institutions

Dear Ms. Misback, Mr. Sheesley, and Mr. McDonough:

I write regarding the proposed long-term debt requirements for large for large bank holding companies, certain intermediate holding companies of foreign banking organizations, and large insured depository institutions (the "Proposed Rule").[1] In this document I will make brief comments and attach documents that elaborate on my points. I note that I and others have submitted comments and written about this topic extensively since 2010. The main message is that *there is no justification for requiring long-term debt for the purpose of absorbing losses, and such requirements make no sense for promoting financial stability. Higher and well-designed equity requirements would serve society much better in every relevant way*.

[1] "Long-Term Debt Requirements for Large Bank Holding Companies, Certain Intermediate Holding Companies of Foreign Banking Organizations, and Large Insured Depository Institutions," 88 Fed. Reg 64524 (proposed Sept. 19, 2023) [hereinafter Proposed Rule].

I also note that today I am also submitting a comment letter on the "Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity."[2] These proposed rules are related because they both concern the funding mix of banking institutions as they affect the institutions' ability to serve society properly. Long-term debt is indeed often considered "regulatory Tier 2 capital" within the capital regulation framework. Effectively, my point in this comment is that we should focus on the highest quality common equity capital, something we have not ever gotten right.

Since 2010, I have written extensively on issues related to the Proposed Rule. The 2013 book I coauthored with Martin Hellwig, *The Bankers New Clothes: What is Wrong with Banking and What to Do about It* (Princeton University Press) is available in a new and expanded edition as of January 9, 2024 and Chapters 9, 11, 14 and 16 include extensive discussions that pertain directly to the issues around the Proposed Rule, including a detailed discussion of the state of resolution mechanisms in Europe and the US.[3] In this context, I served on the FDIC Systemic Resolution Advisory Committee from June 2011 until June 2019, and I am familiar with the work done by the Office for Complex Institution on Systemic Resolution under Title II of the Dodd-Frank Act.

I am sympathetic to the notion that investors should bear losses in banking as they normally do in other corporations. Outside bankruptcy (or "resolution") it is the *equity* investors, who are entitled to profits, whose share lose in value when the corporations' assets suffer a loss. Bankruptcy (or "resolution") generally wipes out shareholders, leaving them with worthless shares. Corporate lenders outside banking know, and set the terms of their loans accordingly, that they may not be paid in full if the corporation files for bankruptcy. They also know that decisions by corporate managers over the life of the debt claim, including to make risky investments with significant downside risk, to avoid taking some worthy investments that would benefit creditors but not necessarily shareholders as a result of the "debt overhang" effect, as well as to bias funding and payouts decisions towards additional borrowing, outsized payouts to managers and shareholders, and the avoidance of new equity issuance, can adversely affect the value of their claims. Shareholders and creditors might be in comflict with each other over these decisions, with shareholders reaping a magnified upside when risks pay off but sharing downside with creditors. As a result, lenders either require collateral (and hope to rely on "safe harbor" provisions if possible), and they may protect themselves through conditions or "covenants" that constrain corporate borrowers. The delays and costs associated with the bankruptcy process, which can deplete corporate assets and thus creditors' recovery, are reflected in the terms of corporate debt contracts such as seniority, collateral (if any) and other clauses.

Consequently, even though the funding mix of corporations outside banking is not generally regulated, and even though corporations are able to reduce the amount of taxes they pay when they

[2] 88 Fed. Reg. 64028 (proposed Sept. 18, 2023)
[3] Additional writings are posted on my personal website under "Research" and "Advocacy" https://gsb-faculty.stanford.edu/anat-r-admati/ and in this website https://www.gsb.stanford.edu/faculty-research/excessive-leverage (not updated much since 2016).

fund with debt instead of equity (as interest payment on corporate debt are deductible, a misguided policy with no justification), *no healthy corporation relies on anywhere near as much debt funding as banks do*. In other words, market forces lead most corporations to stay away from heavy borrowing and frequent distress.

Because banks take deposits, which represent debt liabilities, they are immediately indebted to their depositors. Depositors rely on, and value, being able to access their money any time and use deposits to make payments. They are willing to accept somewhat lower interest payment, or pay fees, in exchange for the "liquidity benefits" deposits provide. As creditors, however, depositors are quite weak. They do not have collateral when they effectively lend to banks. It is also not practical for dispersed depositors to monitor the investments, payouts and funding decisions made by bankers. The only recourse they have if they are concerned with the bank not paying them in full on demand is to withdraw their deposits as soon as possible. When many of them try to do so at the same time, we have a "bank run."

History is replete with examples of crises, panics, and runs before we had deposit insurance and/or support from central banks and without regulations. Is this fragility an essential consequence of the liquidity benefits banks provide? Does it follow that because deposits provide a valuable service, banks "should" have little equity? The answer is **NO**. In fact, under laissez-faire, market outcomes in banking are inefficient and involve excessive borrowing, with default risks that jeopardize the purported liquidity benefits.[4]

Today, of course, extensive safety nets for depositors protect banks and investors from needing to worry about defaults much of the time. Institutions like the FDIC, or governments, provide deposit insurance and at times guarantee other debts as well.[5] Central banks such as the Federal Reserve stand ready to serve as "lenders of last resort" as well as purchase assets to support banking institutions.[6] banks in the US often have access as well to loans from the government-backed Federal Home Loan Banks (FHLBs).[7] Finally, the Department of the Treasury steps in at times to

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[4] See Admati Anat R. and Martin F. Hellwig, "Bank Leverage, Welfare, and Regulation," in: Douglas W. Arner, Emilios Avgouleas, Danny Busch and Steven L. Schwarcz (eds.), Systemic Risk in the Financial Sector: Ten Years After the Great Crash, CIGI Press, 2019. (A working paper version is available at SSRN https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3257957)

[5] For example, an FDIC program allowed large banks to raise debt from in markets with FDIC guarantees after the 2008 crisis, and the program, with few strings attached, enabled large banks, including the investment banks that had just converted to Bank Holding Companies such as Goldman Sachs, to raise money cheaply and return funds they obtained under the more restrictive Troubled Assets Relief Program (TARP) of the Department of the Treasury. See Louise Story, "U.S. Program Lends a Hand to Banks, Quietly," *New York Times*, April 14, 2009 https://www.nytimes.com/2009/04/15/business/economy/15bank.html .

[6] For example, the Federal Reserve provided supports to the acquisition of Bear Stearns by JPMorgan Chase in March 2008. See Chapters 9 and 15 of the 2024 expanded edition of Anat Admati and Martin Hellwig, *The Bankers New Clothes: What's Wrong with Banking and What to Do about It* (Princeton University Press).

[7] See Cornilius Hurly, "Federal Home Loan Banks Should not be Bailing out Banks, "The Hill, May 23, 2023. https://thehill.com/opinion/finance/4017135-the-fed-not-federal-home-loan-banks-should-be-saving-failing-banks/
Stephen Cecchetti, Kim Schoenholtz, and Lawrence White refer to FHLBs as "a byzantine corner of the US financial system" in "The Dangerous Role of America's Weird Lenders-of-Next-to-Last Resort," *Financial Times*, August 17,

invest in banks directly or to provide backstops to other lenders such as the Federal Reserve, as was done during the financial crisis of 2007-2009 and again since spring 2023.

Recent research analyzing the history of FDIC bank resolution shows that it has become rare for uninsured depositors to suffer any losses.[8] With the exception of the creditors of Lehman Brothers, moreover, unsecured creditors have not suffered losses even as banks received supports from governments during the financial crisis, including lenders holding securities that counted as "Tier 2 regulatory capital." Yet reforms since the 2007-2009 crisis included requirements that the largest systemic institutions issue long term debt under various guises, most recently dubbed Total Loss Absorbing Capacity (or Capital,) TLACs. We are to believe that such securities will prevent these institutions from needing bailouts or causing major harm to the economy should they become insolvent. The recent case of Credit Suisse in March 2023, where authorities failed to trigger resolution or to impose losses on some 50 billion Swiss Francs in TLAC should be a warning that the promises of resolution, and of loss absorbing debt, are not to be trusted.[9] Remarkably, the Proposed Rule, with little justification, turns to long-term debt as a way to address a problem that is fundamentally about excessive reliance on debt in banking, which would be best address by increasing reliance on *equity*.

Equity is a form of funding that all viable corporations, including banks, already and necessarily use, and having more equity would allow banks to support the economy ever better and more consistently. If instead of requiring long-term debt the Proposed Rule required *equity*, not only would it help *prevent* the need to invoke resolution and to impose losses on long-term debt investors, imposing them instead on shareholders that benefit from more of the upside but, better yet, it will help alleviate the intense conflicts of interests and distortions associated with heavy borrowing and the debt overhang, financial distress and insolvency that plague highly indebted institutions.

I and others have long articulated the view that equity dominates long-term debt. Former Vice Chair of the FDIC Thomas Hoenig, for example, expressed it frequently when at FDIC and since. He submitted a comment letter with Stephen Matteo Miller in December 2022 pertaining to long-

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2023. https://www.ft.com/content/1ca4240b-e1c3-44ec-9033-f9217ddd4fae See most recently Noah Buhayar, Heather Perlberg, and Austin Weinstein, "A $1.3 Trillion Home-Loan System Gone Astray Is Fighting an Overhaul," Bloomberg News, December 20, 2023 https://www.bloomberg.com/news/articles/2023-12-20/federal-home-loan-banks-why-lobbyists-are-fighting-housing-lending-reform

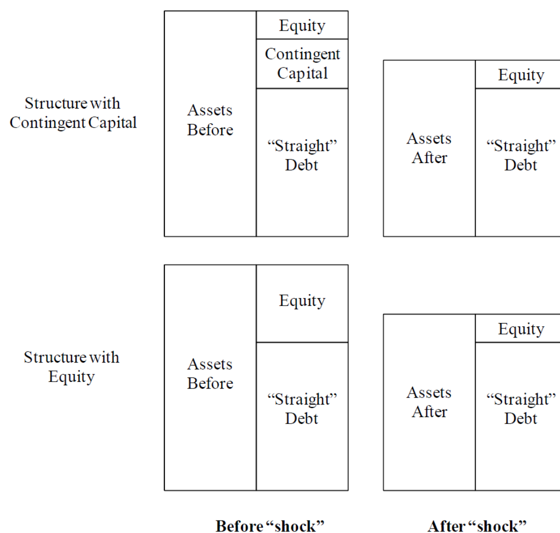
[8] See Michael Ohlrogge, "Why Have Uninsured Depositors Become De Facto Insured?" Working paper (2023) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4624095 .

[9] We offer an extensive discussion of the case of Credit Suisse and its forced merger with UBS, and discuss in detail the challenges of resolution and Single Point of Entry, in the 2024 expanded edition of Anat Admati and Martin Hellwig *The Bankers New Clothes: What's Wrong with Banking and What to Do about It*, particularly in Chapters 14 and 16. See also Anat Admati, Martin Hellwig and Richard Porter, "Credit Suisse: Too big to manage, too big to resolve, or simply too big?" VoxEU, May 8, 2024 https://cepr.org/voxeu/columns/credit-suisse-too-big-manage-too-big-resolve-or-simply-too-big

term debt requirements (TLAC) for large bank organizations,[10] and most recently wrote an opinion piece on September 26, 2023 that refers to the current Proposed Rule. Mr. Hoenig states, in particular, that "simply put, increased debt to solve a leverage problem is contradictory to the goal of greater financial stability."[11] As he points out, and is also discussed in my own writings with others, had SVB been required to have 15 or 20 percent equity funding, it would have been able to absorb losses on its bond portfolio without becoming insolvent and imposing costs on the FDIC and society.[12] The events of spring 2023 should have resulted in a serious reconsideration of the design and implementation of equity requirements rather than in long-term debt requirements as in the Proposed Rule. The Basel Endgame Proposed Capital Rules are a step in the right direction, but they do not go far enough to reduce indebtedness in banking.

To make the point that equity is more reliable than any debt security for absorbing losses, I reproduce here a figure from Section 8 (p. 46) of "Fallacies, Irrelevant Facts and Myths in the Discussion of Capital Regulations: Why Equity is Not Socially Expensive," with Peter M. Demarzo, Martin F. Hellwig and Paul Pfleiderer, first posted in August, 2010 (revised in 2013).[13]

Figure 5: Comparing Contingent Capital to Equity



As discussed in the paper, the figure shows how a loss in the market valuation of assets can be absorbed without triggering default, insolvency or resolution when a bank has equity but may require imposing losses on holders of "contingent capital" (the term academics used at the time

[10] See https://www.mercatus.org/research/public-interest-comments/anpr-resolution-related-resource-requirements-large-banking

[11] See Thomas Hoenig, "Bank Resilience: Equity Capital versus Long-Term Debt," FinRegRag, September 26, 2023, https://www.finregrag.com/p/bank-resilience-equity-capital-versus

[12] See, for example, Anat Admati, Martin Hellwig and Richard Porter, "When Will They Ever Learn? The US Banking Crisis of 2023," VoxEU, May 18, 2023, https://cepr.org/voxeu/columns/when-will-they-ever-learn-us-banking-crisis-2023 as well as the discussion in Chapter 14 of the 2024 edition of *The Bankers New Clothes*.

[13] The paper is available here https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2349739 and see also this website that started in 2010 (but not kept up since 2016) https://www.gsb.stanford.edu/faculty-research/excessive-leverage

for "loss absorbing debt") if used instead.[14] Needless to say, imposing losses on debtholders through resolution (or otherwise) is always challenging and can be destabilizing. Most importantly, *there is simply no valid reason for using equity substitutes for absorbing losses.*

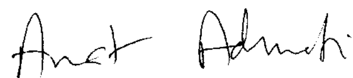
Equity is available to profitable banks, which can simply retain their profits and reduce cash payouts. Viable banks should also be able to issue and sell more shares to investors. If banks are unable to raise equity at a price they like, the main reason is that without it, the bank is shifting significant risks and costs to others. The additional equity is thus doing precisely what it is meant to do, *placing more risks and costs appropriately with banks and their shareholders* and preventing them from imposing as many risks and costs on others to benefit themselves. *A bank that cannot raise equity at any price is effectively failing a basic "market stress test" and its solvency must be questioned.* Ignoring hidden insolvencies is dangerous and misguided because insolvent or highly distressed corporations in any sector are unhealthy and do not support the economy properly.

The following attachments elaborate on the points made above. Additional materials are linked within the document, in my companion Comment on capital rules, and in my other writings.

1. A list of previous comment letters and testimonies I submitted related to the Proposed Rules.
2. A recent document, posted on January 4, 2024, which lists and discusses 44 flawed claims made in the public discourse around capital regulations. They include many claims about the impact of equity requirements, the availability of equity to banks, and the feasibility of resolution mechanisms that would impose losses on long-term debt holders. As mentioned, more details are offered in the 2024 edition of my book with Martin Hellwig, *The Bankers New Clothes: What's Wrong with Banking and What to Do about It* (Princeton University Press).

Thank you for considering my views on this important matter.

Sincerely.



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[14] I am aware that there are distinctions between debt that can automatically convert to equity with a trigger that does not involve resolution, or that might even be wiped out when equity is not, as happened with the AT(1) securities of Credit Suisse. The argument applies across all debt meant to absorb losses. A letter from s a group of 20 academics from banking and finance stated in November, 2010, "Debt that converts to equity, so-called "contingent capital," is complex to design and tricky to implement. Increasing equity requirements is simpler and more effective." The letter and list of signatories is available here https://www.gsb.stanford.edu/healthy-banking-system-goal