Statement by FDIC Vice Chairman Travis Hill on the Proposed Long-term Debt Requirements for Large Banks

August 29, 2023

I plan to vote in favor of the proposal. Although I would have approached aspects of the proposal differently, I am generally supportive of the principle of a long-term debt requirement, and think the proposal is worth issuing to receive comments.

The major benefit of long-term debt is that it provides a pool of resources that will always be available to absorb losses before the Deposit Insurance Fund (DIF) and the depositor class after a bank fails. Long-term debt can significantly reduce the cost of failure to the DIF – thus reducing both the cost that is socialized across the industry and the tail risk of potential taxpayer exposure. Long-term debt also significantly increases the likelihood that, from a financial stability perspective, the least disruptive resolution option – generally a quick sale of the failed institution – is also the least-cost option,[1] while also boosting the probability that an all deposit bridge bank[2] satisfies the least-cost test in the event a quick sale is not available.

There are two major items in the proposal that I would have addressed differently. First, the proposal would generally impose a long-term debt requirement on both the holding company and the bank subsidiary for institutions in scope, requiring that each holding company issue debt externally to markets and each bank issue internally to its parent. However, more than 75 percent of the domestic firms subject to the proposal have more than 97 percent of their assets within the bank. For most of these institutions, the likelihood of an FDI Act resolution of the bank in the event of failure is very high. In that case, the parent company would file for bankruptcy, while the FDIC would resolve the bank subsidiary, meaning the long-term debt we care about needs to be at the bank – and only at the bank. I think that we should consider, and hope we receive comments on, the relative benefits of imposing the long-term debt requirement only at the bank, and not at the holding company, for most of these firms, and allowing the bank to issue externally or internally. I also encourage comments on (1) whether and under what circumstances a separate holding company requirement might be warranted,[3] and (2) for firms subject to a holding company requirement, whether we should consider alternative approaches to determining how much of the resources must be prepositioned at the bank.

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[1] Under the FDI Act, the FDIC is generally required to undertake a failed-bank resolution in a manner that poses the least cost to the DIF. *See* 12 U.S.C. § 1823(c)(4).

[2] The FDIC is authorized to create a temporary national bank chartered by the Office of the Comptroller of the Currency to assume the deposit liabilities and operations of a failed institution (i.e., a bridge bank). 12 U.S.C. § 1821(n). The bridge bank structure is designed to stabilize the failed bank and preserve its franchise value until the FDIC is in a position to implement an orderly resolution through a purchase-and-assumption transaction or liquidation.

[3] As an example, long-term debt could be required at the holding company only for Category II, III, and IV firms (1) whose nonbank assets exceed a certain threshold, (2) for whom the Federal Reserve and FDIC jointly determine have nonbank activities that present systemic risks or substantial resolution challenges, or (3) who have adopted a single point of entry strategy under Title I resolution planning.

The second item that warrants additional thought is the calibration. Under the proposal, the amount of required long-term debt is determined based on the same "capital refill" methodology[4] that was used in the G-SIB Total Loss Absorbing Capacity (TLAC) rule.[5] However, the G-SIBs have all adopted a single point of entry (SPOE) resolution strategy in which the material entities would be recapitalized and continue operating subject to risk-based and leverage capital requirements.[6] By contrast, the domestic banks subject to the proposal have all adopted a multiple point of entry strategy in which the bank subsidiaries would be resolved under the FDI Act and thus no longer subject to capital requirements. For most of these institutions, a sale of the failed bank franchise is a much more likely resolution outcome than a recapitalization, as was the case in the three failures earlier this year. As a result, I question whether the capital refill framework is the right approach.[7] As we consider how to balance costs and benefits in calibrating the requirement, we should also be mindful that Category II, III, and IV banks generally issue materially less long-term debt as part of their business models than the G-SIBs did pre-TLAC; that we are in a very different rate and economic environment now than we were when the G-SIB rule was issued in 2016; that the agencies' recent capital proposal would materially change the calculations of risk-weighted assets;[8] and that we are required by law to tailor enhanced prudential standards for large firms.[9]

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[4] The proposed long-term debt requirement is calibrated using the capital refill methodology so that, if the institution's going-concern capital is depleted and the institution fails and enters resolution, the amount of long-term debt would be sufficient to recapitalize the institution by replenishing its going-concern capital to at least the amount required to be "adequately capitalized" under the Agencies' prompt corrective action regulations, inclusive of the capital conservation buffer applicable to risk-based capital requirements.

[5] *See* 82 Fed. Reg. 8266 (January 24, 2017).

[6] The Federal Reserve's 2015 TLAC proposal explained the capital refill framework by expressly citing the SPOE resolution strategy: "According to the capital refill framework, the objective of the external LTD requirement is to ensure that each covered BHC has a minimum amount of eligible external LTD such that, if the covered BHC's going-concern capital is depleted and the covered BHC fails and enters resolution, the eligible external LTD will be sufficient to absorb losses and fully recapitalize the covered BHC by replenishing its going-concern capital. Fulfilling this objective is vital to the use of eligible external LTD to facilitate the orderly resolution of a covered BHC, because it is a prerequisite to an orderly SPOE resolution that the resolved firm have sufficient going-concern capital post-resolution to maintain market confidence in its solvency so that other market participants continue to do business with it." 80 Fed. Reg. 74926, 74932 (November 30, 2015).

[7] It is also worth noting that the capital refill methodology is based on assumptions that the bank's equity at the point of failure is zero and the pre-failure balance sheet runoff is roughly ten percent – assumptions that may be wildly off in practice. From my perspective, the more long-term debt we require, the more costly it is to banks up front, and the less costly it is to the FDIC in the unlikely event of a resolution, and the calibration is primarily a judgment of the optimal spot along that continuum.

[8] *See* Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Notice of proposed rulemaking: Regulatory capital rule: Amendments applicable to large banking organizations and to banking organizations with significant trading activity (July 27, 2023), at section V.*E.* ("The Board estimates that the average LTD requirement for bank holding companies subject to Category I capital standards would increase by 2.0 percent as a result of the RWA changes…"), available at https://www.fdic.gov/news/board-matters/2023/2023-07-27-notice-dis-a-fr.pdf.

[9] 12 U.S.C. § 5365(a)(2).

In addition to the issues mentioned above, I also encourage comments on the treatment of long-term debt at foreign banks and the transition period, among other issues the proposal asks questions about.

Finally, I think it is important when discussing long-term debt requirements to also mention the existential issue hovering above the proposal – which is whether the agencies will be able and willing to impose losses on bondholders following a failure. Washington Mutual is often cited as an example of a failure in which the presence of long-term debt enabled a resolution at no cost to the DIF, but it's worth remembering that four days (and less than two business days) later, the FDIC invoked the systemic risk exception for the express purpose of ensuring that long-term bondholders at Wachovia did not suffer any losses.[10] More recently, following the "failure" of Credit Suisse, the Swiss authorities imposed losses on a relatively small amount of contingent convertible bonds while fully protecting a much larger pool of TLAC-eligible long-term bonds.[11] All of which is to say – I think that policymakers should be cognizant that support for a long-term debt requirement is in effect an implicit commitment to impose losses on long-term creditors in the face of what may be tremendous uncertainty and continue to think about the tools available to restore confidence if needed.

I would like to thank the staff for their hard work and numerous constructive discussions with me on the proposal. I look forward to the comments.

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[10] *See* Memorandum to FDIC Board of Directors regarding the failure of Wachovia Bank, p. 10 (September 29, 2008) ("In this environment, a least-cost resolution of Wachovia Bank NA with no assistance to creditors and the potential for meaningful losses imposed on the Bank's debt would be expected to have significant systemic consequences. A default by Wachovia Corporation and a partial payout to debtors of Wachovia Bank NA would intensify liquidity pressures on other U.S. banks, which are extremely vulnerable to a loss of confidence by wholesale suppliers of funds. Investors would likely be concerned about direct exposures of other financial firms to Wachovia Corporation or Wachovia Bank NA. Furthermore, the failure of Wachovia Corporation would lead investors to doubt the financial strength of other institutions that might be seen as similarly situated. Wachovia's sudden failure could also lead investors to reassess the risk in U.S. commercial banks more broadly, particularly given the current fragility of financial markets generally and the term funding markets for financial institutions.")

[11] As of year-end 2022, TLAC-eligible long-term bonds outstanding at Credit Suisse (49,117 (CHF million)) were more than three times the amount of additional tier 1 capital (14,736 (CHF million)). *See* Credit Suisse 2022 Annual Report.