May 11, 2020

Ms. Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Total Loss-Absorbing Capacity, Long Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations: Eligible Retained Income – Board Docket No. R-1706 and RIN 7100-AF80

Dear Ms. Misback:

Better Markets[1] appreciates the opportunity to comment on the "interim final rule with request for comment" ("Rule"),[2] issued by the Board of Governors of the Federal Reserve System ("Board") regarding revisions to the definition of "eligible retained income" in the Board's total loss absorbing capacity ("TLAC") rule for the largest, most systemically important banks—U.S. GSIBs and the U.S. operations of the largest foreign banking organizations ("Covered Banks"). The Rule is analogous to a joint rule, issued by the Federal Reserve, as well as the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation (the "Agencies"), that revised the definition of "eligible retained income" for purposes of the Agencies' capital rule ("Joint Rule).[3]

Unfortunately, the Rule, like the Joint Rule, is profoundly misguided under the extraordinary economic circumstances we face today. It is designed and intended to make it easier for Covered Banks to continue making capital distributions in the form of dividends and discretionary bonuses even as their profits plummet, their TLAC buffers could fall below

[1] Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system, one that protects and promotes Americans' jobs, savings, retirements, and more.

[2] 85 Fed. Reg. 17,003 (Mar. 26, 2020).

[3] Regulatory Capital Rule: Eligible Retained Income, 85 Fed. Reg. 15,909 (Mar. 20, 2020).

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important thresholds, and enormous uncertainty looms over the future direction of the economy as the COVID-19 pandemic unfolds. This is precisely the wrong regulatory approach at exactly the wrong time.

During an economic crisis of uncertain depth and duration, banks' TLAC buffers should be used to ensure that they remain financially sound enough to continue to lend through the crisis, supporting the real economy without undermining the safety and soundness of the banking system. At a time of particularly unprecedented uncertainty such as we face today, banks should be preserving capital and other loss-absorbing capacity, not depleting it through capital distributions. These distributions and discretionary bonuses enrich large bank shareholders and executives, while they make the largest and most systemically important banks less financially resilient than they would otherwise have been, increasing both the likelihood and the potential cost of a taxpayer funded bailout. To change a rule at this time to facilitate less restrictive policies covering the largest banks' capital distributions and executive bonuses is myopic, at best, and insulting to the American people who are being asked to make tremendous sacrifices, including supporting taxpayer-funded government programs that ultimately help the banks reduce losses.

The Rule is not only flawed on its face, it ignores the painful lessons of recent history. Just twelve years ago, as the 2008 financial crisis was enveloping U.S. financial markets and the economy, banks were allowed to continue paying out billions in dividends and other capital distributions until they reached the very brink of collapse. The failure to prohibit those payments helped weaken the banks, hasten their near-demise, and increase the magnitude of the taxpayer bailouts they needed to survive. For this reason, among others, many prominent economists and current and former policymakers today are calling upon regulators to prevent, not facilitate, such distributions.

The Release offers no credible rationale or justification for the Rule change. The Board claims that it removes a disincentive to use TLAC buffers to lend—that under the Rule, Covered Banks supposedly will no longer feel the need to cut back lending in order to protect their ability to continue making distributions. But this rationale collapses under the slightest scrutiny. Banks with more capital and other loss-absorbing capacity are better able to lend relative to banks with less capital and loss-absorbing capacity. Moreover, the Board has no assurance that Covered Banks will in fact decide to use their TLAC buffers to lend under the Rule, so the heightened risks that come with the Rule are not necessarily offset with any of the intended benefits. In any case, the Release is devoid of any discussion as to why it is important, under today's conditions, to preserve the flow of dividends to the shareholders of public companies (and a steady stream of bonuses to executives), a small population relative to the millions of Americans at risk of terrible hardship if banks once again become dangerously unstable as a result of unnecessarily depleted capital.

Rather than changing the rules to facilitate the diversion of capital to shareholders and executives via dividends and bonuses in the midst of such economic stress and uncertainty, the Board should immediately restrict all common equity-related capital distributions by the largest banks, and banks should cut discretionary bonus payments to senior executives, for the duration of the crisis.

BACKGROUND

One of the underappreciated aspects of the 2007-2009 financial crisis was that, even as credit markets seized up and banks stopped lending, they were still voluntarily shedding capital in the form of capital distributions.[4] These capital distributions during the height of the crisis had a doubly negative effect. First, they reduced the amount of capital banks had available for lending through the crisis, thus deepening the crisis. Second, they reduced the loss-absorbing capacity of banks, making their failure increasingly likely and necessitating massive taxpayer bailouts.[5]

This was a fundamental failure of the bank regulatory scheme. Banks receive special treatment in our system, especially in the form of deposit insurance, precisely because of the special function they are supposed to perform in supporting the real economy through lending to households and businesses. At the same time, capital and TLAC requirements are intended to make banks more resilient and protect taxpayers from having to bail out failed banks. Banks that significantly curtailed their lending activity, but continued to shed capital to enrich their shareholders, even as they sat at the brink of failure, undermined both of these critical goals of bank regulation.[6]

The changes the Agencies have made to the bank regulatory structure and capital requirements following the financial crisis were intended, in part, to prevent this outcome. For

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[4] Viral V. Acharya , Irvind Gujral, Nirupama Kulkarni and Hyun Song Shin, *Dividends and Bank Capital in the Financial Crisis of 2007-2009* at 3 (Ctr. For Econ. Policy Research Discussion Paper No. 8801) (2012) (noting that even as "capacity to lend suffered as intermediaries attempted to curtail their exposure to a level that could more comfortably be supported by their capital," banks "continued to pay dividends especially in the first part of the crises.") http://pages.stern.nyu.edu/~sternfin/vacharya/public_html/BankCapitalAcharyaGujralKulkarniShin_JACF.pdf.

[5] Viral V. Acharya , Irvind Gujral, Nirupama Kulkarni and Hyun Song Shin, *Dividends and Bank Capital in the Financial Crisis of 2007-2009* at 4 (Ctr. For Econ. Policy Research Discussion Paper No. 8801) (2012) ("This outflow [i.e. the payment of dividends] deprived the banking system of much-needed common equity capital precisely when it was most needed."), http://pages.stern.nyu.edu/~sternfin/vacharya/public_html/BankCapitalAcharyaGujralKulkarniShin_JACF.pdf.

[6] *See* Viral V. Acharya , Irvind Gujral, Nirupama Kulkarni and Hyun Song Shin, *Dividends and Bank Capital in the Financial Crisis of 2007-2009* at 4 (Ctr. For Econ. Policy Research Discussion Paper No. 8801) (2012) ("Banks that ultimately received public funding support and were in serious risk of failure continued to pay out dividends right from the period leading up to the crisis until the period after Lehman Brothers' bankruptcy.").

example, the Agencies' TLAC rule restricts the ability of banks to make capital distributions if they do not maintain TLAC buffers above certain regulatory minimums. Ideally, this encourages banks to maintain enough loss-absorbing capacity to be able to both absorb losses and continue to lend during periods of economic stress.[7] As the Board explains in the Release accompanying the Rule:

> As with the capital rule, the TLAC buffer requirements were established to encourage better capital conservation by covered companies and to enhance the resilience of the banking system during stress periods. In particular, the TLAC buffer requirements were intended to limit the ability of covered companies to distribute capital in the form of dividends and discretionary bonus payments and therefore strengthen the ability of covered companies to continue lending and conducting other financial intermediation activities during stress periods.[8]

We are undoubtedly in a period of extreme "stress," yet having articulated the need to curb distributions under such conditions, the Board has chosen instead to do precisely the opposite: to relax those restrictions and make any required reductions in capital distributions and bonuses "more gradual." This approach weakens the "forward-looking" aspect of the TLAC rule, conflicts with sound prudential regulation, and willfully ignores the clear lessons of history.

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[7] Under the TLAC regime, banks are required to hold a sufficient amount of a combination of tier 1 capital and certain long-term debt. The TLAC regime, which is intended to complement regulatory capital requirements and is primarily concerned with the resolvability of large banks, allows banks to satisfy loss-absorbing capacity requirements with long-term debt that can be "bailed in" to absorb losses during a resolution. That in theory will allow the bank to "reemerge from resolution with sufficient capital to successfully operate as a going concern." Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations, 82 Fed. Reg. 8266, 8267 (Jan. 24, 2017). As Better Markets has previously noted, the TLAC regime, particularly its reliance on long-term debt that would be bailed-in to absorb losses is " the second-best solution to the problem of ensuring that bank holding companies remain resilient and able to withstand losses similar to those they suffered in the financial crisis." Better Markets, Comment Letter on Total Loss Absorbing Capacity Proposal (Feb. 19, 2016) https://bettermarkets.com/sites/default/files/FRS%20-%20CL%20-%20Total%20LossAbsorbing%20Capacity%20-%20Long%20Term%20Debt%20and%20Clean%20Holding%20Company%20Requirements%202-19-2016.pdf; *see also* Better Markets, Comment Letter on Capital Treatment of TLAC Debt, (June 7, 2019), https://bettermarkets.com/sites/default/files/Better%20Markets%20CL%20Fed%20Etc%20TLAC%20Debt%206-7-2019.pdf.

[8] Release at 17,004.

OVERVIEW OF PROPOSAL

The Rule aims to help banks avoid a so-called "distribution cliff" by revising the definition of "eligible retained income." If a bank does not have enough TLAC to meet its buffer requirements, it is subject to restrictions on the amount of capital distributions it can make, which is a function of its eligible retained income. Under the original TLAC rule, "eligible retained income" was "defined as four quarters of net income, *net* of distributions and associated tax effects not already reflected in net income."[9] Under this definition, a bank that failed to meet its TLAC buffer requirements, but which had previously distributed all of its net income when it exceeded those requirements, would find itself unable to make any distributions at all.[10]

The Rule revises the definition of eligible retained income so that it is the **greater** of either (1) four quarters of net income, net of distributions and associated tax effects not already reflected in net income, or (2) the average of a bank's net income over the preceding four quarters.[11] Under this new definition, banks that exceeded the TLAC buffer thresholds in previous quarters and distributed all or nearly all of their income will still be able to make capital distributions even after they fall below their TLAC buffer thresholds.

COMMENTS

1. **Weakening restrictions on capital distributions is a dangerous and misguided policy response to the COVID-19 crisis.**

The Rule is an ineffective response to the economic disruptions caused by the COVID-19 pandemic. Worse, it could prove to be dangerously counterproductive. The Board explains the current rulemaking context as follows:

> Recent events have suddenly and significantly impacted financial markets. The spread of the COVID–19 virus has disrupted economic activity in many countries. In addition, financial markets have experienced significant volatility. The magnitude and persistence of the overall effects on the economy remain highly uncertain. In light of these developments, covered companies may realize a sudden, unanticipated drop in capital ratios. This could create a strong incentive for covered companies to limit their lending and other financial intermediation activities in order to avoid facing abrupt limitations on capital distributions.[12]

At least the premise of this analysis is true: the COVID-19 pandemic has indeed caused a significant economic disruption and significant volatility in the financial markets; uncertainty is

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[9] Release at 17,004.
[10] Release at 17,004.
[11] Release at 17,004.
[12] Release at 17,004.

rampant—no one knows when the pandemic will subside or if it might return after it subsides. It is unknowable how long the economic downturn will persist and how deep it will be, though it is already clear it will be very severe and could be very long-lasting. The world is in unprecedented territory.

Such a severe economic downturn marked by uncertainty is precisely the wrong time to change the rules specifically to give Covered Banks more leeway to make larger capital distributions. TLAC buffers exist to ensure that during periods of economic stress, Covered Banks are able to simultaneously (1) absorb losses without failing and (2) continue to lend and otherwise support the real economy throughout the period of stress.[13] While Better Markets appreciates the concern that Covered Banks could choose to hoard capital during the economic crisis to stay above the buffers, the decision to give the largest banks greater leeway to make capital distributions does not address that concern, but only makes the banking system less safe. The simple fact is that a dollar of capital used for capital distribution is no longer available either to absorb losses or to lend to creditworthy businesses and households, and the Rule wholly fails to account for this reality. The Rule, inexplicably, **encourages** this behavior. Doing so during an economic crisis is risky even for Covered Banks with seemingly strong and stable capital positions, which can change rapidly in such circumstances; [14] it is downright treacherous for Covered Banks whose capital position is deteriorating.[15]

In short, the Rule will threaten the safety and soundness of the banking system by encouraging Covered Banks, the largest banks whose failure would most threaten the stability of the financial system, to shed capital in the middle of a crisis that is defined by unprecedented uncertainty, and by allowing them to continue to do so even as their capital position deteriorates. This contradicts sound capital preservation practices: a reasonable, forward-looking capital plan for a period of extreme stress would necessarily involve ceasing, or at least severely curtailing, capital distributions. During a crisis, the primary focus of banks should be on maintaining enough loss absorbing capacity to weather the downturn.[16]

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13 Release at 17,004.

14 BASEL COMMITTEE ON BANKING SUPERVISION, A SOUND CAPITAL PLANNING PROCESS: FUNDAMENTAL ELEMENTS at 6 (2014) ("In practice, those actions [to preserve capital] include reductions in or cessation of common stock dividends.")

15 The Agencies express concern that banks that "experience even a modest reduction in their capital ratios" could face "sudden and severe" limitations on their capital distributions. Release at 15,911. However, "even a modest reduction" in capital ratios that takes the bank below a key prudential threshold, in the midst of an economic crisis of such uncertain severity and duration, actually warrants "sudden and severe" limitations on capital distributions rather than a more lenient or gradual approach."

16 *Cf.* Basel Committee on Banking Supervision, A Sound Capital Planning Process: Fundamental Elements at 6 (2014) ("Basel Committee on Banking Supervision, A Sound Capital Planning Process: Fundamental Elements at 6 (2014) ("In the absence of comprehensive information, some banks continued to pay dividends and repurchase common shares when capital could have been retained to insulate them against potential future losses.").

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2. **The Rule will not facilitate lending nor will it produce any other meaningful benefits, a view shared by an increasing number of prominent economists.**

The Board's explanation for the Rule is that the current rule "could create a strong incentive for covered companies to limit their lending and other financial intermediation activities in order to avoid facing abrupt limitations on capital distributions."[17] In other words, the Board claims that the Rule is needed to encourage banks to continue lending through the crisis. But the Rule does not contain any mechanism to ensure that, given the relief provided, Covered Banks will actually continue lending into the economy. The Rule entirely fails to account for the possibility that, given the uncertainty inherent in the current climate, Covered Banks will restrict lending to remain above the capital buffer thresholds,[18] and then continue to make unrestricted capital distributions once the disincentive of the "distribution cliff" has been removed. Put another way, there is no reason to believe that the Rule actually will facilitate bank lending during the crisis; indeed, the Rule's only mechanism serves to facilitate capital distributions into the crisis, which will inevitably decrease the amount of money banks have available to lend.

Implicitly recognizing the weaknesses in this Rule and the Joint Rule, the Board and the other Agencies have attempted to promote lending simply by encouraging banks to do so. However, those gestures cannot suffice, especially under the extraordinary economic circumstances we face. For example, in the Joint Rule, the Agencies "encourage banking organizations to make prudent decisions regarding capital distributions."[19] And along with the Joint Rule, the Agencies issued a joint release expressing their "support" for banks that continue to lend:

> These capital and liquidity buffers were designed to provide banking organizations with the means to support the economy in adverse situations and allow banking organization to continue to serve households and businesses. The agencies support banking organizations that choose to use their capital and liquidity buffers to lend and undertake other supportive actions in a safe and sound manner. The agencies

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17 Release at 15,912.

18 Better Markets recognizes that the Rule's change to the definition of "eligible retained income," defining it as the bank's average net income over the previous four quarters, does at least retain some limitation on the amount of distributions banks that fall under the capital buffer thresholds can make, relative to other options the Agencies could have adopted. At best, then, the Rule is slightly less dangerous than it could have been. If the Agencies insist on continuing down this misguided path, it is imperative they not compound the mistake by relaxing the definition even further to increase the amount of distributions banks can make, something that the industry is sure to request in their comment letters.

19 Joint Rule at 15,911. The Rule lacks even this tepid admonition.

> expect banking organizations to continue to manage their capital actions and liquidity risk prudently.[20]

However, none of this is legally binding. We know from recent history that as long as distributions are allowed, banks will continue to make them, even as the economy, and their own financial condition, deteriorates.[21] Simply encouraging banks to act appropriately and hoping they do so is not enough. The Board should use its authority to compel banks to act prudently—after all, that banks may not always act in the public interest is a key reason regulation and supervision by the Board is so important.[22]

Finally, the Rule offers no significant countervailing benefits, gracing a comparatively small universe of shareholders and executives with financial rewards, while leaving all American taxpayers at greater risk.[23] And there is no benefit to be derived from avoiding a prohibition on bank distributions out of concern that it would it would stoke fear in the financial markets or stigmatize banks. A general, temporary, government-imposed ban on distributions could only be seen as a prudent step in the current environment and would actually be helpful to the banks by eliminating any risk that a particular bank would be stigmatized as singularly unstable should it decide to cut its common dividends.

For these reasons, a growing number of experts and policy makers have questioned the Board's approach and issued calls for a complete ban on common equity capital distributions as long as the economy remains in the grips of turmoil and uncertainty—Sheila Bair, Janet Yellen, and Daniel Tarullo, to name a few.[24] On the Hill, U.S. Sen. Sherrod Brown (D-OH), ranking member of the U.S. Senate Committee on Banking, Housing, and Urban Affairs; Sen. Brian Schatz (D-HI); and Sen. Elizabeth Warren (D-MA) recently sent a letter to Jerome Powell, Chairman of

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[20] *See* Joint Release, Federal Reserve, FDIC, and OCC, Statement on the Use of Capital and Liquidity Buffers (Mar. 17, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20200317a1.pdf.

[21] Viral Acharya, Hyun Song Shin, Irvind Gujral, *Bank Dividends in the Crisis: A Failure of Governance*, VOX: CEPR POLICY PORTAL (Mar. 31, 2009), https://voxeu.org/article/amidst-crisis-banks-are-still-paying-dividends.

[22] *See* Sheila Bair, *Force Global Banks to Suspend Bonuses and Payouts*, FIN. TIMES (Mar. 22, 2020) ("We should be wary of…voluntary measures given the relentless (and successful) lobbying by big banks in recent years to chip away at capital rules.").

[23] Release at 15,912.

[24] Jeanna Smialek, *Fed Gives Banks a Break to Keep Markets Calm, Asking for Little in Return*, N.Y. TIMES (Apr. 15, 2020), https://www.nytimes.com/2020/04/15/business/economy/fed-banks-dividends-virus.html; Telis Demos, *Banks During Coronavirus Crisis Can Sustain Their Dividends, for Now*, WALL STREET J. (Apr. 3, 2020), https://www.wsj.com/articles/banks-during-coronavirus-crisis-can-sustain-their-dividends-for-now-11587121200; *see also* Matt Egan, Banks Big, Fat Dividends Under Fire as Profits Plunge, CNN (Apr. 14, 2020), https://www.cnn.com/2020/04/14/investing/bank-dividends-recession/index.html; Press Release, Better Markets, As the Federal Reserve Floods the Financial System with Capital, It Must Order Large Banks to Stop Capital Distributions via Stock Buybacks and Dividends (Mar. 24, 2020).

the Federal Reserve, calling for the Fed to end capital distributions like stock buybacks, dividends, and executive bonuses as the economy recovers from the coronavirus pandemic.[25] And this view is even shared by an increasing number of other nations and international organizations. [26]

3. The Agencies have at their disposal an obviously superior alternative, which is to promote large bank resilience and lending by restricting common equity capital distributions.

The upshot is that, not only does the Rule fail to address the Board's concern that Covered Banks may not lend through the crisis, it makes it easier for Covered Banks to make larger capital distributions as we struggle through the crisis, which is risk-enhancing and economically counter-productive. If the Board is concerned that Covered Banks' desire to make capital distributions could cause them to reduce lending to stay above the TLAC buffers, the better solution is to prohibit bank capital distributions while the crisis is ongoing.[27] If banks are not allowed to make capital distributions during the pendency of the crisis, that removes an incentive to hoard capital and they are more likely to put that capital to productive use, in the form of lending to support the real economy. As former Chair of the FDIC Sheila Bair explained:

> Big banks need to be positioned to absorb impending losses, while simultaneously expanding their balance sheets to support the real economy. They need to remain solvent so that they can continue to lend as the crisis unfolds. As an important first step to achieve this, the Federal Reserve . . . should take action . . . to require systemically important banks to build their capital buffers by retaining their earnings. This means that such banks would suspend all capital distributions, including discretionary bonuses to top executives, until the global economy starts

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[25] *See* Letter from Sens. Brown, Schatz, and Warren to Jerome Powell, Chairman of the Federal Reserve (Apr. 10, 2020), https://www.banking.senate.gov/newsroom/minority/brown-schatz-warren-urge-fed-to-end-capital-distributions-like-stock-buybacks-dividends-and-executive-bonuses.

[26] Among them are England, Australia, and New Zealand, along with the European Banking Federation. *See* David Crow and Stephen Morris, *European Banks Back Suspension of Dividends and Buybacks*, FIN. TIMES (Mar. 26, 2020), https://www.ft.com/content/5fac9d7a-5c5d-4017-9934-c15b97d7230f; Telis Demos, *Banks During Coronavirus Crisis Can Sustain Their Dividends, for Now*, WALL STREET J. (Apr. 3, 2020), https://www.wsj.com/articles/banks-during-coronavirus-crisis-can-sustain-their-dividends-for-now-11587121200; *see also* Tanvir Gill, Latest Investment Strategy Menaced by Flailing Markets: Dividend Stocks, CNBC (Apr. 8, 2020), https://www.cnbc.com/2020/04/08/dividend-stocks-the-latest-investment-strategy-menaced-by-flailing-markets.html. For example, the Bank of England has essentially **required** banks to cut distributions. Faisal Islam, *Coronavirus: Banks Bow to Pressure and Axe Shareholder Payments*, BBC (Apr. 1, 2020), https://www.bbc.com/news/business-52114410.

[27] Systemic Risk Council Statement Financial System Actions for Covid-19 (Mar. 19, 2020) ("Banks should immediately cease all equity buy backs and dividends, and should be ready to suspend bonuses to a thick layer of senior and other highly remunerated staff in order to maximize their capacity to lend.")

to recover. This simple step, which would include dividends and share buybacks, would potentially free up trillions of dollars of additional loan capacity.[28]

If the Board, after due consideration, determines that some form of relief from restrictions on distributions is appropriate, that relief should not be effective until after the crisis has passed; under no circumstances should relief that encourages capital distributions become effective while the crisis is still ongoing.[29]

CONCLUSION

We hope you find these comments helpful.

Sincerely,

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28 Sheila Bair, *Force Global Banks to Suspend Bonuses and Payouts*, FIN. TIMES (Mar. 22, 2020).

29 For example, it might be reasonable, to grant relief from capital distribution restrictions, for banks that exceeded the capital buffers prior to a certain date before the onset of the crisis and who fell below those thresholds during the pendency of the crisis.

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