September 30, 2020

Financial Stability Board
Attn: Secretariat to the Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Re: Evaluation of the Effects of Too-Big-To-Fail Reforms

Dear Ladies and Gentlemen:

Better Markets[1] appreciates the opportunity to comment on the Evaluation of the Effects of Too-Big-To-Fail Reforms consultation report ("Consultation Report") issued by the Financial Stability Board ("FSB"), assessing the effects of the G-20's too-big-to-fail ("TBTF") reforms. The report is part of a useful effort to evaluate the effectiveness of the regulatory reforms adopted in the wake of the 2008 global financial crisis. It includes helpful information and analysis. In our comments, we highlight a number of areas that deserve more attention, including the threat of de-regulation, flaws in the TLAC regime, shortcomings in the cost-benefit analysis, and challenges posed by disparate regulatory standards in member jurisdictions as financial markets continue to converge across borders.

BACKGROUND

The Great Depression of the 1930s revealed how unregulated financial markets, rampant speculation, and illegal, if not criminal, conduct in the financial system could destroy the world economy and, with it, the lives and livelihood of hardworking people worldwide. In the wake of that economic and human tragedy, the United States passed a series of ambitious and far-reaching laws to protect families' jobs, homes, and savings as well as the public interest by

[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.

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properly and comprehensively regulating the financial industry.[2] Remarkably, those laws—and the agencies created and rules promulgated to implement those laws—worked reasonably well for decades.

Despite the decades-long success of the post-Depression laws in preventing another devastating economic depression, beginning in the 1980s policy makers in the U.S. began dismantling them. Elected officials, regulators, and others—all pushed by the financial industry's money, power, and connections—increasingly took the view that markets knew best; that they could, and should, regulate themselves; and that natural market discipline would induce them to act appropriately, eliminating the need for prescriptive regulation.[3] According to this view, lenders would not make bad loans, because bad loans are less likely to be repaid; sophisticated investors and the market itself could and would accurately price and assess risks; and financial firms would never be so reckless as to endanger their firms because that would be obviously contrary to their own self interest.

The industry and its allies also claimed they were merely "cutting red tape," "modernizing" or eliminating burdensome regulation, "right sizing" the rules, and increasing innovation and choice, supposedly for the benefit of all investors and consumers. This process of tearing down the longstanding rules that prevented major economic meltdowns included getting rid of a premier Depression-era law, the Glass-Steagall Act, which separated traditional commercial banking from high-risk trading and investment banking. That law was de facto repealed in 1998, triggering a supersizing of the U.S. financial industry. Risk-taking increased and profits soared.[4] Other major de-regulatory steps followed, including passage of the

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2 *See* Alejandro Komai & Gary Richardson, *A Brief History of Regulations Regarding Financial Markets in the United States: 1789-2009* 8-18 (Nat'l Bureau of Econ. Research, Working Paper No. 17443, Sept. 2011) (cataloging the panoply of financial regulations adopted between 1929 and 1980), https://www.nber.org/papers/w17443.pdf; *see also also* Frank Partnoy, *Financial Systems, Crises, and Regulation, in* THE OXFORD HANDBOOK OF FINANCIAL REGULATION 85 (Niamh Moloney et al. eds, 2015).

3 FINANCIAL CRISIS INQUIRY COMMISSION, THE FINANCIAL CRISIS INQUIRY REPORT 28 (2011) ("More and more, regulators looked to financial institutions to police themselves—"deregulation" was the label.") https://www.govinfo.gov/content/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf; Alan Greenspan, The Evolution of Banking in a Market Economy, Remarks at the Annual Conference of the Association of Private Enterprise Education (Apr. 12, 1997), https://www.federalreserve.gov/boarddocs/speeches/1997/19970412.htm.

4 In addition to killing the old laws and rules like Glass-Steagall, Wall Street's allies also prevented the regulation of new financial products and activities. The foremost example is the Commodity Futures Modernization Act ("CFMA") which essentially exempted swaps—the derivatives instruments that would enable the downturn in the housing market to spread to the entire financial system—from any meaningful regulation. See, e.g., William Spencer Topham, *Re-regulating Financial Weapons of Mass Destruction: Thoughts on Repealing the Commodity Futures Modernization Act and Future Derivatives Regulation*, 47 WILLIAMETTE L. REV. 133 (2010), https://willamette.edu/law/resources/journals/review/pdf/volume-47/wlr-47-1-topham.pdf.

Commodity Futures Modernization Act of 2000, which insulated the massive and highly leveraged derivatives markets from meaningful oversight.

The 2007-2009 financial crisis was a direct result of this deregulation and the ineffective supervisory oversight that accompanied it. The too-big-to-fail ("TBTF") banks and financial firms played a key role in this crisis.[5] TBTF refers to financial institutions so vast and interconnected that their failure could cause the entire financial system and economy to collapse. Because of the potentially catastrophic threats they pose, TBTF institutions are favored by investors with an implicit guarantee that the government will bail them out with taxpayers' money rather than let them fail and possibly bring down the financial system and the economy. Accordingly, TBTF institutions can take on excessive risk, knowing that their executives and shareholders will privately reap the profits when things are going well, but that if the risk goes against them, taxpayers will ultimately be forced to pay for potentially massive losses because the firms supposedly could not be allowed to collapse. This is exactly what happened in the financial crisis. In the U.S., the government lent, spent, pledged, committed, loaned, guaranteed, and otherwise used or made available up to $29 **trillion** to bail out the very financial firms whose risky activities had caused the crisis in the first place.[6] Of course, the bailout of the financial system, while it may have kept the economy from total collapse and prevented a second Great Depression, still offered little direct and tangible benefit to most people, who did not receive the bailout money and who still suffered significantly as a result of the actions of the TBTF institutions and the economic fallout. The crisis has cost just the U.S. alone $20 trillion in lost GDP along with incalculable human devastation.[7]

This also resulted in massive government spending, which exploded budgets and deficits.[8] That, on top of plummeting economic activity and tax revenues coupled with the increasing costs of responding to the crash and crisis, resulted in governments across the world having less funding available to meet the needs of their citizens. This included funding for priorities like education, health care, science, housing, energy, infrastructure, and other critical needs, which all suffered because funds were diverted to stop the crash and repair the damage. Thus, the existence of TBTF does not just create moral hazard and the inherent unfairness of

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5 Consultation Report at 11-12.

6 James Andrew Felkerson, Levy Economics Institute of Bard College, *A Detailed Look at the Fed's Crisis Response by Funding Facility and Recipient* 4 (Public Policy Brief No. 123, (2012) https://www.econstor.eu/bitstream/10419/121982/1/689983247.pdf.

7 BETTER MARKETS, THE COST OF THE CRISIS: $20 TRILLION AND COUNTING (2015), https://bettermarkets.com/sites/default/files/Better%20Markets%20-%20Cost%20of%20the%20Crisis.pdf.

8 BETTER MARKETS, SPECIAL REPORT, TEN YEARS OF DODD-FRANK AND FINANCIAL REFORM; OBAMA'S SUCCESSES, TRUMP'S ROLLBACKS, AND FUTURE CHALLENGES 8 (July 21, 2020), https://bettermarkets.com/sites/default/files/images/BetterMarkets_DoddFrankReport.pdf; *see also* Consultation Report at 11-12 ("In the global financial crisis of 2007-08, governments spent considerable amounts of public money in order to prevent a meltdown of markets and mitigate negative consequences for the real economy.").

privatized gains and socialized losses—which would independently be sufficient to put an end to it—but also has contributed to broad-based deprivation and economic inequality.

U.S. and international policymakers responded to the crisis with major regulatory overhauls to bring vastly more transparency, oversight, accountability, and above all stability, to the global financial system. In the U.S., the Dodd-Frank Act and its hundreds of implementing regulations focused on three fundamental goals: enhancing the financial resiliency of the financial system by reducing the likelihood large banks would collapse; bringing derivatives trading out of the shadows and reducing the risks it poses; and fundamentally improving consumer and investor protection. To varying degrees, the Dodd-Frank Act paralleled the G-20's regulatory reforms.

With respect to banking more specifically, the Dodd-Frank Act and G20 reforms were in large part intended to address and reduce, if not eliminate entirely, the problem of TBTF.[9] They sought to do so by, among other things, increasing the loss absorbing capacity of systemically important institutions, enhancing supervision and oversight, and taking steps to ensure that if systemically important institutions were to face financial distress, they would be resolvable in an orderly fashion without taxpayer bailouts.

The U.S. banking system successfully adapted to the Dodd-Frank Act reforms, taking in record earnings and maintaining robust lending levels to fully satisfy demand in the credit markets. Yet in 2017, the Trump Administration embarked on a campaign to roll back many of the reforms, and they have done a significant amount of damage. Better Markets has detailed those de-regulatory measures and outlined the critically important steps that are necessary to repair the damage to our regulatory framework in a special report entitled "Road to Recovery: Protecting Main Street From President Trump's Dangerous De-Regulation of Wall Street."[10] As the FSB and all governments assess the impact of the post-2008 crisis financial reforms, the dangers of this de-regulatory trend must remain foremost in mind.

OVERVIEW OF REPORT

In May 2019, the FSB began an evaluation of three key reforms established to address the problem of TBTF:

- the standards for additional loss absorbency through capital surcharges and total loss-absorbing capacity (TLAC) requirements;
- the recommendations for enhanced supervision and heightened supervisory expectations; and

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9 Consultation Report at 10.

10 The report can be read here: https://bettermarkets.com/sites/default/files/documents/BetterMarkets_Road_To_Recovery_Sept_15_2020.pdf.

- the policies to put in place effective resolution regimes and resolution planning and to improve the resolvability of banks.

The dual aim of the report is to “assesses whether the reforms are reducing the systemic and moral hazard risks associated with systemically important banks (SIBs) and examine broader effects (positive or negative) of the reforms on the financial system.”[11] Academic experts were engaged, a working group was established, and data was gathered from the public, FSB member jurisdictions, and other stakeholders. The FSB now seeks comment on its preliminary findings.

SUMMARY OF COMMENTS

We commend the FSB for undertaking the evaluation of the effectiveness of the TBTF reforms. Periodically engaging in this type of exercise is a critical component of any robust, enduring, and adaptable regulatory regime.

For the most part, as we explain in more detail below, the Consultation Report provides a useful assessment of the TBTF reforms to date, which it finds to have been a qualified success. Banks and other systemically important institutions are safer than they were pre-crisis, a finding that is supported by the fact that the financial system has, to date, performed relatively well in the midst of the severe financial stress and economic downturn wrought by COVID-19 pandemic; in combination with the extraordinary actions taken by Congress and the Federal Reserve and other regulators, the post-crisis reforms have prevented, thus far, the banking system from exacerbating the economic downturn that has accompanied the pandemic. At the same time, and contrary to the dire predictions of the industry, the safer financial system built by the TBTF reforms also remains a massively profitable industry that has continued to serve the needs of consumers and businesses in the credit markets. Banks and systemically important institutions have also, at least in theory, been made more resolvable, although grave doubt hangs over the feasibility of resolving a TBTF bank in the future without enormous disruption. Those doubts loom especially large with respect to the simultaneous resolution of the multiple TBTF banks that one would expect to be in jeopardy during a future crisis. And, of course, the effectiveness of living wills and other enhancements to resolvability remain, as yet, untested.

It is equally clear that more can and should be done to fortify the financial regulatory framework, in general and specifically with respect to the TBTF banks. We urge the FSB to delve further into a number of pressing issues that the global regulatory community continues to face.

(1) The Report lacks sufficient analysis of the de-regulatory threat that looms in a number of jurisdictions, including notably the U.S., a threat that arises from incessant industry lobbying as well as the potential for complacency in the regulatory community. It is clear that the post-crisis banking reforms did not go far enough, so scaling back those that have been adopted is plainly misguided.

[11] Consultation Report at 10.

(2) The Report should devote greater attention to the shortcomings surrounding reliance on TLAC to enhance the resolvability of the TBTF banks.

(3) While the Report commendably takes a holistic approach to evaluating the costs and benefits of the TBTF reforms, it can and should do more to highlight the enormous net benefits that preserving systemic stability and avoiding global financial crises confer on whole economies and societies.

(4) While the Report acknowledges the increasing convergence of international financial markets, it fails adequately to address the risk of regulatory dilution that trend poses—the race to the bottom.

I. THE CONSULTATION REPORT'S ASSESSMENT THAT THE TBTF REFORMS HAVE MADE THE FINANCIAL SYSTEM SAFER IS BROADLY CORRECT.

A. The Financial System Is Safer Due to Enhanced Capital Requirements for TBTF Banks.

Without a doubt, as the Report states, the financial system is safer now than it was pre-crisis, in large part because of the reforms to address TBTF.[12] While there are still many banks and other financial institutions that are too big and too complex, the largest banking organizations have been made meaningfully less likely to fail.[13] Specifically, the enhancements to capital and liquidity requirements, especially for the largest banks, have made them more financially resilient and better able to withstand periods of severe stress.

Ultimately, all that stands between a failing bank and a taxpayer bailout is the amount of its loss-absorbing capital, i.e. its so-called capital cushion. Among the most important lessons from the crisis was the inadequacy of the pre-crisis bank capital regime. That regime relied heavily on risk-weighting—attempts to calibrate capital requirements to the perceived riskiness

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12 Consultation Report at 5. As we have pointed out previously, and as we explain further below, that the financial system is "safer" does not mean it is "safe enough." Many of the reforms did not initially go far enough. Accordingly, as Better Markets has repeatedly said, policymakers should be looking for ways to bolster the reforms and make them more effective, not looking to weaken them.

13 The "too big" problem, of course, exists in multiple dimensions. The Consultation Report, and this letter, focus on the "to fail" aspect, but TBTF banks are not just too big to fail; they are also too-big-to-jail, too-big-to-manage, and too-big-to-supervise. These aspects of TBTF institutions must also be addressed. DENNIS M. KELLEHER, BETTER MARKETS, THE TOO BIG TO FAIL PROBLEM IS ALIVE AND GETTING WORSE (Sept. 16, 2019), https://bettermarkets.com/sites/default/files/documents/Better_Markets_Too-Big-To-Fail_FSB_Conference-9-16-2019.pdf.

of particular assets—so that banks have to hold less capital for assets deemed less risky, and more capital for those assets deemed more risky.[14] This attempted calibration and fine tuning of capital ratios proved utterly ineffective during the financial crisis—many assets deemed less risky (which therefore required less capital and allowed more leverage) in fact performed poorly during the crisis.[15] Moreover, banks had increasingly been allowed to satisfy capital requirements—already set too low—using instruments that did not effectively absorb losses.[16]

To address this, the G20 reforms required bank regulators to set minimum capital and leverage standards,[17] especially for the largest banks, in an effort to ensure that banks had sufficient resources to absorb losses.[18] These enhancements have proven effective thus far during the COVID-19 crisis: despite the severe economic contraction, and the fallout from that contraction, that has accompanied the pandemic, the financial system, including the largest TBTF banks, have not been a source of economic or financial instability, nor have they acted as a contagion or accelerant exacerbating the crisis.[19] This has been true even in the U.S., where the sluggish response to the pandemic has likely prolonged the decreased economic activity. Ultimately, the TBTF reforms have largely accomplished their goal of making the financial

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14 BETTER MARKETS, SPECIAL REPORT, TEN YEARS OF DODD-FRANK AND FINANCIAL REFORM; OBAMA'S SUCCESSES, TRUMP'S ROLLBACKS, AND FUTURE CHALLENGES 8 (July 21, 2020), https://bettermarkets.com/sites/default/files/images/BetterMarkets_DoddFrankReport.pdf.

15 Eric S. Rosengren, Bank Capital: Lessons from the U.S. Financial Crisis, Speech before the Bank for International Settlements Forum on Key Regulatory and Supervisory Issues in a Basel III World (Feb. 25, 2013), https://www.bostonfed.org/news-and-events/speeches/bank-capital-lessons-from-the-us-financial-crisis.aspx.

16 Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action, 77 Fed. Reg. 52,792, 52,800 (Aug. 30, 2012).

17 "Leverage standards" refer to requirements that banks finance a sufficient amount of its assets with equity, which reduces the likelihood of individual bank failures and also that any bank will contribute to overall financial market distress. See Better Markets Comment Letter on Regulatory Capital Rules (Oct. 22, 2012), https://bettermarkets.com/sites/default/files/documents/FRS%2C%20OCC%2C%20FDIC-%20CL-3nprs-%2010-22-12.pdf. In the context of the current capital regime, strong leverage standards serve "as the ultimate backstop against the shortage of equity based on risk-weighted capital requirements." Nijolė Valinskytė, et al., *The Leverage Ratio as a Macroprudential Policy Instrument*, VOX CEPR POLICY PORTAL (Apr. 12, 2018), https://voxeu.org/article/leverage-ratio-macroprudential-policy-instrument.

18 Consultation Report at 17-18.

19 DENNIS KELLEHER & TIM CLARK, BETTER MARKETS, NO FINANCIAL CRASH YET THANKS TO DODD-FRANK AND BANKING REFORMS (June 24, 2020), https://bettermarkets.com/sites/default/files/Better_Markets_White_Paper_Dodd-Frank_Banking_Reforms.pdf.

system safer and more resilient to stress. However, they will continue to be tested as the pandemic and its economic fallout persist, and their ultimate success remains to be seen.[20]

B. **The TBTF Reforms Have Not Hampered the Ability of Banks to Supply Credit to Individuals and Businesses Nor Generate Robust Earnings.**

Whenever facing the prospect of enhanced regulation, the financial industry inevitably launches a wave of dire predictions, warning of severe, earth shattering consequences if reforms intended to impose even a modicum of responsibility on the industry are adopted—predictions that inevitably fail to come to pass.[21] The industry's reaction to the implementation of the G20 reforms, including the Dodd-Frank Act in the U.S., was no different. Notwithstanding that the public was stilling dealing with the fallout from their reckless actions, the industry breathlessly warned that implementation of the G20 reforms would make banks unprofitable, curtail lending, and otherwise usher in a parade of horrible outcomes that ostensibly threatened the economy.

Unsurprisingly, that has not been the case, as the Report makes clear. Indeed, the TBTF Wall Street megabanks, especially those in the U.S., that have been subject to the most significant regulatory reforms were reporting record levels of earnings prior to the COVID-19 pandemic, and even now many continue to generate impressive profits.[22] The financial intermediation function of the financial system, particularly lending to households and businesses, remains essentially intact. The TBTF reforms have shown that banks can be made safer without impairing their ability to serve their core lending function and generate large revenues in the process.[23]

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20 Although the Consultation Report briefly discusses enhancements in supervision as an aspect of the TBTF reforms, there is little substantive assessment of the impact of enhanced supervision on the safety of the financial system. However, enhanced supervision complements the increased loss absorbing capacity in the system and has been an important component of making the financial system safer. DENNIS KELLEHER & TIM CLARK, BETTER MARKETS, NO FINANCIAL CRASH YET THANKS TO DODD-FRANK AND BANKING REFORMS 7-10 (June 24, 2020) (explaining how post-crisis enhancement of large bank supervision in the U.S. has contributed to making the financial system safer), https://bettermarkets.com/sites/default/files/Better_Markets_White_Paper_Dodd-Frank_Banking_Reforms.pdf.

21 Marcus Baram, The Bankers Who Cried Wolf: Wall Street's History Of Hyperbole About Regulation, HUFFPOST (June 21, 2011), https://www.huffingtonpost.com/2011/06/21/wall-streethistory-hyperbole-regulation_n_881775.html.

22 BETTER MARKETS, SPECIAL REPORT, TEN YEARS OF DODD-FRANK AND FINANCIAL REFORM; OBAMA'S SUCCESSES, TRUMP'S ROLLBACKS, AND FUTURE CHALLENGES 45 (July 21, 2020), https://bettermarkets.com/sites/default/files/images/BetterMarkets_DoddFrankReport.pdf.

23 BETTER MARKETS, SPECIAL REPORT, TEN YEARS OF DODD-FRANK AND FINANCIAL REFORM; OBAMA'S SUCCESSES, TRUMP'S ROLLBACKS, AND FUTURE CHALLENGES 45 (July 21, 2020), https://bettermarkets.com/sites/default/files/images/BetterMarkets_DoddFrankReport.pdf.

II. FSB MUST MORE THOROUGHLY ADDRESS A NUMBER OF PERSISTENT PROBLEMS AND THREATS.

A. Regulators Must Resist Further Deregulation and Restore Reforms That Have Been Unwisely Repealed.

One critical question that will largely determine the effectiveness of the TBTF reforms going forward is the extent to which policymakers resist deregulatory pressures and repair the damage already done by deregulation. As we have pointed out, the financial industry never stopped pushing back against regulatory reform, even as we were still dealing with the fallout from the 2008 crisis. Facilitating and enabling this incessant push against regulation is the threat of regulatory complacency, even as we witness the ongoing success of the reforms.[24]

The further removed we get from the financial crisis, the more likely it is that regulators will be swayed by the specious arguments of the financial industry that the regulations that have protected the financial system are unnecessary or even damaging to the economy. This is what happened in the U.S. beginning in the 1980's—policymakers began dismantling the very safeguards erected in response to lessons from the Great Depression that had allowed for decades of market stability and broad-based growth in the economy. That wave of unnecessary deregulation ultimately contributed to the worst financial crisis since the Great Depression and wreaked devastation on many millions of people around the world.

And we are already seeing it in the U.S., as the Trump administration has been on a sustained campaign to weaken the Dodd-Frank reforms, marginally enhancing the profits of megabanks while materially increasing the risks of another crisis and another round of bailouts. In order to fully assess the TBTF reforms, the FSB must address the fact that, just a dozen years after the crisis and just a decade after the implementation of the reforms, policymakers are already moving to weaken them, notwithstanding the evidence of their efficacy in stabilizing the

24 This is not an uncommon paradox of human behavior —if the steps taken to prevent an adverse outcome are successful, and the adverse outcome is avoided, many will come to view those steps as overly restrictive. That successful preventive measures might cause complacency was a significant cause for concern for public health officials at the onset of the pandemic, Maarten Boudry, *A Strange Paradox: The Better We Manage to Contain the Coronavirus Pandemic, the Less We Will Learn From It*, THE CONVERSATION (Apr. 3, 2020) ("Alas, one major drawback of such prophecies is that sceptics will inevitably come forward and say: "You see – we told you it wouldn't be all that bad." In fact, you can see people committing that logical fallacy right now."), and in countries where measures have successfully mitigated the impact of the pandemic, this "self-defeating prophecy" or "prevention paradox" has taken root. Laura Spinney, *Germany's Covid-19 Expert: "For Many I'm the Evil Guy Crippling the Economy*, BLOOMBERG (May 26, 2020) ("Now, what I call the "prevention paradox" has set in. People are claiming we over-reacted, there is political and economic pressure to return to normal."), https://www.theguardian.com/world/2020/apr/26/virologist-christian-drosten-germany-coronavirus-expert-interview.

banking system during a period of undoubted and significant stress. The FSB should call upon any jurisdictions following this path to reverse course, restore any reforms that have been rescinded, and proceed with the unfinished business of fully addressing the core problem of TBTF banks.

The dismantling is proceeding even more quickly now than it did in the years leading up to the 2008 financial crisis. Just ten years since the height of the crisis, the Trump administration in the U.S. began the process of tearing down the regime intended to protect against another $20 trillion catastrophe.[25] They have weakened capital standards, reduced resolution planning requirements, and essentially shut down the Financial Stability Oversight Council, established to ensure a comprehensive approach to identifying and addressing systemic risk. These profoundly misguided steps are designed to systematically rollback the Dodd-Frank reforms for the benefit of the financial industry, at the expense of the American public.

And while a large part of that may be due to the anti-regulatory, pro-industry policy preferences of Trump and his party, the reality is that as we get further from the financial crisis, the siren song of deregulation will grow stronger to policymakers across the political spectrum. The longer the financial system remains stable, the more that policymakers will think they can "enhance efficiency" here or "streamline regulations" there until the regime intended to protect against financial crises has been rendered ineffective.

Intensifying these concerns is the fact that many reforms have simply not yet been tested. In particular, this is the case with regard to reforms intended to address the resolvability of TBTF firms, such as the resolution planning process and orderly liquidation authority in the U.S.[26] Whether these TBTF firms can effectively be resolved through these enhanced processes, or whether the failure of a TBTF firm would result in a panic similar to that which occurred following Lehman's bankruptcy, resulting in another round of bailouts, remains to be seen. Accordingly, no changes that might weaken these reforms or otherwise make them less effective would be justifiable.

In short, FSB must explicitly address this risk of de-regulation as to the TBTF banks. It should assess the degree of pressure being exerted in its member jurisdictions; evaluate the governmental responses so far; specifically gauge the heightened risk that de-regulation poses to

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[25] *See* BETTER MARKETS, SPECIAL REPORT, TEN YEARS OF DODD-FRANK AND FINANCIAL REFORM; OBAMA'S SUCCESSES, TRUMP'S ROLLBACKS, AND FUTURE CHALLENGES 44-58 (July 21, 2020), https://bettermarkets.com/sites/default/files/images/BetterMarkets_DoddFrankReport.pdf; *see also* BETTER MARKETS, ROAD TO RECOVERY: PROTECTING MAIN STREET FROM PRESIDENT TRUMP'S DANGEROUS DEREGULATION OF MAIN STREET (Sept. 15, 2008), https://bettermarkets.com/sites/default/files/documents/BetterMarkets_Road_To_Recovery_Sept_15_2020.pdf

[26] Better Markets Comment Letter on Resolution Planning (June 21, 2019), https://bettermarkets.com/sites/default/files/Better%20Markets%20CL%20FRS%20FDIC%20Resolution%20Planning%206-21-2019.pdf.

the financial system and the world economy; and call upon policymakers to resist this trend. Moreover, it must call upon all members to take all politically feasible steps to restore any protections that have been repealed through misguided calls for de-regulation, and ultimately, implement the additional measures necessary to adequately fortify the banking system.

B. The Financial System Can Be Made Safer Through Enhanced Loss Absorbing Capacity.

That the financial system has been made safer through enhanced capital requirements does not mean the financial system has been made safe **enough**. To that end, multiple studies have suggested that banks need to hold capital of between 13 and 30 percent to prevent taxpayer bailouts of dangerously overleveraged banks.[27] However, as a group, the aggregate risk-based capital ratio for the largest U.S. banks was just over 12% at year-end 2018 and the tier 1 leverage ratio was 8.6 percent, below even the bottom end of the range suggested by the aforementioned studies.[28]

Of particular concern, is the continued reliance on the total loss absorbing capacity ("TLAC") regime, which, as relevant here, allows firms to meet their loss-absorbing capacity requirements through issuance of long-term debt instruments with certain characteristics that would allow that debt to be "bailed in" to absorb losses.[29] For a variety of reasons, as Better Markets has detailed elsewhere, the TLAC regime is the "second-best solution to the problem of ensuring that bank holding companies remain resilient and able to withstand losses similar to

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27 *See*, JIHAD DAGHER ET AL., IMF, BENEFITS AND COSTS OF BANK CAPITAL (Mar. 2016) (capital should be in the range of 15-23%), https://www.imf.org/external/pubs/ft/sdn/2016/sdn1604.pdf; FABRIZIO PERRI & GEORGIOS STEFANIDIS ,FEDERAL RESERVE BANK OF MINNEAPOLIS, CAPITAL REQUIREMENTS AND BAILOUTS (Staff Report 554, 2017) (capital in the range of 20-30% needed to prevent public recapitalization); FEDERAL RESERVE BANK OF MINNEAPOLIS, THE MINNEAPOLIS PLAN TO END TOO-BIG-TO-FAIL (2017) (same), https://www.minneapolisfed.org/~/media/files/publications/studies/endingtbtf/the-minneapolis-plan/the-minneapolis-plan-to-end-too-big-to-fail-final.pdf?la=en; Simon Firestone, Amy Lorenc & Ben Ranish, *An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the US*, 101 Federal Reserve Bank of St. Louis Review 203 (2017), (finding that the "optimal range" of capital is between 13%-26%), https://files.stlouisfed.org/files/htdocs/publications/review/2019/07/12/an-empirical-economic-assessment-of-the-costs-and-benefits-of-bank-capital-in-the-united-states.pdf. *See also* ANAT R. ADMATI AND MARTIN HELLWIG, THE BANKERS' NEW CLOTHES: WHAT'S WRONG WITH BANKING AND WHAT TO DO ABOUT IT (2013).

28 Dodd-Frank Act Stress Test 2019: Supervisory Stress Test Results, June 2019, available at: https://www.federalreserve.gov/publications/files/2019-dfast-results-20190621.pdf
FSB, Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution (Nov. 9, 2015), https://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf.

those they suffered in the financial crisis."[30] This is because TLAC debt may actually propagate instability if, in the middle of a crisis, TLAC debt holders are "bailed in" and forced to take losses.

And, relatedly, it is far from clear that there will actually be political will to impose losses on TLAC debt holders in the midst of a financial crisis. As currently structured, TLAC is likely to be sold to investors in vulnerable populations, such as retirees, who may not be fully informed about the attendant risks, and the inequity of foisting the bail-in burden on these segments of the market may trigger a backlash.[31] In short, there is an open question about whether TLAC debt will actually absorb losses in a crisis—which is the whole point of capital—and this uncertainty demonstrates that TLAC debt is not capital in fact and may not behave like capital when it matters. The FSB should take seriously the possibility that there is still insufficient loss absorbing capacity in the system to prevent taxpayer bailouts in the event of an event similar to the 2007-2009 financial crisis. Accordingly, it should further study this risk and the drawbacks of relying on TLAC as a major component of the bank capital framework.

C. <u>The FSB Should Further Analyze the Enormous Benefits that Come from Preventing Financial Crises.</u>

In the decades-long battle over financial regulation, the financial industry has relentlessly used cost-benefit analysis as a weapon to nullify specific rules, largely in court, and to more generally assail regulation as imposing huge compliance and other costs that are not justified by the benefits.[32] These arguments are specious because in reality, quantitative cost-benefit analysis is unreliable, inherently biased in favor of industry, and extraordinarily burdensome on agencies that attempt to apply it in their rulemaking process.

Fortunately, the FSB has not fallen prey to the "Trojan Horse" of cost-benefit analysis in the Consultation Report. It takes a holistic and largely qualitative approach to evaluating the

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[30] 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.

[31] Better Markets Comment Letter on Regulatory 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.

[32] BETTER MARKETS, SETTING THE RECORD STRAIGHT ON COST BENEFIT ANALYSIS AND FINANCIAL REFORM AT THE SEC (July 30, 2012 https://bettermarkets.com/sites/default/files/Setting%20The%20Record%20Straight.pdf; BETTER MARKETS, UPDATE: RECENT TRENDS IN THE LAW GOVERNING COST-BENEFIT ANALYSIS (Dec. 29, 2017), https://bettermarkets.com/resources/update-recent-trends-law-governing-cost-benefit-analysis-securities-and-exchange.

costs and benefits associated with the TBTF reforms. For example, the Consultation Report explains:

> The evaluation has estimated social costs and benefits using a simple framework, in which the social benefits of TBTF reforms are reduced probability and severity of financial crisis, and the social costs of the reforms arise via increases in the cost of bank credit. Under conservative assumptions, estimated net benefits are positive. . . . Potentially negative side effects, such as a fall in aggregate lending or greater unintended fragmentation of financial markets, have not been observed. . . . . Financing for the economy has not fallen: following the introduction of TBTF reforms, aggregate credit and gross domestic product (GDP) have grown at similar rates. Even if G-SIBs may have reduced their domestic credit relative to GDP, other banks and financial institutions have picked up the slack.[33]

At the same time, the Consultation Report concedes that it has not taken all benefits (or potential costs) into account.[34] And is some respects, the analysis appears to discount the net benefits of the TBTF reforms significantly. For example, as it ventures into a quantitative assessment, the report explains that—

> The analysis suggests that TBTF reforms produce significant net benefits for society. The reforms are estimated to yield a present value benefit of 0.30% of GDP, while the cost of the TBTF reforms is estimated to amount to 0.09% of GDP. To place this in context, the aggregate GDP of FSB member jurisdictions amounted in 2019 to USD72.05 trillion. Estimated gross benefits would amount to USD216bn and estimated gross costs would amount to USD65bn.[35]

Setting aside the actual numbers, these datapoints suggest that the TBTF reforms confer a net benefit that is approximately three times the costs of those reforms. This is certainly a wide margin and one that more than justifies the costs of these reforms, but we believe it is still an overly conservative estimate that should be revisited.[36] We recognize that the analysis in the Consultation Report is focused on the TBTF reforms specifically, and that preventing a financial crisis involves a broader collection of reforms working in concert. But given the central role played by increased capital requirements, more rigorous bank supervision, and effective

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33 Consultation Report at 6.

34 *Id.*

35 *Id.* at 68

36 BETTER MARKETS, THE COST OF THE CRISIS: $20 TRILLION AND COUNTING (2015) (financial crisis cost America at least $20 trillion in lost GDP); , https://bettermarkets.com/sites/default/files/Better%20Markets%20-%20Cost%20of%20the%20Crisis.pdf; Regis Barnichon, Christian Matthes, & Alexander Ziegenbein, *The Financial Crisis at 10: Will We Ever Recover?*, FRBSF ECONOMIC LETTER (Aug. 13, 2018), https://www.frbsf.org/economic-research/publications/economic-letter/2018/august/financial-crisis-at-10-years-will-we-ever-recover/.

resolution plans in preventing another crisis, we submit that this ratio of benefits to costs is nevertheless an understatement.

For example, as the Consultation Report makes clear, even the significant net benefits of the TBTF reforms are likely underestimated for a variety of reasons, including conservative assumptions about how the costs of reforms are passed on to customers.[37] And, of course, a quantitative analysis cannot possibly capture all of the qualitative benefits of the TBTF reforms—avoidance of the severe human costs of financial crises and associated economic downturns cannot be reduced to a dollar amount.

The FSB should re-evaluate its analysis. Accurately assessing the true scale of the benefits of financial regulation, particularly as to the TBTF banks, is essential as a means of refuting claims that financial regulation is overly costly and should be repealed.

D. The FSB Should Further Analyze the Regulatory Challenges Posed by the Increased Internationalization of Financial Markets.

The Consultation Report makes passing reference to a trend that is of increasing and already enormous importance:

> The 2007-08 financial crisis slowed down, but did not reverse, the long-term trend towards global financial integration. Cross-border lending by banks other than European banks continued to expand. Measures of cross-border connectedness peaked at the onset of the financial crisis and, after a sharp drop in 2008, have since returned to or surpassed their pre-crisis levels.
>
> Global financial integration has major benefits but also entails risks that need to be managed. An open and integrated financial system has major benefits, provided the system as a whole is resilient against shocks. On the one hand, it contributes to the efficient allocation of global savings across countries and supports international trade and investment through financial deepening, risk sharing and diversification across institutions and markets, with positive effects on growth. On the other hand it also entails risks. Sudden stops and abrupt reversals of capital flows can impose significant costs. Increased openness also exposes economies to shocks originating abroad.[38]

Unfortunately, missing from this analysis is any reference to the risks arising from a lack of regulatory harmony across international borders and the race to the "regulatory bottom" that these variations inevitably foster. As Better Markets has cautioned again and again, the U.S. must not lower its regulatory standards or acquiesce to a weak "substituted compliance" regime

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37 Consultation Report at 68.
38 Consultation Report at 8; 61-62.

in the international arena.[39] That approach, urged upon policymakers in the name of protecting market share, is profoundly misguided. Members of the FSB have an interest in promoting the highest possible standards so banks are not tempted to forum-shop their way into a nation that ultimately becomes a repository of massive financial risk and potential instability that inevitably affects all nations. The FSB should more thoroughly assess the variations in regulatory approaches adopted in the member jurisdictions; evaluate the risks associated with those variations; and analyze effective approaches for achieving greater harmony along with the highest possible standards of financial regulation.

CONCLUSION

We hope you find these comments helpful.

Sincerely,

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39 *E.g.* Better Markets Comment Letter on Cross-Border Application of the Registration Thresholds and Certain Requirements Applicable to Swap Dealers and Major Swap Participants (Mar. 9, 2020), https://bettermarkets.com/sites/default/files/Better_Markets_Comment_Letter_on_Cross-Border_Application_of_the_Registration_Thresholds_and_Certain_Requirements_Applicable_to_Swap_Dealers_and_Major_Swap_Participants.pdf; BETTER MARKETS, FACT SHEET: ELEMENTS OF THE CFTC'S PROPOSED CROSS-BORDER REGULATIONS FACILITATE REGULATORY ARBITRAGE, IF NOT EVASION, OF U.S. LAW (Mar. 11, 2020), https://bettermarkets.com/sites/default/files/Better_Markets_One-Pager_on_the_CFTC%27s_Proposed_Cross-Borders_Regulations.pdf.

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