MERCATUS CENTER
George Mason University
Bridging the gap between academic ideas and real-world problems

PUBLIC INTEREST COMMENT

TLAC: OFF TO A GOOD START BUT STILL LACKING

STEPHEN MATTEO MILLER, PHD
Senior Research Fellow, Financial Markets Working Group
Mercatus Center at George Mason University

Agency: Federal Reserve System
Proposed: November 30, 2015
Comment period closes: February 1, 2016
Submitted: January 29, 2016
RIN: 7100-AE37
Docket ID: R-1523

Thank you for the chance to comment on the proposed rule regarding the "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; Regulatory Capital Deduction for Investments in Certain Unsecured Debt of Systemically Important U.S. Bank Holding Companies," pursuant to Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[1]

The Mercatus Center at George Mason University is dedicated to bridging the gap between academic ideas and real-world problems and advancing knowledge about the effects of regulation on society. My comments do not reflect the views of any affected party or special interest group, but are designed to assist the Federal Reserve Board of Governors (the Board) in the rulemaking process and reflect my general concerns about the unintended consequences of regulation.

While higher capital requirements can reduce the likelihood of banking crises, I would like to raise two key issues concerning the proposed policy statement: 1) bank subsidiary capital

1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (2010).

For more information, contact
Chad Reese, Assistant Director of Outreach for Financial Policy
703-993-8921, creese@mercatus.gmu.edu
Mercatus Center at George Mason University
3434 Washington Boulevard, 4th Floor, Arlington, VA 22201

requirements may be more effective than holding company capital requirements, and 2) the benefit-cost analysis used to analyze the rule could be improved by adding other dimensions to the analysis. Before addressing specific questions posed in the notice of proposed rulemaking, I will briefly summarize how state banking laws and regulations helped shape the banking system we have.

UNINTENDED CONSEQUENCES OF STATE BANKING LAWS AND REGULATIONS: BANKING CRISES, BANK HOLDING COMPANIES, AND THE MORTGAGE-BACKED SECURITIES MARKET

Calomiris and Haber and Bordo et al. have pointed out that throughout much of US history, populist politicians and small banking interests colluded to pass state laws and regulations restricting branching and interstate banking to limit competition from large city banks.[2] The unintended consequences of these laws and regulations include 1) frequent banking crises, 2) the formation of bank holding companies to get around the branching restrictions, and 3) the development of a mortgage-backed securities (MBS) market to help banks diversify their risks nationally, since they could not diversify directly.

To see how banking crises arise as unintended consequences of state banking laws and regulations, Calomiris and Haber and Bordo et al. observe that prohibitions against branching and interstate banking made US banks too small to weather regional economic shocks. As a result, the United States has experienced 10 banking crises since 1867 (see Calomiris and Haber, 5).

By way of contrast, Canadian banks, while well regulated, faced no branching or interstate banking restrictions; they were allowed to create deposits and originate loans throughout the country, which meant they could better withstand regional shocks. As a result, since Confederation in 1867, Canadian banks have yet to experience a system-wide crisis. This suggests that the institutions, or rules of the game, that define banking activity factor into the frequency of banking crises and have other unintended consequences.

For instance, entrepreneurial bankers had incentives to tinker with their organizational form to circumvent the rules. Bankers used the group bank, later called the bank holding company, to get around the onerous state laws that restricted branch banking.[3] This new structure helped banks to diversify risks and take advantage of economies of volume within states. That still left the national banking system in the United States fragmented, leading to a third unintended consequence.

As Bordo et al. argue, the MBS market was created in part to help banks gain access to loan exposures from across the United States since that was prohibited by state banking laws and regulations. By contrast, Canadian banks, which always operated throughout the country and

2. Charles Calomiris and Stephen Haber, *Fragile by Design* (Princeton, NJ: Princeton University Press, 2014); Michael Bordo, Angela Redish, and Hugh Rockoff, "Why Didn't Canada Have a Banking Crisis in 2008 (or in 1930, or 1907, or . . .)?," *Economic History Review* 68, no. 1 (2015): 218–43.
3. For a discussion of the organizational form, see Joe Mahon, "Bank Holding Company Act of 1956," Federal Reserve History website, November 22, 2013.

had steady access to deposit funding, could diversify their loan risks. Canadian banks rely on securitization less because they can do in-house what US banks were prevented from doing as a result of interstate banking restrictions.

THE MOST RECENT CRISIS NOT LIKE PREVIOUS BANKING CRISES

The most recent crisis breaks with the traditional pattern of a large number of small banks failing simultaneously. It was the first US crisis after the Riegle-Neal Act of 1994, which permitted US banks to operate nationally.[4] While the crisis seemed concentrated among large banks, Cordell et al. observe that structured finance collateralized debt obligation (CDO) tranches were the instrument at the heart of the recent crisis, given that expected losses averaged 65 percent.[5]

Erel et al. find that banks that were more heavily involved in securitization were more likely to hold the highly rated private-label tranches, including structured finance CDO tranches, which experienced high expected losses, since they could use those holdings to signal that they stood by their product (i.e., the securitization byproduct effect).[6] In forthcoming research, I find that some banks increased their holdings of these highly rated private-label tranches after the Recourse Rule was finalized in 2001, since the rule embedded reductions in risk weights for the highly rated tranches.[7] I also find that banks that held more highly rated tranches on the eve of the crisis were much closer to default as the crisis unfolded. So just as the rules of the game governing state banking contributed to banking crises in the past, reductions in the risk weights for the highly rated private-label tranches that experienced high expected losses helps explain why some banks held those tranches. With these observations in mind, I now turn to my comments.

COMMENTS ON TLAC AND LTD

Question 2 invites comments on the scope of application of the "External TLAC and LTD Requirements for U.S. GSIBs." Black et al. argue that higher capital could provide a low-cost way for holding companies to offset the risks associated with nonbank subsidiaries, so in this sense the TLAC and LTD could be consistent with this objective.[8] However, both Black et al. and Kupiec argue that holding company capital requirements are unnecessary if the subsidiaries are well capitalized, and suggest that capital requirements should be applied to the bank subsidiary.[9]

---

4. Riegle-Neal Interstate Banking and Branching Efficiency Act, Pub. L. No. 103-328 (1994).
5. Larry Cordell, Yilin Huang, and Meredith Williams, "Collateral Damage: Sizing and Assessing the Subprime CDO Crisis" (Working Paper No. 11-30, Federal Reserve Bank of Philadelphia, Philadelphia, PA, May 2012).
6. Isil Erel, Taylor Nadauld, and René Stulz, "Why Did Holdings of Highly Rated Securitization Tranches Differ So Much across Banks?," *Review of Financial Studies* 27, no. 2 (2014): 404–53.
7. 66 Fed. Reg. 59614 (November 29, 2001).
8. Fisher Black, Merton Miller, and Richard Posner, "An Approach to the Regulation of Bank Holding Companies," *Journal of Business* 51, no. 3 (1978): 379–412.
9. Paul Kupiec, "Is Dodd Frank Orderly Liquidation Authority Necessary to Fix Too-Big-to-Fail?" (AEI Economic Policy Working Paper 2015-09, American Enterprise Institute, Washington, DC, October 2015).

Moreover, Black et al. also point out that regulatory capital requirements should specify whether the purpose is to protect depositors (their preferred approach), in which case the bank's capital structure matters less. Alternatively, if the purpose is to prevent bank failure, then higher debt increases default risk and should be avoided. Since the proposed rulemaking seems more concerned with eliminating bank failure than protecting depositors, then the higher debt requirement could actually increase default risk.

COMMENTS ON THE BENEFITS AND COSTS OF THE TLAC

Question 24 invites comments on all aspects of the benefit-cost analysis. The Board has chosen a detailed and well-reasoned framework to estimate the inputs used to conduct the benefit-cost analysis. However, one aim of economic analysis should be to justify a new rulemaking compared to alternatives, not merely to examine whether the proposed rule's estimated benefits exceed its costs.

To demonstrate the merits of TLAC and LTD and widen the scope of the findings, the cost side of the analysis might offer better insight if it included other forms of capital. Alternative questions to consider include:

- What if capital requirements were applied at the bank subsidiary instead of the holding company?
- What if capital were defined as equity only, or long-term bonds only?
- What if institutions determine their own composition of capital?
- What if only the flat leverage ratio were used instead of risk-based capital requirements?

On the benefits side, the proposal's analysis relies on a sample of countries that a recent Bank of International Settlements (BIS) study used to determine the frequency of crises during the 1985–2009 period.[10] That approach may make sense for the BIS, given the organization's international focus. However, it does not make sense for the United States, given that the US banking system has been highly prone to banking crises throughout history.

During the 1985–2009 period, the United States experienced the savings and loan crisis and the most recent crisis, while Canada experienced none. If measured using historical frequencies, the estimated expected benefit using this methodology for the United States might be

10. Basel Committee on Banking Supervision, "An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements," Bank for International Settlements, August 2010. Countries in the sample include: Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong, India, Indonesia, Italy, Japan, Korea, Luxemburg, Mexico, Netherlands, Russia, Saudi Arabia, South Africa, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

positive, but for Canada the estimated benefit would be zero, since banks there have never experienced a crisis. Instead of assuming a crisis will occur every *x* years, the discussion justifying the estimates of the likelihood should at least recognize that the frequency of banking crises is a function of the rules of the game defining banking and other financial activity—and that US banks have often been fragile by design, as Calomiris and Haber suggest.

It is also ironic that the current methodology relies on a relatively short historical window of data to estimate the likelihood of a future crisis, given that some have suggested that a proximate cause of mispriced CDO tranches before the crisis was the rating and pricing methodologies that relied on a relatively short historical window of data to estimate the default correlations of the underlying collateral.[11]

Overall, the proposed rule's emphasis on higher capital, using debt and equity, is a step in the right direction for mitigating future crises, but the holding company is not necessarily the correct entity to rely on to mitigate future crises. Also unclear is whether the continued use of risk-based capital could create problems in the future.

11. See Felix Salmon, "The Formula that Killed Wall Street," *Wired*, February 23, 2009; *The Financial Crisis Inquiry Commission Report*, January 2011, 147.