FSB Consultation on the Adequacy of Loss-absorbing Capacity of Global Systemically Important Banks in resolution

Credit Suisse Response Letter

Credit Suisse welcomes the FSB initiative to define a strong global standard for Total Loss Absorbing Capacity (TLAC) for large banks. We believe this initiative will provide the resourcing to resolve a G-SIB convincingly and restore it to a sound financial footing. It builds effectively on the prior FSB efforts to establish the legal and market framework for effective resolution regimes and end "too big to fail". TLAC provides the last critical component to complete this project, putting the capstone onto the most critical reform of the post-crisis agenda.

Credit Suisse has long supported the suite of reforms needed to make bank resolution practical, and end the presumption of "too big to fail" for major banks[1]. In particular, we have emphasized the importance of a significant pool of mandated bail-in resourcing to ensure that resolution is fully funded in the event of a future crisis. The FSB's proposed TLAC standard sets out a strong framework to ensure sufficient resourcing. We hope that this reform, like the other elements of the FSBs Key Attributes, oblige the core of the international financial system to a consistent, high standard.

We appreciate the opportunity to comment on the FSB's TLAC proposal. While we agree strongly with the intent and core principles of TLAC, there are a number of specific areas where we believe the current term sheet should be refined. We are happy to provide follow up on any of our suggestions.

Our responses are set out in detail in the material, below, but we highlight several core recommendations here:

1. The External TLAC standard should be a strong, straightforward Pillar 1 requirement. We believe this is the best mechanism to assure systemic safety, a level playing field, and the broad credibility of this reform. We believe that the TLAC range and buffer package set out in the proposal is appropriately conservative, and could handle a GSIB failure without requiring any solvency support from taxpayers, in line with the FSB's Key Attributes.

   The External TLAC requirements proposed in the draft terms sheet, together with standard capital conservation and G-SIB buffers, could absorb any historic G-SIB loss events that we have been able to review over the last 40 years. This TLAC standard would be sufficient to replenish the maximum net capital drawdown (excluding capital raises for conservatism), restore the capital ratio to a robust going concern level, and do so with a significant margin of error.

2. The proposals around Internal TLAC ("ILAC") are important, but this is the area of the proposal that perhaps needs the most attention. International regulations prescribing the internal structure for banks are relatively novel, and raise a number of delicate issues. This final terms sheet will need particular care to address these issues and avoid unintended adverse consequences.

   We support the concept of ILAC for two reasons:

   a) it provides comfort to host regulators by increasing the incentives for a group to recapitalise a distressed subsidiary, either by means of distributing available capital or through the triggering of External TLAC issued at the resolution entity; and

   b) it can provide comfort to host regulators in non-distressed jurisdictions, so that they are assured of some resourcing for potential future problems in their entities.

[1] Credit Suisse executives developed and published the first public outline of "Bail-in" resolution in 2009 -10, and have been active in the subsequent development and implementation of this concept. (see: The Economist "From Bail-out to Bail-in", dated January 30th 2010).

However, there is a risk that ILAC may become the binding constraint for many banks, and produce a requirement that is super-equivalent to External TLAC. There are a number of frictions that can emerge when the legal entities within a global group are consolidated, each of which is subject to different constraints and local requirements. These considerations present important real world challenges for G-SIBs and cannot be assumed away; it is critical that the architecture of ILAC address these challenges.

Even more important from a systemic perspective, an improperly-specified ILAC can lead to internal balkanization and actually increase the risk of a group failing. Many of the banks that survived the recent crisis reallocated group resources to support key subsidiaries that were subject to local shocks. The "source of strength" doctrine worked, and prevented a number of groups from failing. Private actions of these banks served the broader systemic interest in this case. However, such reallocations may be more difficult in the future. If the new regime requires heavy ILAC pre-placement, and if this ILAC becomes difficult to move because of increased "ring fencing" tendencies, it could become difficult to transfer capital or liquidity in the future. If this is not addressed carefully, the risk of entity failure -and the risk of subsequent group failure - will increase. The possibility of creating a more brittle institution runs directly against the objective of the project.

We make some recommendations to mitigate this issue, including:

a. Support for the notion of top-down "proportional distribution" of External TLAC to key entities, to ensure that all jurisdictions are treated fairly, and to maintain an unallocated "central reserve" for additional group resilience. A proportional distribution also helps ensure that host supervisors are protected from the concern that a different jurisdiction might move early to capture a disproportionate share of unallocated TLAC.

b. Support for a lower figure for the amount of External TLAC allocated to ILAC, at or below the bottom end of the FSB's proposed range. We suggest a figure within a 65% to 75% range. We also recommend using a component of general, unfunded support (e.g. via a guarantee or legal keepwell mechanism) to provide additional assurance to hosts while reducing the risk of brittleness.

c. While some hosts might initially prefer to maximize the percentage of dedicated, fully funded ILAC, the potential brittleness of such a system would ultimately work to their detriment. In the end, thoughtful hosts benefit enormously if the groups that operate in their jurisdictions are more resilient.

3. We also suggest some more technical revisions that we believe will make the proposal regime more efficient and robust.

    a. Sections 12 and 13 of the current draft appear to create an inadvertent "poison pill" that would invalidate the structural subordination provided by holding company funding structures. We believe that this method of subordination is an effective legal and economic strategy, and that legitimate concerns can be handled effectively by a refined set of rules. See Annex 2 for a detailed discussion of this issue.

    b. A broad, deep and liquid market will be important for the industry to achieve the high level of loss absorbency required by the External TLAC standard. Together with required regulatory buffers and a prudent "management buffer" over minimum requirements, GSIBs will be required to issue between 20% and 27% of their RWAs in the form of TLAC. The TLAC requirements for G-SIBs will amount to approximately $4 trillion; this will require a broad set of markets that are attractive to investors.

        i. Many structured notes meet the underlying goals of TLAC and can provide good loss absorbency. We estimate this market at between $500 and $700bn for GSIBs, which provides an important additional source of supply that can improve the depth and the resiliency of the TLAC market. See Annex 1 for detailed comments.

ii. We believe that market making and underwriting exceptions for G-SIBs will be important to support liquidity in this market, and can be established without undermining the conservativeness of the standard.

iii. We recommend against the introduction of investor restrictions beyond the existing G-SIB arena. Unnecessary prohibitions could impede the size and efficiency of the future TLAC market, which will need both.

iv. Currently only instruments with a remaining maturity of 12 months or longer are considered eligible for TLAC. While we understand the need to avoid cliff effects, and "hair trigger" maturities, this appears overly conservative. A maturity requirement cut off of 6 months would provide a sufficient period for mitigation before the firm would move into a position where actual bail-inable resources fell below the target. This would also align the TLAC requirement with the recent delineation of the NSFR standard.

c. The redemption requirements in the text could be interpreted to require pre-approval for normal redemption and liability management. For institutions operating above the TLAC threshold, this is unnecessary and cumbersome, and should be relaxed.

d. The final proposal should be careful to avoiding creating a presumption that there is a PONV trigger at or near the TLAC barrier. While a TLAC breach should be treated seriously, a presumed trigger could create unnecessary investor anxiety, just at the point when a bank most needs to replenish its supply. We would encourage stronger statements to alleviate this concern.

1. FSB consultation paper: Question catalogue

1. Is a common Pillar 1 Minimum TLAC requirement that is set within the range of 16 – 20% of risk-weighted assets (RWAs), and at a minimum twice the Basel III leverage requirement, adequate in the light of experiences from past failures to support the recapitalisation and resolution objectives set out in this proposal? What other factors should be taken into account in calibrating the Pillar 1 Minimum TLAC requirement?

The size of the common Pillar 1 Minimum TLAC requirement is important. It should be calibrated to a level where it can absorb crisis losses plus any resolution transaction costs, and convincingly recapitalize a failing bank. A common Pillar 1 standard should be calibrated to eliminate TBTF and support the resolution of all G-SIBs.

We believe historic crisis analysis is likely to provide the most useful and practical guidepost for this exercise. Credit Suisse has performed historic loss analysis of previous bank failures and crisis events. The analysis confirmed that 16% of RWAs (double the Basel Total Capital Requirements) plus the capital conservation buffer and the G-SIB buffer would have been sufficient to deal with all G-SIBs in economic crises going back to and including the Latin American sovereign debt crisis of the late '70s/early '80s.[2] This figure would be sufficient to handle the most severe G-SIB equity drawdowns, even if markets for fresh capital were closed for a multi-year period, and restore the post-resolution entity to a full and convincing capital base.

In addition to these elements, it is also reasonable to consider some additional margin for surprises, possible resolution transaction costs, home-host frictions, and to ensure liquidity providers are well protected. Because of these factors, we believe the proposed range of 16% - 20% RWA is well founded, and we defer to the Quantitative Impact Study[3] and Historic Loss Analysis to inform the exact credible figure within that range.

Changing rules on the calculation of RWAs could alter the historic loss analysis by changing the benchmark unit of measure. Many changes in RWA have already taken place with the implementation of Basel 2.5 and Basel 3, which are set on a materially more conservative foundation. Recent EBA analysis indicated an average differential of approximately 1.3x in severity between current rules and full Basel 3[4], and other analyses suggest higher net effects when the full course of crisis reforms are considered. This would imply that an historical loss drawdown of 4% in Basel 2 terms would equate to a 3% drawdown in Basel 3 RWA terms. If there are further fundamental recalibrations of RWA (for example via the FRTB, or other RWA refinement workstreams), then the historic analysis and implied TLAC should be adjusted, to maintain a consistent measurement standard. If final rules on RWA are not available before the TLAC standards are adopted, we suggest the final rules include a suitable review clause.

We support a conservative calibration of the minimum Pillar 1 TLAC requirements for several reasons:

- **Full recapitalization:** resolution authorities should account for the need to recapitalize the full operation to a credible level following determination of non-viability (PONV). While some argue that recovery measures will shrink the firm, we believe enforced recovery shrinkage or forced resolution cuts is likely to create

[2] For events in the Basel capital regime era, the RWA denominator is rebased to a Basel 3 standard, based on best available transition disclosure.

[3] Some research papers have focused on outliers –including outcomes from small, less diversified banks in a particular country, or even monoline banks. GSIBS are inherently more diversified, and are much less prone to local stress events or a model error in one part of the RWA regime. Given that TLAC is designed for GSIBS which are inherently more diversified by product and geography, the calibration ought to focus on the relevant historical supporting evidence.

Some other research papers have focused only on gross pretax losses, or included factors like goodwill write-downs which are not relevant for a proper analysis (goodwill is already deducted for regulatory capital purposes). Other analyses have ignored the higher severity of Basel 3 vs prior RWA regimes, which is an important baseline shift to take into account. It is important to consider the *net drawdown of regulatory capital*, recalibrated to current RWA rules, as the primary metric, and to choose a sample set of institutions that broadly resemble a G-SIFI with its inherent diversity of business lines.

[4] See EBA document "Basel III monitoring exercise", Results based on data as of 31 December 2013. http://www.eba.europa.eu/documents/10180/534414/Basel+III+monitoring+report+(results+as+of+December+2013).pdf/9b9a96b4-0c23-4ea5-bf8e-4651acfa2acd

adverse franchise damage. Such actions can also induce fire sales that can produce adverse systemic and economic outcomes.

There are also those who argue a full recapitalization is not necessary, given that only Critical Economic Functions (CEFs) need to be maintained post PONV, however, given both the volume and inter-linkage of CEFs for many G-SIBs, we think such an approach could be unpredictable, operationally complex and risky. For systemic banks in particular, it is better to base resolution on the clean concept of full recapitalization for credibility, efficiency and stability. Any bank restructuring should be deferred to a later period after the critical phase of resolution, in conjunction with the new management and ownership structure. We accept this can lead to a more conservative TLAC standard.

- **Protect liquidity providers:** it is critical for an effective bail-in to ensure sufficient protection for market liquidity providers and / or central banks so that they are protected by a robust buffer of capital after the event. This will also aid in the rapid transition of funding from emergency providers to normal market sources.

Pillar 1 better than Pillar 2: a clear and robust Pillar 1 requirement is helpful for financial stability, and sends a positive message about progress on TBTF. It reduces the need for ad hoc, inconsistent and difficult-to-estimate Pillar 2 add-ons, and results in a more transparent and uniform global standard. A credible Pillar 1 rule with little or no Pillar 2 variability would also ensure strength across the system, and avoid sanctioning pockets of weakness that can introduce vulnerabilities. Finally, we are sceptical that there are sufficient grounds to differentiate between banks for such extreme "tail" type risks, and that quantitative fine-tuning is not likely to be productive.

We welcome the principal calibration of TLAC on RWAs. This method focusses appropriately on the risk of loss and creates positive incentives for risk management. However, we also accept that any resolved bank would need to meet both risk weighted and nominal capital ratios, and to that extent understand the need to include a leverage ratio test. We encourage this test to be kept as a backstop with simple mechanics, and to that end recommend clarifications to the current term sheet. There is significant confusion as to whether the term sheet implies minimum TLAC at 2x the Basel leverage ratio, whether it involves further buffers, and other questions around the numerator and overall calibration. We understand the purpose of the requirement to ensure a newly recapitalised entity would meet required nominal as well as risk-weighted capital ratios, and therefore recommend the FSB clarify the leverage requirement to refer to 2x the minimum Basel Tier 1 leverage ratio with no additive buffers, which will be set as a global standard for large banks by Basel in 2017.

2. Does the initial exclusion of G-SIBs headquartered in emerging market economies (EMEs) from meeting the Common Pillar 1 Minimum TLAC requirement appropriately reflect the different market conditions affecting those G-SIBs? Under what circumstances should the exclusion end?

Exclusion of emerging market GSIBs from TLAC requirements should end if the EME GSIB becomes more internationally active in the broader financial system and thus interconnectivity is rising. Current emerging market GSIBs are primarily domestic institutions, with activities relatively contained in their country of origin. This provides a potentially valid rationale for exclusion, but clear, quantitative metrics should be developed to ensure that that this exclusion remains valid.

We also accept that the capital markets of many EME countries are less developed. Because of this, we suggest a slow phase in transition from 2019 to 2022 for any EME GSIB still considered a GSIB and not a DSIB. Should an EME G-SIB emerge in a new jurisdiction in the future, we recommend that phase in rules also apply so that abrupt discontinuities are avoided here as well.

3. What factors or considerations should be taken into account in calibrating any additional Pillar 2 requirements?

Pillar 2 regimes are frequently opaque and often overly complex. The aim of TLAC is to create a simple, transparent and internationally harmonized measure to ensure safe resolution. Adding a Pillar 2 component to TLAC requirements would send the wrong signals to the market, suggesting that some countries calibration for TLAC was not sufficient to solve TBTF and creating concerns about the strength of other countries' regimes. That could signal that other countries have it wrong and undermines the effort and credibility of solving TBTF. Given the rapid advance on substantive issues, a large portion of the remaining concern around TBTF is market perception. TLAC has the potential to achieve a high degree of investor, counterparty and rating agency credibility, if consistently implemented. The concepts and legislation are all now coming into place. A consistent and well founded Pillar 1 TLAC will be a strong message that communicates a practical end to TBTF.

Finally and by extension, we would welcome clarification that that the FSB opposes Internal TLAC Pillar 2 add-ons which could undermine the CMG negotiations implied under Section 22, introduce additional complexity and incentivise trapping of capital and liquidity.

4. Should TLAC generally be distributed from the resolution entity to material subsidiaries in proportion to the size and risk of their exposures? Is this an appropriate means of supporting resolution under different resolution strategies? Which subsidiaries should be regarded as material for this purpose?

We believe Internal TLAC ("ILAC") should be allocated proportionally from the Resolution Entity down to the Material Subsidiaries, up to an agreed portion of the External TLAC requirement. The remaining portion should be kept in a central reserve[5] for additional flexibility, and would be available to provide additional protection to particular subsidiaries that come under stress, as needed.

Because of legal entity governance requirements, and certain issues around downstreaming capital to distressed entities, we believe that home nation solo requirements should be considered under an Internal TLAC system. This will put significantly more pressure on the careful design of the system, as it materially increases the risk of super equivalence (see below).

We see 2 primary objectives for Internal TLAC:

- Distressed entities: Internal TLAC should create an economic and legal structure that allows losses to be upstreamed from distressed legal entities, and capital to be downstreamed to help stabilize them. Internal TLAC provides one mechanism to effect that, one that is consistent with legal entity needs and governance procedures.

- Non-distressed entities: Capital must be sufficient for other jurisdictions to work cooperatively in a time of stress. Cooperation agreements, pre- planning and trust are important in this regard, but the strongest foundation is likely to be well-calibrated incentives for both sides to cooperate.

We note that Credit Suisse policy has been to support its legal entities on a consistent basis around the world; we believe that maintaining an integrated operation and a strong brand are an essential part of our business. During the recent crisis, we maintained a strong global position and shifted resources to key subsidiaries to absorb local market shocks that took place at different times. We believe that a thoughtful CMG, despite the pressures of a resolution event, would understand the strong economic incentives to continue such a policy.

While we support the concept of internal TLAC for these issues, the concept also raises 3 major concerns:

- A potential binding constraint: There are scenarios in which the sum of Internal TLAC could become the binding constraint of the group. The combination of local buffers, possible consolidation difficulties, different RWA calibration enforced by different regulators, and the possibility that leverage binds in some subsidiaries but RWA in others, all produce effects that could become super-equivalent to External TLAC requirement. Several firms have expressed the concern that they believe the current text would have this result; we do not believe the FSB's intention was for internal requirements to become the binding external constraint and displace External TLAC.

[5] Note that a "central reserve" might be held in securities at the Resolution Entity in some cases, but may also be downstreamed into productive use at various subsidiaries in other cases. The essence of this concept is however, that such investments are not required or restricted in their current form and use. They can be reallocated as needed, which creates the necessary flexibility to think of them as a 'central reserve'.

- A risk of brittleness: If the demands for Internal TLAC are high or superequivalent, the cushion provided by a central reserve can be squeezed, potentially to zero. This could mean that the group's ability to rescue a single troubled subsidiary can become difficult or potentially impossible if regulators indulge in ring fencing (i.e. a scenario of high ILAC preplacement that is locked in place by ring fencing – restricting the ability to transfer surplus capital to a weaker entity). In such a case, the local entity might fail, and trigger a cascade of runs and failure across the group – even when the consolidated entity was strong. In this scenario, an SPE bank could fail based on the condition of a single weak component, which ignores the strength of the whole. This effect multiplies the sources of potential distress dramatically. Such a scenario would mean that reforms have made banks more brittle, not more resilient. It is essential that we avoid that outcome.

- Possible disruption of resolution strategy: Banks and their CMGs will establish a core resolution strategy that is designed to preserve critical functions and franchise value, and minimize systemic risk. However if local ILAC is too small, there can be fear that a parent company would be incentivized to walk away from this strategy. On the other hand, excessive ILAC could encourage a host jurisdiction to "break for the exits". A *proportionate* amount of internal TLAC, coupled with a fair distribution across subsidiaries and a central reserve, should provide the most balanced and constructive set of incentives for both home and host. This should support the overall group resolution strategy, and help preserve franchise value and critical economic functions.

To address the brittleness concern, we suggest starting with choosing the right amount of External TLAC to preposition with Material Subsidiaries in the form of ILAC. We recommend a figure set at a point between 65% - 75% of the External TLAC, and ensure that the remainder was preserved as a central reserve for the benefit of the group and all hosts. The 65-75% portion of External TLAC would be distributed to the Material Legal Entities, including material home country subsidiaries, in proportion to their share of group RWA exposure.[6]

We propose that a layer of unfunded, uncollateralized TLAC (e.g. a tranche of parent guarantee support, or a legally binding keepwell agreements) could provide an additional layer of support for both objectives (perhaps an additional 10% of External TLAC), to reach the higher host target range set in the paper.

Such a hybrid system - one that includes both funded and unfunded Internal TLAC - should strengthen the ability to achieve the two enumerated objectives of ILAC, while mitigating the drawbacks noted above. While unfunded commitments may seem less reliable in extreme cases than preplaced cash, they are legal requirements that will provide important comfort to host supervisors and further align legal entity decision making inside an SPE group. This would enhance the flexibility and avoid unnecessary failure risk – while still using cash ILAC as the core element. In the end, host authorities also benefit strongly from a more balanced system and a more resilient bank.

We also believe that the "expectation" that 33% of TLAC will be in non-equity instruments should not apply to ILAC. The requirement for non-equity instruments in External TLAC introduces a useful monitoring tranche, promoting oversight by motivated investors. Internal TLAC is not owned by 3rd parties and cannot provide any additional information. Relaxing this constraint can reduce the effect of one of the potential constraints that arises on consolidation.

Requests for additional Internal TLAC to replenish capital depleted by local losses are reasonable. However, a request for additional Internal TLAC to guard against *potential* risk can be counterproductive. A disproportionate capital request by a "nervous" host should be assessed by the CMG in the context of the group, and granted only on if other jurisdictions are given a simultaneous opportunity to participate on a pro-rata basis. This should discourage hoarding incentives, and help offset the impulse to "move first" by the most aggressive host regulators. By maintaining parity among other subsidiaries, the strength of the group is maintained to support all subsidiaries – not just a nervous "first mover".

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[6] We believe this approach to be in line with the FSB's stated overall objective, as described in the first paragraph of Section 22 of the term sheet. However, some of the other comments describing the ILAC process in the rest of Section 22 imply a more problematic" bottom-up" method, which can result in the super-equivalence problem noted above.

5. To what extent would pre-positioning of internal TLAC in material subsidiaries support the confidence of both home and host authorities that a G-SIB can be resolved in an orderly manner and diminish incentives to ring-fence assets? Is a requirement to pre-position internal TLAC in the range of 75 - 90% of the TLAC requirement that would be applicable on a stand-alone basis, as set out in the term sheet (Section 22), appropriate to satisfy the goals of the proposal and ensure that TLAC is readily and reliably available to recapitalize subsidiaries as necessary to support resolution? Can this pre-positioning be achieved through other means such as collateralized guarantees?

A bail-in resolution is designed to re-capitalize the top resolution entity (whether SPE or the relevant top entity in MPE) and keep the operating subsidiaries of these resolution entities open and unaffected. We believe whole-bank recapitalization is likely to be the most powerful and efficient way to ensure continuity of all functions, especially critical and systemically relevant activities. Stabilization and ongoing services will work best if capital and liquidity stays fungible within a group, and is allocated fairly across functions and jurisdictions. We believe that this approach is effective and powerful, and should provide confidence to both home and host authorities.

However, we accept that local regulators may also need local, specific support for confidence. Prepositioning of TLAC should provide incentives for regulators to take a coordinated approach in resolution[7]. This starts in the Crisis Management Groups (CMG) by agreeing on a resolution strategy and working on joint actions. As such prepositioning should distribute loss absorbency fairly within a group, but it should not ring-fence or otherwise limit the fungibility of TLAC in order for it to be effective in stabilizing a failing banking group.

Heavy prepositioning requirements for ILAC can also reduce the fungibility of capital and liquidity within a group, which is an impediment to restructuring and stabilization. It could also lead to the unnecessary failure of a legal entity, which in turn could undermine the group. Please see our response in Q4 for a more detailed discussion of this issue.

We support the concept of a pooled resource, including both collateralized and uncollateralized pools, to help address some of our logistical concerns about ILAC. We believe this can work in practice and would be helpful in many situations.

The cooperation agreements among regulators should address the home host concerns of regulators and provide additional comfort that cooperation will be forthcoming. To address the remaining doubts, the prepositioning requirement should be based on a proportionate percentage of the group's External TLAC. This would more fairly distribute TLAC within a group. Alternatively, unfunded commitments such as keep well agreements between parent and subsidiaries could further strengthen the balance between home and host regulators during resolution. This would augment existing "source of strength" effects, which motivate the group to address home-host issues to preserve franchise value and meet legal requirements.

6. Are the eligibility criteria for TLAC as set out in the term sheet (Sections 8-17) appropriate?

Building up TLAC will require a significant effort for many banks to restructure their organization and funding mix. The amounts are very large. The markets need to fully understand TLAC, the funding and subordination solutions chosen by each banks (contractual, statutory or structural) and clear guidance for the transition period. This is necessary to avoid undue speculation on calls, eligibility and future issuance pattern. The eligibility criteria need some further specification, which we highlight section by section below.

Section 8

- **Transparent disclosure:** Liabilities ineligible for TLAC may still be liable for loss absorption under the relevant national/regional recovery and resolution law, and this should be communicated clearly. To

[7] For certainty and common cross-border understanding, the FSB should clarify that the MLE list for the purpose of TLAC allocation (as well as any other purpose) is identical to the list of MLEs that has already been identified by global regulators for the purpose of resolution and recovery planning. Having disparate lists of which G-SIB legal entities qualify as MLEs for different purposes would be confusing for the work-plan of the CMG and national regulators, and counter-productive to efficient cross-border coordination.

minimise the potential for market stress as a result of unforeseen loss absorption, and to facilitate efficient pricing, all bank creditors must be clearly informed about bail-in risk. We recommend the FSB and BIS consider such broader disclosure requirements within the work programme mentioned in Section 24 of the term sheet. We also believe that this will require cooperation from the relevant resolution authority, as the choice of strategy is in their hands, and can sometimes affect the approach taken to different classes in resolution.

- **Pillar 2:** As previously stated, we would prefer regulators to prioritize a robust Pillar 1 resourcing for clarity and consistency. The need for a Pillar 2 regime is also reduced by the significant conservatism already built into Pillar 1 TLAC – for example:

  - The assumption that no regulatory capital would remain in an institution at PONV;
  - The distribution restrictions that apply once the buffers are breached;
  - No reduction in RWA during recovery phase;
  - The size of the CCB, G-SIB and possible CCyB buffers on top of the TLAC requirement.
  - The management buffers that banks will choose to impose given the implications of TLAC breach or buffer depletion
  - The unrecognized loss absorbency of bail-inable liabilities that have fallen below the minimum maturity requirement (currently 1 year).
  - The conservatism of the likely Pillar 1 minimum requirement itself

- If the FSB decides that external Pillar 2 for TLAC is unavoidable, then we would recommend that this is framed as an exceptional tool, agreed by the CMG, and the criteria for instrument eligibility are sufficiently flexible. Anything that qualifies as TLAC, where it is Pillar 1 or 2, needs to be clearly bail-inable, so in effect subordinated to Excluded Liabilities. However, as Pillar 2 TLAC would be a back-up buffer, we think that the strict Pillar 1 TLAC requirements on breach should not apply to any Pillar 2 add-on.

Section 9

- **External TLAC to be issued by resolution entities:** the termsheet requires External TLAC to be issued and maintained by resolution entities. We understand the underlying impetus here but think the final rules should allow TLAC to be issued by a SPV in various circumstances.[8]

- We strongly believe that capital instruments which are only partially recognised as regulatory capital (i.e. due to amortisation inside the 5 year mark), should have a 100% efficiency in terms of TLAC eligibility. Despite not fully counting towards regulatory capital they are still subordinated to OpCo senior liabilities (avoiding NCWOL issues) and fully bail-inable. We believe that if such instruments meet the criteria in sections 10 through 17, then they should fully count towards the minimum Pillar 1 TLAC requirement.[9]

Section 11

- **Minimum maturity:** We understand the importance of avoiding run-risk, and protecting against any reduction in a firm's TLAC resulting from temporarily impaired access to capital markets. However, we think a cut-off at 1 year of remaining maturity is too restrictive. We estimate that a meaningful amount of G-SIB senior unsecured is currently < 1 year, which would effectively disqualify a large amount[10] of robustly bail-inable capacity. Moreover, due to the reputational and financial implications of TLAC breaches, banks will run management buffers above the minimum requirements. When added to the non-qualifying buffers (e.g. CCB, CCyB and G-SIB buffers), this will result in effective TLAC levels significantly in excess of what is intended. In total, these factors could bring the effective requirement to 6.5% to 8% (or more) above the TLAC requirement (expressed in % of RWA terms). This will also

[8] For example, SPVs may be needed for jurisdiction-specific legal or tax requirements, or if there are specific contractual provisions that novate any bonds to the relevant resolution entity following a PONV determination by the resolution authority.

[9] "Old style" capital instruments should count as well, assuming they satisfy the same TLAC criteria noted above.

[10] Consider the following G-SIB funding strategy for TLAC, where roughly half of the total TLAC plus buffers is funded by term debt, amounting to 10 – 14% of RWA. A funding strategy based on regular issuance into the liquid 5 year sector would have approximately 1/5th of the debt stack fall inside 1 year at all times. This translates into 2%-3% (RWA terms) of effective Bail-in resourcing that is uncounted for TLAC.

exacerbate demand side issues, as banks will have to issue materially higher volumes of subordinated debt.

We would prefer an approach based on a 6 month residual maturity cut-off, which we think recognizes a more appropriate balance between certainty of loss absorption and amortization risk. To the extent that regulators desired additional protection, this could be augmented by an added concentration limit for 6m – 1 yr funding, as per their powers to consider the overall maturity structure. A further benefit of this approach would be alignment with the 6 month NSFR threshold. It would seem inconsistent to exclude 6-12 month instruments from TLAC on run-risk grounds, when from a liquidity perspective they are considered stable funding.

In addition, we would propose to consider deleting the second paragraph "*In addition, the appropriate authority should ensure that the maturity profile of a G-SIB's TLAC liabilities is adequate to ensure that its TLAC position can be maintained should the G-SIB's access to capital markets be temporarily impaired*": if the aim is to introduce management buffers, this will already happen as a consequence of TLAC being a regulatory minimum requirement, therefore no need to specify. If this wording is instead hinting at a more granular power may be given to relevant / local regulator to specify concentration limits by maturity buckets on a forward looking basis, this would unnecessarily restrict banks' flexibility in funding, as banks may need to over fund or underfund in certain maturities depending also on available market demand.

Section 12: Excluded Liabilities

<u>Structured Notes:</u>

We believe a segment of structured notes issuance is suitable for TLAC eligibility. Structured notes should be included in TLAC as long as they meet the other requirements of the final terms sheet (e.g. unsecured status, effective subordination to operating liabilities, sufficient maturity, etc.), and have proper operational support for effective Bail-in. Structured note obligations do not differ conceptually from vanilla instruments with hedges, such as fixed rate bonds swapped to a floating rate, which is a widely used industry practice. Although concerns have been suggested with respect to operational issues, valuation complexity, callability, and market disruption, these concerns can be relieved through further understanding of these products and haircutting the eligible note population where appropriate.

Structured notes are an important funding class for many banks, and inclusion will diversify the investor base for funding. Based on a review of recent G-SIB disclosure for major issuers, we estimate the size of this market at between $500 and 700bn. This funding sector has often been resilient during periods when capital markets are inhospitable. A broad and resilient funding base can promote larger and more stable resourcing and better burden sharing. A large and diversified investor pool will help to lower contagion and mitigate systemic ramifications.

A more detailed presentation is included in Annex 1.

Section 13:

- **Priority:** we are strong supporters of a clean separation between Capital Structure and Operating/Excluded Liabilities to ensure that bail-in is feasible, predictable, and can be executed without systemic spillover. Without subordination of TLAC to Excluded Liabilities (appropriately amended, as per Annex 2), there is a danger that TLAC resources could be inaccessible (due either to set-off, or regulatory forbearance in anticipation of legal claims), or that there could be post hoc NCWOL challenges.

  The most effective mechanism to achieve TLAC subordination will vary by firm, but the principles of effectiveness and transparency should be strictly adhered to.

- **Structural subordination:** CS have announced a legal entity strategy predicated on enhancing resolvability by structurally subordinating our unsecured term debt via Holding Company issuance. We believe this is an effective strategy, but currently frustrated by certain drafting elements in the term sheet. Please see our detailed response in Annex 2.

- **2.5% allowance for operating company TLAC :** see our response in Question 9

Section 14:

- **Set-off / netting:** this is crucial to avoid a reduction in bail-inable capacity at the critical moment of resolution. If investors can sell TLAC positions to investors holding set-off claims (e.g. corporate borrowers from the same entity), the loss absorbency of TLAC could be eliminated. The set off borrower would be protected by his NCWOL claim – potentially making a distressed instrument worth par in his hands. In the run up to resolution, there could be strong financial incentives for market participants to restructure their claims in this manner. We note set-off rights vary by country, but it is essential that regulators protect against this risk in operating company bail-in.

Section 15:

- **Redemption:** the redemption requirements described here are too punitive, effectively treating senior GLAC as equity. There should not be a need for regulatory approval for GLAC redemption when the firm continues to have outstanding TLAC in excess of the minimum requirement.

Section 16:

- **Governing law:** no comment

Section 17:

- **Triggers for externally issued TLAC:** no comment

7. What considerations bear on the desirability of an expectation that a certain proportion of the common minimum Pillar 1 TLAC requirement consists of (i) tier 1 and tier 2 capital instruments in the form of debt plus (ii) other eligible TLAC that is not regulatory capital?

While some assert that "equity is always best", we think that a well-structured array of capital and senior capital markets instruments can be superior in many situations. For example, additional Tier 1 can provide a capital class whose investors are largely focussed on safety, and perform an important monitoring function. It also allows banks to access different investor groups, which helps build a more diverse funding base. However, institutions should be given wide latitude to build their capital structure with instruments of their choice, so long as they satisfy the final TLAC standards.

We do not think this expectation should apply to internal TLAC, as the monitoring function does not apply in the case of internal instruments

8. Are the conditions specified in the term sheet (Section 8) under which pre-funded commitments from industry-financed resolution funds to provide resolution funding contribute to TLAC appropriate?

Credit Suisse opposes the inclusion of resolution funds in TLAC. Resolution funds mutualise losses across the industry, effectively forcing the equity holders of well-managed banks to "bail-out" the creditors of poorly-managed banks. This weakens market discipline, complicates investor expectations, and introduces moral hazard.

There is also a risk of spreading of contagion, as marginal banks can be weakened by resolution fund obligations at a time of systemic fragility. While a prefunded scheme is less prone to this issue compared to an ex-post fund, it still creates the potential for a future liability to refill the fund.

The inclusion of resolution funds can also create aberrant incentives, due to the differential treatment expected by the first bank to tap the resolution fund, when compared to the last in a long queue. This "time-priority" problem provides good outcomes to the "first to fail" bank and delivers the worst outcome to the "last to fail" bank.

Because of these concerns, resolution funds are excluded in many jurisdictions. In the case of the Swiss TBTF regime, banks are required to hold the necessary resolution capital individually in the form of a systemic surcharge, which has the additional benefit of internalizing moral hazard. As a result, the Swiss Financial Market Supervisory Authority FINMA considers system-wide resolution funds as “neither necessary nor efficient”.[11]

EU resolution fund: The purpose of TLAC, as defined by the FSB, is to ensure “…the availability of adequate loss-absorbing capacity.” We do not believe the inclusion of the EU’s resolution fund, established under the Bank Recovery and Resolution Directive, would satisfy this objective. The EU’s resolution fund cannot be accessed until 8% of total liabilities (incl. own funds and measured at the time of the resolution action) have been bailed-in first. In effect, this disqualifies it from TLAC effectiveness, as it cannot *start* to be used until after the bank has already bailed in more than the TLAC requirement. Furthermore, use of the EU fund introduces governance complexity[12] and state aid considerations, which would undermine the objectives of TLAC by increasing the uncertainty of the loss absorption. For these reasons, we support the current wording in the terms sheet which prohibits inclusion of the EU resolution fund.

9. Is the manner in which subordination of TLAC-eligible instruments to excluded liabilities is defined in the term sheet (Section 13) sufficient to provide certainty regarding the order in which creditors bear loss in resolution, and to avoid potentially successful legal challenges or compensation claims? Where there is scope for liabilities which are not subordinated to excluded liabilities to qualify for TLAC, are the transparency and disclosure requirements set out in section 13 and 24 sufficient to ensure that holders of these instruments would be aware of the risk that they will absorb losses prior to other equally ranking but excluded liabilities? If not, what additional requirements should be adopted?

- There are important technical issues with the current specification of holding company requirements (structural subordination), relating to the interaction of Section 12 and 13. As written, these requirements would frustrate the use of an otherwise effective structure, which we believe is an unintended outcome. We set out our concerns and recommendations in some detail in Annex 2.

- The inclusion of a 2.5% (or larger) amount of operating company senior unsecured debt provides a means to include some of the existing stack of debt issued by operating company issuers. While Credit Suisse is currently an operating bank issuer, we have announced a shift to a holding company model to avoid the issues raised by operating company issuance. In particular, such issuance can give rise to a problematic choice: either NCWOL claims if a large portion of pari passu operating debt was protected – or the risk of systemic disruption if the operating liabilities were haircut. This issue can be exacerbated in many (but not all) jurisdictions by “set off rights”, where corporate borrowers from this entity could potentially frustrate the loss absorption of TLAC by purchasing TLAC debt in the secondary market. In the hands of these holders, set off rights can provide a NCWOL “poison pill” and effectively negate the loss absorbency of TLAC. In effect the NCWOL problem has both a “static” and a “dynamic” dimension, and the resolution authority should ensure than neither issue would prevent effective bail-in of the 2.5% contemplated for inclusion in TLAC. These issues may differ on a jurisdictional and structural basis, but they should be addressed cleanly and the risks explained properly to the holders.

- Credit Suisse agrees with the broad description of subordination and transparency, and we agree that this would provide sufficient certainty regarding the order in which creditors bear losses. We also think that disclosure across G-SIBs should be as consistent as possible to improve the usefulness for investors. See our response to Question 11 for more details.

[11] See FINMA: „Addressing ‚Too Big To Fail‘“, June 23, 2011, p. 18
[12] Depending on the amount of either liquidity or solvency support, a full plenary session of the SRB may be required to sign-off use of the fund, with authorisation resting on strict voting rules.

10. Do you agree that the TLAC requirement for G-SIBs should be integrated with Basel III such that the minimum TLAC requirement should be met first, and only after TLAC is met should any surplus common equity tier 1 (CET1) be available to meet the Basel III buffers?

It is simpler to integrate TLAC into a Basel 3 continuum, rather than create a duplicative, parallel structure that would be more complex to manage and less transparent to investors. It also makes sense that surplus equity above Basel 3 minima should count towards TLAC, and that buffers will absorb losses without breaching TLAC.

As previously stated we believe that whole-bank bail-in is the most powerful and straightforward approach to resolution for many G-SIBs. This means such banks would need to be recapitalised to a level of capital adequacy consistent with at least Basel 3 authorisation, which reinforces the logic of combining TLAC into the Basel 3 structure.

We recommend that the FSB clarify that national Pillar 1 and 2 buffers above the Basel 3 buffers (Countercyclical, Capital Conservation and the G-SIB buffer), can be counted as good TLAC, rather than sitting on top.

In the current draft, surplus CET1 is used to meet TLAC before it can be included in the Combined Buffer. This implies that a breach of the GLAC element of TLAC is analogous to a breach of the Combined Buffer. That in turn can result in MDA restrictions, possible market stress and conceivably lead to consideration of resolution.

We recommend that a breach of GLAC requirements does not involve or imply an immediate 'hard trigger'. This argument is particularly strong in cases where a firms' effective bail-in capacity has not diminished (i.e. for example, when some instruments have fallen beneath 365 days to maturity, but are still outstanding). Firms should also be given appropriate time and margin to remediate their GLAC resources. This will also be important to communicate to investors, so that confidence in the bank does not erode too quickly, and potentially undermine an otherwise sound institution.

11. What disclosures (in particular in terms of the amount, nature and maturity of liabilities within each rank of the insolvency creditor hierarchy) should be required by resolution entities and material subsidiaries to ensure that the order and quantum of loss absorption in insolvency and resolution is clear to investors and other market participants?

Credit Suisse welcomes the emphasis on transparency present in the current draft. While investors typically adapt relatively well to changes in economic circumstances, they respond badly when they are surprised on matters of "framework". Such surprises can lead to a dramatic re-evaluation of similar exposures to other banks, and introduce significant distress into the system. If investors feel that they no longer know the "rules of the game", most will sell as fast as possible. On the other hand, if investors know the approximate order of risk, they will evaluate trading decisions based on economics, resulting in more-informed prices and better market discipline.

Transparency can also help comfort the holders of operating liabilities – clients and counterparties – and help reduce the risk that these investors would run.

We suggest 2 elements that we believe will help make this system more effective:

1) Disclosure across G-SIBs should be standardized, so that firms are comparable to the extent possible. Comparability can often help "explain" the rules to the market in a way that is easier for it to understand than detailed descriptions.
2) The home authority should review these disclosures prior to dissemination, and prohibit incorrect disclosure. A firm may believe that a certain liability constitutes good TLAC and would be bailed-in at a certain point in the priority waterfall, but the real test is what the Home Authority intends to use (or the relevant host authority overseeing a Resolution Entity for an MPE firm). If the Home Authority decided not to bail-in a certain class of liabilities – perhaps because of legal enforceability concerns or other consideration – that would put more

pressure on the next class of liabilities. Both sets of holders would be surprised – and this can lead to distrust and in some cases panic. Whilst we recognise the need for flexibility in the event of resolution, we believe it is better to assess and determine these issues ex ante where possible, so that investors receive disclosure that is broadly reliable.

12. What restrictions on the holdings of TLAC are appropriate to avoid the risk of contagion should those liabilities be exposed to loss in resolution?

We support some restrictions on G-SIB ownership of TLAC issued by other G-SIBs, to reduce systemic concerns at the core of the system. The "threshold deduction" approach in Basel 3 provides a good template for this – it allows for moderate holdings of other banks' capital to support market making and other appropriate activities, but treats excessive concentration harshly. We note that senior TLAC is inherently a less risky asset for a bank to hold than common equity, so it would be inconsistent to apply a harsher treatment.

However, we believe that extending these prohibitions beyond G-SIBs is unwarranted and could frustrate the development of a broad investor base. The G-SIB banks will need outstanding TLAC comprising roughly $4 trillion of eligible funds to meet the current standards. We need to support a diverse and well-functioning market to support the large TLAC requirements and achieve the prudential objective; excessive investor restrictions could frustrate that important goal

Other institutions including smaller banks, insurers, and pension funds should be able to invest in bank paper subject to their normal prudential rules on obligor and industry concentrations. Such asset side restrictions, made in the normal way, should be the way that TLAC is governed. There is no reason that these institutions should have to restrict TLAC ownership more harshly than their ownership of investments in other sectors.

We note that senior forms of TLAC carry less risk than shares or regulatory capital instruments, and we believe that some of the current concerns about GLAC holdings are overblown. Senior debt takes losses or is converted to equity when firms fail in many other industries. Disclosure should be clear, but excessive restrictions could prohibit appropriate investors from participating in an important, legitimate sector. And, because we need to build a broad and deep market for TLAC, we cannot afford to create such restrictions unless they are truly necessary.

There needs to be a clear exemption for appropriate market making and underwriting for G-SIBs. Without liquid secondary markets, TLAC instruments would be less attractive and it would be more challenging to maintain a solid TLAC cushion. We agree with the proposal of Section 18 that market making positions be regulated "generally parallel to existing provisions in Basel 3", and would only note that TLAC instruments beyond regulatory capital will tend to be less risky and therefore should be afforded somewhat greater latitude.

One practical issue for consideration is how to identify cross holdings in some cases. Consider the issue of an EU bank that counts 2.5% in its TLAC from the senior unsecured class of its operating company. If the total size of the class is 10%, should other banks count all of that class as TLAC, one-quarter of the class, or none of the class? Clear guidance will be needed on how to identify TLAC properly for cases like this. This issue will be much reduced in practical terms if the market making exemption noted above is established.

13. Should G-SIBs be required to conform with these requirements from 1 January 2019? Why or why not? What, within the range of 12 to 36 months following the identification as a G-SIB, should be the conformance period for banks identified as G-SIBs at a future date?

This date is workable for banks operating in a market that has a settled TLAC issuance structure. There are at present some G-SIBs, particularly in the EU, where this is not the case. Because of this, we would recommend that an additional period be provided to allow firms to adapt their organization to the right form of financial structure, and then to commence issuing from that structure. We would suggest that 66% adherence be required by 2019, with 100% compliance met by 2021. It is important to provide a clear guiding path to investors for a smooth transition, and avoid periods of accelerated compliance by banks which could have negative consequences on the market.

14. How far is the TLAC proposal, if implemented as proposed, likely to achieve the objective of providing sufficient loss-absorbing and recapitalization capacity to promote the orderly resolution of G-SIBs?

Credit Suisse considers TLAC as the last missing piece to solve TBTF, which we see as the core underlying problem of the most recent global crisis[13]. We believe it will achieve this objective.

- The FSB Key Attributes provide a clear road map for resolution.
- National resolution regimes are by large now updated and upgraded to provide the resolution tool box set out in the Key Attributes.
- Crisis Management Groups are established.
- Critical markets have been reformed with an eye to support resolvability, in particular the recent ISDA protocol reform that modifies swap unwind procedures.
- All G-SIBs have implemented Recovery and Resolution plans, which provide the necessary information and transparency to resolve and restructure complex organizations.
- Impediments are being identified and organizational structures are being adapted appropriately.

But effective resolution requires the right resourcing available in the right places. TLAC will provide this necessary loss absorbency for resolution. Historic loss analysis showed that the overall calibration of 16% to 20% of RWA is sufficient – indeed ample - to support robust resolution of G-SIBs. As this piece moves into place, we believe that the official sector has addressed the substantive elements of the TBTF problem with a practical solution.

There is, however, one remaining requirement: clear and consistent communication that an effective plan is in place, and sufficient transparency to support the credibility of that plan. Resolution Authorities must communicate clearly and credibly that they have sufficient power to execute an effective resolution, and willingness to use their trigger when failure conditions are truly met. Messaging to the market needs to be consistent -that in the future no bank needs to be - or will be - bailed-out. This will reduce the risk of surprise, reduce systemic aftershocks, and eliminate residual perception of any implicit government subsidy.

15. What will be the impact on G-SIB's overall funding costs of the adoption of a Pillar 1 Minimum TLAC requirement?

The FSB proposal requires eligible TLAC instruments to be contractually, statutorily or structurally subordinated. Each potential form of subordination is anticipated to attract different funding costs, and factors related to firm credit and home jurisdiction will also have an effect.

Credit Suisse plans to issue future senior debt from its holding company, and as such is commenting on funding costs regarding HoldCo senior debt. Market observations currently suggest a cost increase of 40-50bps for HoldCo senior debt issuances by high quality banks that currently fund via traditional OpCo senior instruments. This represents an increase of 30bps since the FSB proposal was released. This premium may rise further as the major rating agencies have announced new credit risk frameworks which are expected to assign lower ratings by one or more notches to HoldCos. Lower ratings will drive increased spread premiums because of the rating itself, but also through reduced market capacity, as large investor groups may not invest in non-investment grade or NAIC2 rated instruments.

The above represents incremental cost for transitioning from traditional Op Co senior to HoldCo senior debt issuance. To the extent the TLAC requirement is large enough to displace funding beyond existing Op Co senior bonds, the cost of compliance will increase further. Specifically, covered bonds, deposits, and structured notes provide meaningful funding to many G-SIBs, typically at lower spreads than traditional senior bond issuances. Their replacement with TLAC senior creates a second source of spread premium. Moreover, the diminished value of

[13] This view has been expressed by many official sector commenters. See inter alia: Ben Bernanke FCIC testimony, 2 September, 2010. "If the crisis has a single lesson, it is that the too-big-to-fail problem must be solved"

these instruments in the funding stack due to TLAC ineligibility reduces the diversity of funding channels which can be important liquidity tools, especially in weaker market conditions. Permitting eligibility of certain structured notes, as discussed previously, would help maintain funding diversity and stability.

16. What will be the impact on the financial system and its ability to provide financing to the real economy?

Credit Suisse expects a modestly negative impact on real economy funding, based on the following rationales[14]:

Financing the real economy depends on both loan supply from banks and also loan demand from borrowers. Incremental lending demand depends on pricing, which in turn depends on the overall cost of production including funding costs. TLAC will raise financing costs at most banks, in some cases materially, and thus will reduce lending and other intermediation by banks.

Evidence of this trend can be found in a recent Bank of England working paper: 'Changing regulatory capital requirements affects bank capital ratios and lending. Banks are keen to keep unchanged their buffers of capital above the regulatory minima, and tend to rebuild their excess capital buffers over three to four years. Banks respond to increased capital requirements by reducing lending more to the real estate sectors (household and commercial) and less to other types of lending.' (BoE working paper No. 486, The impact of capital requirements on bank lending).

We believe that these effects will be moderate in the overall context, and partly offset by increased use of capital markets and other funding alternatives for customers, at least the larger ones.

If TLAC - by eliminating the underlying TBTF concerns that drove the 2008-9 crisis - allowed the authorities to reconsider or refine other less efficient regulatory reforms, then the net effect on the economy could be positive.

The size of the TLAC requirement is estimated at approximately $4 trillion, and will require a broad, deep and liquid market to support this amount of investment. To ensure sufficient demand, it is important to avoid unnecessary limitations; we urge that restrictions on investor eligibility, maturity and exclusions of certain loss absorbing instruments be carefully considered in light of the need for a large market. For example, we believe that extending investor restrictions beyond G-SIBs could reduce demand for these instruments, pushing required yields higher, and increasing the degree of impact on the financial system.

We believe that the TLAC system, appropriately adjusted for comments such as the ones included here, will contribute to financial system stability and robustness. A careful consideration of investor needs will ensure that the incremental funding costs for G-SIBs remain at a level that is sustainable for the real economy

17. Do you have any comments on any other aspects of the proposals?

Please see our introductory remarks for a broader examination of the key issues. We welcome the FSB's initiative in this regard. While many details should be refined, the intent and broad structure of the proposal is well founded. We hope the FSB continues to engage with practitioners to refine implementation issues, and would be pleased to provide any further comments that would help the FSB achieve its objectives.

[14] Material used:

- CS Q3 transcript
- PWC: Ten key points from the FSB's TLAC ratio: http://www.pwc.com/us/en/financial-services/regulatory-services/publications/2014-basel-iii-fsbs-tlac-proposal.jhtml
- Bridges, J, D Gregory, M Nielsen, S Pezzini, A Radia, and M Spaltro (2014), "The impact of capital requirements on bank lending", Bank of England Working Paper 486.

Annex 1: Structured Notes

Structured Notes (STNs) can provide an important contribution to bail-in resources, and should not be arbitrarily excluded from TLAC. Many notes satisfy the core requirements for eligibility, such as unsecured status, sufficient remaining maturity and effective subordination to operating liabilities, and could provide the authorities with significant additional resources to execute an effective resolution. The current TLAC term sheet excludes STNs however, because of their “linkage to derivatives”. We believe such concerns can be addressed by thorough examination of the product, appropriate operational preparations, and stability restrictions which we set out in more detail below.

An Important Sector: Structured notes are an important funding source for Credit Suisse and many other G-SIBs. As of Q3 2014, CS had STNs outstanding with a market value of approximately 46bn CHF, representing 28% of our long-term debt. We estimate the size of the overall G-SIB structured note market at between $500bn and $700bn, based on a review of public disclosure. This market can make an important contribution to TLAC resourcing.

Structured notes can add diversity and depth to the TLAC supply base, adding a significant market beyond the traditional equity and debt capital markets. Indeed, the market for structured notes can often provide access to unsecured term funding when issuance in benchmark debt capital markets is unattractive or difficult to access. This resilience can be especially important in market downturns. Finally, STNs can help improve burden sharing in resolution, reducing the degree of stress on individual investments. We believe it is prudent to allow appropriate STNs into TLAC, rather than push them into a more senior liability category that has to be protected by other loss-taking liabilities.

Characteristics of Structured Notes: Structured note obligations are issued with particular coupon and principal features that appeal to investors, and typically swapped back to LIBOR for risk management purposes. They do not differ conceptually from plain vanilla instruments that are hedged, such as fixed rate bonds swapped to a floating rate. In both cases, unsecured claims on the notes can be ascertained and effectively converted into equity in resolution.

While the structured notes business is diverse, a considerable portion of our STNs conform to the guiding principles of TLAC. As disclosed in our 2013 Annual Report, approximately 76% of our notes have a maturity of one year or greater. The primary underlying reference assets are typically quite liquid, and refer to major indices / credits in the following categories:

Equity:	68%
Interest Rates & other FICC:	21%
Credit:	11%

Operational Preparation: To support effective bail-in, we would recommend the following preparations to make STN Bail-in most efficient:

- Note Capture and Valuation Support System: G-SIBs should maintain a crisis-tolerant system to bail-in of STNs (as well as vanilla notes). They should provide resolution authorities with the information they need to make bail-in of structured notes just as effective as plain vanilla notes. This system(s) should:

- <u>Produce a list</u> of outstanding STNs summarizing the characteristics relevant for resolution, including those which qualify as eligible TLAC,[15] and

- <u>Value the notes</u> on a daily basis. This is important to establish the size of claims from structured note holders, and how much capital could be generated from such claims (valuations should be for both individual STNs and in aggregate)

- <u>Accounting</u>: The amounts determined by this system will be used to calculate the amount of loss-absorbing capacity of structured notes included in TLAC, based on the fair value of the notes, adjusted for any issuer-specific CVA reflected on the issuer's balance sheet. (For principal protected notes, this should be adjusted for any stated minimum amount payable upon early termination or entry into resolution.)

- <u>Notification</u>: STN investors should be notified of a bail-in through the same clearing system communication channels used to inform other senior unsecured debt. Notices should describe the amount of write down, how and when the amount of any equity to be delivered will be determined, as well as any other relevant execution details for bailed-in structured note holders. Well-established securities settlements systems are already equipped, or can be updated, to facilitate these transactions for STN holders.

- <u>Preparation for Hedge Rebalancing:</u> During a resolution, swap hedges should be reduced pro-rata to the amount of debt reduction, to maintain a balanced risk profile. This should occur for both STNs and vanilla debt with hedges.[16] G-SIBs should maintain a summary of the primary risk factors for the aggregate net swap position[17] used to hedge the issuer's STN exposure, so that risk rebalancing can be accomplished easily and quickly.

  The amount of desired net hedge reduction should be terminated at market. From a resolution perspective, it may be helpful to route all holding company STN hedge transactions via an internal operating entity, to avoid any need to terminate external swaps.

- <u>Degree of Market Impact</u>: Although Credit Suisse is one of the larger individual issuers in the STN market, even a complete unwind of STN hedges should not produce a measurable impact in the markets. The size of our net STN hedges is less 0.1% of our overall swap book in notional terms. Our issuance is generally linked to highly liquid underlying reference indices where market liquidity is deep[18], allowing for immediate re-hedging even during a systemic crisis like the one which occurred in 2008.

<u>Valuation Stability</u>: the TLAC terms sheet emphasizes the importance of "reliability" – it is essential to ensure that TLAC doesn't evaporate when it is needed. For example, the term sheet excludes liabilities with short remaining maturity or investor demand rights, like deposits at call. TLAC eligible STNs should be likewise reliable, which should include being subjected to the same maturity requirements as vanilla notes. Certain structured notes also present an additional issue for consideration, the issue of reliability due to valuation stability.

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[15] A resolution authority will want to know the total resources available to it at the point of resolution; this will include both structured notes that are eligible TLAC and other structured notes in the same priority class that can be converted to equity, but might no longer qualify. An example of the latter is a long-dated structured note that has a remaining maturity of less than one year (i.e. just disqualifying it under the current terms sheet).

[16] A more general approach would be to net these risk factors for hedges against both structured notes and vanilla notes; this can further reduce hedging needs and simplify operational elements in a resolution. Note that records for individual hedges should not be needed, as STNs are often hedged on an aggregated portfolio basis.

[17] The net external hedges should then be adjusted downward by the appropriate percentage. More precise second order hedges could be executed as needed over subsequent trading sessions.

[18] For example, LCH SwapClear regularly clears over $1trillion/day of interest rate swaps. http://www.lchclearnet.com/asset-classes/otc-interest-rate-derivatives/volumes/daily-volumes-swapclear-global. A full unwind of our interest rate swap linked STNs would comprise well under 1% of daily volume for this clearing house.

Principal protected STNs are generally stable in value terms, and should not pose any difficulties in this respect. However, some leveraged STNs (for example, a non-principal protected note that declines precipitously in the event of a modest equity downturn) may be less reliable for write down at the critical moment of resolution.

There are a variety of approaches that could be taken to ensure that TLAC qualification was assessed in a conservative way for this issue. One approach would be to develop a system of haircuts to discount the value of the STN book for an extreme scenario move in underlying markets. Another approach would be to only include STNs with full or partial principal protection, and to exclude other notes from TLAC. While the latter approach is perhaps overly conservative, it should at least provide a robust and simple starting point for inclusion.

Structured notes are an important funding sector for many G-SIBs, and could provide a substantial addition to TLAC resourcing. We believe that a proper investigation of these instruments can account for the variability of this product type and show that – with proper preparations and controls – it can add to the pool of loss-absorbency. The conceptual issues are not dissimilar from vanilla notes with hedges, and the operational requirements should be part of resolution preparations in any case. Structured notes should not be excluded arbitrarily, but utilized where they can provide a useful contribution to resolvability.

Annex 2: Creating Effective Structural Subordination via Holding Company Structures

1. The holding company model provides a strategy to achieve structural subordination (and also clean separation) of TLAC-eligible liabilities versus operating liabilities. However, the specific requirements of Sections 12 and 13c in the current consultation draft appear to make this approach unworkable in practice:

   a. Section 12 "Excluded Liabilities" sets out a list of liabilities that are not well suited to write down & conversion into equity. This list includes, among other instruments:
      c) liabilities that are funded directly by the issuer or a related party
      d) swap liabilities
      e) tax liabilities
      g) any other liabilities that cannot be effectively written down (e.g. operating liabilities like a utility bill, etc.)

   b. Section 13 "Priority", subsection c, describes the requirements for holding company senior debt to qualify without contractual or statutory subordination. This section states that "TLAC eligible liabilities may not be pari passu or senior to any excluded liabilities". In practice, **this amounts to a "poison pill" for structural subordination** because it is practically impossible to run a holding company that does not have some of these liabilities. Specific issues include:

      i. Tax liabilities are naturally senior claims (though typically preferred in liquidation) -- but it is normally impossible to create a company that is not subject to tax.
      ii. Excluding swaps would prohibit normal hedging of holding company debt, including collateralized internal swaps that are needed to properly manage risk.
      iii. The prohibition on having any internally funded liabilities would exclude market making in your own equity or debt (because such liabilities would be funded by a related party subsidiary). There is a legitimate underlying concern about reduction of bail-in capacity if held by the other entities owned by issuer, but this could be handled by a system of limits and /or TLAC offsets
      iv. The comment on "any other liabilities that cannot be effectively written down" raises a question about whether there are any specific issues that the authorities are concerned about.

2. We believe that the intent was not to undermine the holding company model of bail-in, which can provide for clean segregation and good subordination of TLAC to Operating Liabilities. It can support an effective bail-in resolution. We expect that the likely reasoning was rather to tackle other concerns, such as:

   a. To ensure that sufficient bail-in liabilities are externally held so that a write down of HoldCo liabilities creates net equity for the troubled firm on a consolidated basis.
   b. To ensure that we do not force write down of Operating Liabilities in any material size, so that critical functions can continue in a robust way
   c. To ensure that we don't create problems with respect to NCOWL or set off
   d. To ensure that the prospect of bail-in does not encourage runs

   Another way to handle these concerns is to consider the following: the purpose of the holding company strategy is to create separation of TLAC from critical functions and benefit from structural subordination. However, this could be undermined if the holding company engaged in critical functions to a material degree or issued a material amount of runnable liabilities. How can we best ensure this does not occur? **What is the right test to ensure that the holding company is sufficiently "clean"** so that conversion of holding company TLAC does not pose any meaningful concerns?"

3. Recommendations for effective structural subordination: The language in 12 and 13c should be restructured to forbid material critical functions from being housed in the holding company, but not to create a list of "poison pill" liabilities that would invalidate TLAC if even a penny of pari passu obligations was found.

Section 13c should eliminate the text prohibiting "pari passu" excluded liabilities. Instead, excluded liabilities should be subject to a new "materiality constraint": Excluded liabilities should not be present at any scale that would disrupt resolution, cause NCWOL challenges, or jeopardize systemic stability if they were bailed in. For example:

a. Debt hedging swaps should be allowed in a HoldCo, but large street-facing dealer swap books should be prohibited.
b. Contract liabilities (including tax) and "other liability items" should be fine as long as they did not create any operational continuity concerns for the post-resolution entity.
c. Structured notes should be permitted as long as operational procedures are in place to make bail-in workable (see Annex for a fuller discussion)
d. Intra-company holdings of TLAC should not be prohibited. Instead, they should be deducted from External TLAC, with an exemption for a reasonable amount of market making and underwriting positions (both debt & equity) by a subsidiary. In addition, this language should allow for external issuance via an SPV or other specialized funding vehicle.
e. Additional requirements could include general prohibition on any other material customer activities (which would frustrate the protection of operating liabilities).

This approach would ensure a high quality holding company that could issue TLAC without jeopardizing critical functions, and it would remove the "poison pill" concern. Excluded Liabilities could be present in modest amounts, subject to strict limits and oversight.

We suggest that this structure would be better supported if the liabilities of the holding company were separated into 3 buckets:

a. **TLAC**
b. **Near-TLAC** (e.g. 11 month remaining maturity debt) – resources that are usable (and indeed desirable) for additional loss absorption in bail-in, but which (currently) do not qualify as full TLAC.
c. **Excluded Liabilities:** Tax liabilities, other liabilities, derivatives, etc. These would not count for TLAC, and could be troublesome if they grew to large size. Such liabilities would be limited, rather than prohibited. A threshold that required excluded third-party liabilities to be less than 10% of holding company TLAC could be a simple and workable benchmark.