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Financial Stability Board
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Per email to:
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June 21, 2019

**Evaluation of Too-Big-To-Fail reforms and initiatives
Call for feedback from stakeholders dated May 23, 2019**

Dear Sir/Madam:

Credit Suisse welcomes the opportunity to participate in the Financial Stability Board's (FSB) call for feedback from stakeholders regarding the evaluation of the TBTF reforms and initiatives. It is a timely evaluation as the effects of the multiple reforms and initiatives become visible in both national implementation and combination. To ensure that the trajectory of this reform remains on track, it's important to evaluate the effectiveness of these reforms, especially to identify weaknesses and unintended consequences.

Credit Suisse¹ encourages the FSB to undertake a rigorous and balanced review. In particular, we suggest that the FSB commission conduct fresh research based on the key themes resulting from this stakeholder feedback. An examination of existing literature might not be sufficient, as it may be based on older data and prior concepts that were used when designing the reforms. It therefore bears the risk of circular references.

In our answers below, we show that the key elements of a strong structural solution are now in place to support the resolvability of GSIBs. While operational elements and planning can always be refined, we believe that the banking sector has achieved the key milestones necessary for success. Market data and investor feedback broadly supports this conclusion. See our attached FSB Resolution Steering Group (ReSG) market review deck for further details on market developments and pricing behaviour.

Furthermore, we respectfully ask the FSB to go beyond simply publishing the results and using findings for consideration by the appropriate bodies. Credit Suisse believes that the TBTF reforms are central and transformative - but also underappreciated in related regulation. In particular, the issues of ring-fencing and fragmentation are closely related to the TBTF reforms, but these regionalist responses have the potential to distort and weaken the financial system. They have significant potential to reverse many of the important gains of the post-Crisis reform agenda, and warrant specific policy recommendations. In this regard, we commend the recent FSB paper on fragmentation published in

¹ Credit Suisse has been an active participant in the TBTF reform effort from the first days of this important reform. We published the first proposal describing the potential for "Bail-in Resolution" (Economist, 30 January 2010), helped to pioneer the Contingent Capital market, and numerous other efforts in conjunction with the official sector, including leading the industry response at the recent ReSG evaluation of TLAC market developments last September.

June, which provides a good overview of current issues. We encourage the FSB to follow up on those issues vigorously.

Key Messages

- In the past ten years, the public and private sector have worked relentlessly to implement Too-Big-To-Fail reforms. We are positive that the critical components of a strong structural solution are now in place to support the resolvability of GSIBs.
- The most important reform has been the vast increase in both going and gone concern (TLAC) funding. For Group 1 banks, CET1 capital has increased significantly in terms of both quality and quantity; it has increased by \$1.9 trillion since June 2011 and exceeded \$4 trillion at June 2018. Gone concern capacity has grown from zero to nearly \$1.5 trillion, at the developed-market GSIBs alone.² The scale of these resources ensure that we can solve future banking mistakes with private resources, even for stress events that go far beyond the loss levels seen in the global financial crisis (GFC). We do not believe there is a case to further increase these requirements, or to rebalance the obligations to require a higher equity component.
- Although GSIBs have borne a significant cost for shifting to the new financial structure, amounting to billions of dollars per annum, we consider the cost of subordinated TLAC broadly to be an appropriate expense to end real or perceived TBTF market failures. From our analysis and experience, the regime has gained the confidence of markets and investors.
- However, there are a number of unintended consequences, including localist responses to TBTF reforms that have introduced ring-fencing and fragmentation. Liquidity and capital ring-fencing have generated higher requirements (sum of the parts) for individual banking groups than originally intended. Furthermore, these localist tendencies undermine the resilience of banking groups via misallocation risk if resources cannot move to the right entity. We encourage the FSB to tackle these issues rigorously, including by means of the capital pre-positioning work stream emanating from the FSB report to the G20 on Fragmentation.
- We believe that internal TLAC requirements need recalibrating in key jurisdictions. In the EU and US authorities set nominal (Internal) TLAC requirements at approximately 90%, the most conservative end of the FSB's 75-90% scale. Effective requirements can go higher still when other constraints are considered. In the US, the effective requirements for the large and complex IHCs exceed 130% on average³, far above FSB recommendations.
- More generally, we would invite the FSB to assess the impact and interplay of TBTF measures with other post crisis reforms. The cumulative impact of prudential (BCBS) and resolution (FSB) requirements is debilitating for banks, especially if combined with ring-fencing & gold-plating. Funding and capital obligations derived from resolution reforms now prevail over traditional prudential capital and liquidity regulations. Concretely, we would advocate for HOLA retained for resolution to be exempted from the Leverage Ratio.
- We believe that access to central bank facilities during resolution is another area requiring a more consistent and transparent approach. We strongly support a move away from "constructive ambiguity" towards "constructive certainty."

² Source: Bloomberg, Company Fixed income reports and Credit Suisse analysis.

³ Source: FR Y-9C data, Credit Suisse analysis, assuming minimum funding of LTD component.

- Finally, we support further efforts to streamline RRP's to ensure they are focused at the group level and usable, as well as more work on presumptive paths. We welcome the FSB focus on Solvent Wind Down to ensure these time-consuming and costly exercises remain resolution tools rather than supervisory ones.

Questions

1. **To what extent are TBTF reforms achieving their objectives as described in the terms of reference? Are they reducing the systemic and moral hazard risks associated with SIBs? Are they enhancing the ability of authorities to resolve systemic banks in an orderly manner and without exposing taxpayers to loss, while maintaining continuity of their economic functions? What evidence can be cited in support of your assessment?**

We believe the reforms have been highly effective in key jurisdictions, especially those which rely on TLAC to provide fresh resolution capital via bail-in of dedicated and either structurally or contractually subordinated debt instruments.

Procedural Objectives

The TBTF reforms have achieved the core procedural objectives to enable resolution as set out in terms of references:

- a. The reforms created a set of common resolution tools which largely have been implemented across a number of FSB member states. Instead of attempting to change and harmonize the national insolvency laws – an arduous task at best - the creation of a common tool box enables resolution authorities across the globe to apply coordinated resolution actions, despite different underlying legal mechanics. Recovery and Resolution plans created the necessary transparency and scoped out viable options to work through the resolution of a GSIB without putting taxpayers at risk to suffer losses. The Crisis Management Groups for each GSIB have by now all the tools to make resolution work and the banks are finalizing the required "resolution capabilities".
- b. Structural changes to the way banks are organized have been widely implemented and processes to identify and remediate impediments to resolution are in place.
- c. Derivative markets have been substantively reformed to account for resolution events, both in respect of resolution stay powers in the major jurisdictions, and in respect of the public-private solution developed via the ISDA Protocol. Derivatives unwind costs were the largest single loss accelerator in the Lehman bankruptcy; this reform effectively changes those mechanics to avoid that situation, improving outcomes for both the stressed firm and the wider marketplace.

- d. Resolution strategies for both Single Point of Entry and Multiple Point of Entry are now reality and planned out in the Crisis Management Colleges, where cooperation agreements, information sharing agreements, etc. have been put in place.
- e. All banks have also invested substantially in conduct and compliance standards. The compensation instruments are transparent and improve alignment with the interests of the shareholders.
- f. To date, a large amount of work has been done in some jurisdictions to ensure continuity to Financial Market Infrastructure (FMI) participants at the point of resolution. There seems to be a general understanding by FMIs that they would not automatically terminate agreements at the point of resolution. However, as the focus seems to be on the banks to ensure they will maintain access there is here too scope for improvement. It would be beneficial if the FSB agreed with FMIs, FMI Regulators and Banks Regulators a consistent approach to resolution. This would reduce the burden on both banks and industry participants to work out individual agreed approaches. This would also ensure that regulators have a clear understanding how global FMIs would act at the point of resolution, especially for cross border agreements.

Resourcing Objectives

Perhaps the most visible and impactful change, however, has been the significant increase in capital and TLAC resourcing. These funds provide a robust financial solution to avoiding failure for a wide range of stress events ensuring an effective resolution in the unlikely event of failure. These resources are fully sufficient to address stress events even more severe than those encountered in the 2008 Crisis.

The post-Crisis regulatory reforms have forced banks to build up massive capital and liquidity buffers, and increase the resiliency at the core of the financial system.⁴ The increases in going concern capital are substantial in terms of both quality and quantity. The BIS estimates that Group 1 banks have increased capital by 85% since 2011, adding \$1.9 trillion of additional CET1 resources in 7 years.⁵ Indeed, the capital definitions are now sufficiently conservative to ensure full loss absorbency in crisis situations similar to 2008 severity⁶, even without any support from gone concern TLAC.

⁴ We confine our remarks to the developed market GSIBs, as the emerging markets GSIBs are subject to a later implementation timetable. We also focus on large institutions; there were also some small banks with limited geographic and product diversity that had higher losses (e.g. Anglo Irish which was concentrated in a single sector in a small market), but we do not consider these relevant benchmarks for a diversified or moderately diversified banking group.

⁵ See Basel Committee on Banking Supervision, Basel III monitoring report, March 2019.

⁶ For example, the US DFAST and CCAR stress tests require firms to absorb severe losses from a full market and credit cycle with a severity similar to 2008-9, while still exiting a multi-year test with capital above minimum requirements, even assuming that dividends are not reduced through the exercise (despite regulatory requirements to do so in parts of the cycle).

A key analysis examines the largest losses suffered by GSIBs in the Financial Crisis. That analysis⁷ looked at the most severe drawdown of capital for a GSIB from that period (or near GSIB, as the definition was not yet developed) in the crisis. The worst case situations for large banks reached a maximum drawdown of approximately 9% of RWA, measured from peak-to-trough, and ignoring capital raises.⁸ In the context of the lower capital ratios of the era, that was fatal to some organizations.

The build-up of loss absorbency has been substantially augmented by the issuance of gone concern TLAC by GSIBs, which have added roughly \$1.5 trillion of additional loss absorbency into the system. Total subordinated TLAC resources stands on average at roughly 25% of Basel 3 RWAs, or approximately 2.7x the worst case drawdown suffered by any GSIB in the Crisis. Put another way, just the gone concern component of the US GSIBs is nearly 10x the size of the FDIC insurance fund and roughly 4x the size of the TARP program outlays for all banks.⁹

The GSIBs have borne a significant cost from shifting to the new financial structure, amounting to many billions of dollars per annum. It represents the market discipline that FSB set out to reintroduce in pursuit of the ending TBTF agenda and points to the credibility of the regime with investors.¹⁰ This is corroborated by the redesign of rating frameworks by credit rating agencies to take account of resolution and the elimination of sovereign support for all GSIB ratings in major FSB member jurisdictions.

Several of the FSB questions raise the issue of whether this cost has been appropriate to end the moral hazard of the pre-Crisis years. We attach materials from a recent ReSG event that considered various questions around the market for TLAC instruments. Overall, the new TLAC markets are performing well, and are functioning in line with the goal of internalizing credit costs at the GSIBs themselves.¹¹ Indeed there is some evidence that the cost of the

⁷ Comments are based primarily on internal CS analysis, but are largely consistent with FSB Findings Report "Historical Losses and Recapitalisation Needs", 9 November 2015, when adjusted to Basel 3 equivalents.

⁸ This figure is expressed in Basel 3 equivalents, using an estimated conversion factor of 1.25x developed from major bank disclosures at the dates of transition. For the major US broker dealers, we estimate an historic Basel 3 figure by using a recent RWA density ratio from the 2 surviving broker dealers and applying it to assets at the time. Given the significant changes in RWA methodology, it is important to translate data from that time into current equivalents to reflect the considerably tougher yardstick established by the Basel 2.5 and 3 reforms, not to mention continuing reforms like Fundamental Review of The Trading Book.

⁹ US gone concern TLAC estimated from Bloomberg data, CS analysis at ca \$940bn; FDIC insurance fund at \$102bn, per FDIC Quarterly Banking Profile release for December 2018. TARP bank outlays estimated at \$246bn per April 2009 CBO Report.

¹⁰ Credit Suisse has held an annual bank investor conference in London for many years. A (non-scientific) poll taken regularly at this event shows that over 90% of investors believe that TLAC will be used in bank resolution going forwards, rather than taxpayer resources. However, these same investors also express confusion about official sector intent in resolution, as the path of likely outcomes is unclear in the EU region.

¹¹ The GAO study from 2014 was perhaps the most comprehensive analysis of this issue in the US market. It found that TBTF uplift in the markets had declined and was no longer visible based on a variety of analytic models. Most analyses we have seen support this view if they look at post 2012 data. One recent exception was Liberty Street Economics: "Did the Dodd-Frank Act End 'Too Big to Fail'?" by Afonso, Blank and Santos, March 5, 2018). The post was positive on rating agency developments, but suggested that bond markets did

reforms may even go beyond this level and impose costs beyond those necessary to re-balance market incentives.

In summary, we consider that the core planks of the TBTF reforms are in place. They address the critical legal procedures and have imposed vast increases in both going concern and gone concern (TLAC) funding. There have also been ongoing refinements to CMGs and Operational Resilience programs, which are worthy efforts that should continue in a balanced way. However, we consider that the enormous supply of private sector resources is now sufficient to overcome the shortcomings that may arise in a future resolution. The scale of these resources ensure that we can solve future banking mistakes with private resources, not public ones, even for stress events beyond the levels seen in the global financial crisis. Market evidence broadly concurs with this assessment.

2. Which types of TBTF policies (e.g. higher loss absorbency, more intensive supervision, resolution and resolvability, other) have had an impact on SIBs and how? What evidence can be cited in support of your assessment?

We consider that the most important elements have been the increases in equity and TLAC requirements, which are foundational. They address the central issue of the global financial crisis.¹²

We also consider that the broad balance of going concern capital and gone concern TLAC requirements is roughly correct at the current equilibrium.¹³ However, there are some ongoing regulatory efforts to further increase capital requirements, including the Fundamental Review of the Trading Book reforms. Others (mostly from the academic sphere) suggest that equity requirements should be boosted even beyond current level. We would note that the most extensive empirical survey of the cost of equity saw no reduction in the cost of equity as leverage was reduced.¹⁴ We believe that a balanced approach, that uses both equity and TLAC debt, will be the most cost effective solution under these market conditions.

not exhibit the credit spread relationships expected in a post-TBTF regime, (i.e. whether creditors assigned higher risk to holding companies than bank subsidiaries, as they should if they believed in a credible SPOE Bail-in strategy). This is an appropriate test, but the study was hamstrung by a dearth of bank level bonds. The authors tested 4 GSIB pairs, but only the pair from Bank of America pair was well structured (and traded appropriately), The other bonds were simply inappropriate vehicles for this test (different maturity, non-bank subsidiaries, different subordination ranking etc.); the conclusion would differ if normal credit market adjustments were made. Now that bank debt issuance is returning (slowly) to the market (since US TLAC stacks are largely completed), it may be possible to run a structural subordination test properly in the near future.

¹² See, inter alia, Ben Bernanke FCIC testimony: "If the crisis has a single lesson, it is that the 'too big to fail' problem must be solved".

¹³ See Bank of England: "Measuring the macroeconomic costs and benefits of higher UK bank capital requirements", December 2015; also see Francisco Covas and Bill Nelson "What is the Optimal Level of Bank Capital" January 17, 2019, BPI post.

¹⁴ See Baker and Wurgler, "Do Strict Capital Requirements Raise the Cost of Capital? Bank Regulation, Capital Structure and the Low Risk Anomaly", http://www.hbs.edu/faculty/Publication%20Files/Wurgler_Paper_78db6340-ae41-4630-8e25-d990b547171b.pdf

3. Is there any evidence that the effects of these reforms differ by type of bank (e.g. global vs domestic SIBs)? If so, what might explain these differences?

The largest increases in regulatory requirements have been applied to GSIBs, despite the fact that many DSIBs also suffered severe losses that had significant spill over into financial market stress conditions. In some markets, DSIBs are not subject to any TBTF requirements. For example, in the US, foreign banks placed into category 2 & 3 are required to carry significant internal TLAC (with a few exceptions for parent banks that do not carry the GSIB label). However, none of the domestic banks in these categories carry any gone concern TLAC. This can create level playing field concerns.

There is some difference in geography. For example, the Japanese market still retains a small 'sovereign uplift' for bank ratings by the main agencies. Our discussions with investors also indicate that the jurisdictions with holding companies and structural subordination of TLAC funding also provide more clarity and confidence in resolution actions. For more detail, see our attached deck on External TLAC Market Developments.

4. What have been the broader effects of these reforms on financial system resilience and structure, the functioning of financial markets, global financial integration, or the cost and availability of financing? What evidence can be cited in support of your assessment?

The broad effects of the reforms have been positive for the stability of financial markets. Credit Suisse is convinced that they contributed to regaining trust into the financial system. This has allowed the majority of banks to be able to support funding of the economy and providing vital banking services supporting economic growth. Evidence of this re-gained trust is found in the reduced credit spreads for bank debt as well as the national statistics on loan growth.

However, there is also clear evidence that many banks also reduced important market-making activities and that cross-border financing activities have also declined.

- a. First, active market making in equities, bonds and other financial products has become more difficult for banks given the new rules that were implemented. The evidence as to whether, and to what extent, this may have impacted the efficiency and liquidity of markets is not clear. Bid-offer spreads for various asset classes are driven by many factors, and identifying precisely the impact of regulations of banks is very difficult. The fact is undeniable however, that banks which had deleveraged and shrunk their balance sheets were left with substantially less room to take on new positions and thereby contribute to "making" markets.

- b. Possibly of greater consequence is that in the new regulatory regime we operate under, some of the global functions of banks have been curtailed, be it by design or due to market pressures. Regulations and, more specifically, so called "ring-fencing" have forced many banks to focus more on national markets and to substantially limit cross-border activity. Indeed, according to the BIS, cross-border claims of banks are today around 4 trillion USD lower than at the peak in 2008, despite the fact that the global economy has grown by about 40%. See our answer to Q5 for additional commentary.

Also, while the resolution plans for GSIBs are fairly mature by now in most cases, further focus should be dedicated to major DSIBs.

5. Have there been any material unintended consequences from the implementation of these reforms to date? What evidence is available to substantiate this?

The core of the TBTF reforms are robust and fit for purpose. They have resulted in generally resolvable GSIBs and increased financial stability. However, several areas of unintended consequences have emerged:

- a. The combination of all TBTF policies together with other reforms is showing cumulative effects. These can be debilitating for certain institutions, especially where jurisdictions employ significant national gold plating and ring-fencing. While we support bearing the extra cost of the TLAC reforms to finance an efficient resolution structure, we are deeply opposed to bearing inefficient structural costs. These additional costs weaken bank Return on Equity, which has been persistently low in many markets. Weak Return on Equity in turn make banks less resilient overall; low Return on Equity banks are less able to bear losses or incentivize investors to participate in future capital raises.

Credit Suisse would like to highlight one area in particular: Recovery and Resolution Planning (RRP) has created a regulatory dynamic of its own. It is broadly detached from other BCBS process and governance, but RRP deals with prudential standards in the most fundamental sense. For example, TLAC standards are an extension of capital regulation; Funding in Resolution capabilities are an extension of liquidity regulation. RRP rules sometimes impose additional standards that override the design of capital instruments. Group capital and liquidity requirements can be affected by "sum-of-the-parts" consolidation effects. The amount of liquidity reserves required in resolution scenario because of fragmentation challenges (ring-fencing and central bank access) can also detach requirements and elevate them above regulatory standards. These costs are especially significant for GSIBs.

In general there are strong links between these two disciplines, and they should be better coordinated. For example additional liquidity for resolution is needed to address legal entity needs driven up by fragmentation and local gold plating. The extra HQLA drives up regulatory capital requirements via leverage ratio regulation. This is an area where Credit Suisse urg-

es the FSB to expand the ambition of this evaluation and to issue clear policy guidance that RRP induced liquidity holdings should be permanently excluded from the prudential leverage exposure definition.

- b. Liquidity and capital ring-fencing have led to higher requirements (sum of the parts) for individual banking groups than originally intended. These requirements are unnecessary and costly, and pose a long term threat to financial stability due to the misallocation of resources.
- c. Competitive disadvantages are emerging in areas where DSIBs are not held to similar standards to manage down own systemic impact in their respective local markets.
- d. We need to better coordinate, or alternatively integrate, prudential regulation (BCBS standards) with resolution regulation to ensure that a single problem is not solved multiple times with multiple resources - but only once and in an effective way.

However, today's reality is that we have more and more fragmented national markets. This has occurred because jurisdictions have implemented national versions of resolution standards first, before considering group wide resolution effectiveness and consistency. These national policies for GSIBs have often included gold-plating and ring fencing – especially around capital and liquidity resources. This imposes a substantial risk of misallocation of financial resources even before issues like consolidation effects are considered. This will jeopardize recovery efforts and will offset much of the positive effects of the increased capital and liquidity buffers to financial stability. As of today, there is no agreement or code of conduct on how to use buffers and reallocate resources within a group in resolution, or how SPOE group support and internal TLAC could be used to mitigate other resource requirements.

- e. Access to central bank facilities during resolution is another area which requires more thought and a harmonized approach. Some jurisdictions – like the UK – have a clearly expressed a constructive approach, while others have been silent to date. In the U.S. senior officials have expressed concern about the loss of key tools like emergency lending powers.¹⁵ Closely linked hereto are open questions around FX swap lines between central banks and a clearer understanding on which extended collateral is acceptable.

We believe that one lesson of the crisis was the rapid collapse of 'constructive ambiguity' as an effective policy. We suggest that constructive certainty, buttressed by 'peacetime' exposition and debate, is likely to be a more durable and effective policy.

¹⁵ See New York Times op-ed by Bernanke, Geithner and Paulson, "What we need to fight the next financial crisis", 7 September 2018.

In the absence of effective and consistent implementation of national policies this fragmentation leads to either (i) undesired damage to financial stability, or (ii) uneconomically high capital and liquidity needs for GSIBs.

For example, the US imposes nominal (Internal) TLAC requirements at the top of the FSB 75%-90% scale, but the effective requirements for the 'large and complex' IHCs average over 130% - far above the FSB recommendations. However it would be unfair to single out the USA (although data is more visible there); similar effects arise in other countries. Data for the UK is more sparse, for example, but some subsidiaries there show a similar gold plating of local resources.

One underlying factor contributing to fragmentation has been the separation of TBTF from other areas of financial reform. Another factor has been the lack of clear regulatory statements about the degree of success in the TBTF area, which have consistently used weaker framing (often framed as "making progress - but more to do"). Stronger statements can help clarify the new reforms for investors, which will improve market function and ensure the durability of the improvements in moral hazard. Stronger statements can also help address concerns of host countries, and mitigate fragmentation incentives

6. Are there other issues relating to the effects of TBTF reforms that are not covered in the questions above and on which you would like to provide your views? Please substantiate your comments with evidence.

One aspect of the financial reforms has been to require the strengthening of governance in subsidiaries which for example led to the introduction of so-called independent Non-Executive Directors (NEDs). This has weakened Group cohesion and is particularly harmful for banking group's whose resolution strategy is SPOE.

Before we conclude, we would like to reiterate how important it is for us that the regulatory authorities, in consultation with the banks, take the opportunity provided by this consultation to fully evaluate the effect of the financial reforms and, in particular, focus on identifying and rectifying any unintended consequences such as those we listed earlier. In our opinion, this is important if we want to ensure the sustainability of the work accomplished to date to make the financial system more resilient and banks more resolvable.

We would be happy to discuss our perspective more fully with FSB staff if this would be helpful, and appreciate the opportunity to comment on this consultation.

Yours sincerely
CREDIT SUISSE AG



Wilson Ervin



Volker Bätz

Attachments:

FSB RESG Meeting with Private Sector: Follow up on External TLAC Market Developments
(Slide deck, dated as of 18 September 2018)