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Thomas W. Killian
PRINCIPAL

January 20, 2016

The Honorable Janet Yellen - Chairman
Board of Governors of the Federal Reserve System
regs.comments@federalreserve.gov
Docket No. 1523 and RIN 7100 AE-37

c/o:
Mr. Robert deV. Frierson, Esq.
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Re: Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations; Regulatory Capital Deduction for Investment in Certain Unsecured Debt of Systemically Important Bank Holding Companies; Proposed Rule

Dear Chairman Yellen:

On behalf of Sandler O'Neill + Partners, L.P., I am commenting on the Board of Governors of the Federal Reserve System (Board) notice of proposed rulemaking ("NPR") to promote financial stability by improving the resolvability and resiliency of large, interconnected U.S. bank holding companies and the U.S. operations of large, interconnected foreign banking organizations pursuant to Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and related deduction requirements for all banking organizations subject to the Board's capital rules.

Sandler O'Neill is a market-leading, full-service investment banking firm and broker-dealer focused on the financial services sector.[1] Our clients include almost a thousand banks and thrifts (together, "banks") and their holding companies. This letter has been prepared from the perspective of experienced practitioners in the financial sector at a 27-year-old firm that, with its clients, have navigated several periods of crisis and several rounds of regulatory reform. We are currently ranked among the most active firms in the U.S. in M&A financial advisory services for banks[2] and have consistently been among the top advisors for debt and equity capital raising for U.S. banks and their holding companies.

[1] For further information on Sandler O'Neill, please see http://www.sandleroneill.com/.
[2] SNL Financial. *Sandler Tops 2015 M&A Bank League Table*. January 7, 2016. Page 1.

SANDLER O'NEILL + PARTNERS, L.P.
1251 Avenue of the Americas, 6th Floor, New York, NY 10020
T: (212) 466-7709 / (212) 466-7800
tkillian@sandleroneill.com

The topics covered reflect our review of the TLAC NPR[3], the Basel III final capital rules[4] and the Dodd-Frank Act, the Small Bank Holding Company Policy Statement[5], as well as discussions with our banking clients and investors. The four sections of this letter cover the following concerns:

(i) Capital Deductions for Investment in GSIB BHC Senior Debt: push back the start date from January 1, 2019 to January 1, 2022 for the potential Basel III deduction for investments by state member banks, BHCs and savings and loan holding companies (Board-regulated institutions) in senior bank holding company debt issued by U.S. GSIB BHCs (covered BHCs) and expand the time frame for the market maker[6] exemption for ownership of covered debt beyond 5 days and potentially up to 30 days to facilitate orderly market making in covered debt by GSIBs;

(ii) Disruption to the Bank Holding Company Long Term Debt Market: avoid large scale LTD issuance by GSIBs that would disrupt the long term debt market for U.S. bank holding companies by modifying, grandfathering or offering forbearance for outstanding senior long term bank holding company debt issued by global systemically important banks (covered debt) that generally meets the requirements for eligible LTD except for acceleration clause(s);

(iii) Impact of Capital Buffers on GSIB Market Making Activity: reduce the SLA penalty by decreasing the SLA applicable to covered BHCs as of July 1, 20122 from 9.5% to 6.75%, to be more in line with the buffer applicable to foreign BHCs; and

(iv) Greater Use of LTD in BHC Capital Structures: we are not suggesting a change but rather making an observation about what may become an emerging issue about the lack of comparability of BHC capital regimes among TLAC, the Small BHC Policy Statement and Basel III capital requirements. Clearly, with the TLAC requirement for substantially more loss absorbing debt in the BHC capital structure, the Board and other regulators have demonstrated that they are comfortable with more debt at the BHC, and having more third party loss absorbing capacity in the banking system can be helpful to increase the capacity to lend, but guidance on target levels on BHC LTD would be helpful towards capital planning across BHCs of all asset sizes.

[3] Federal Register / Vol. 80, No. 229 / Monday, November 30, 2015 / Proposed Rule.
[4] Federal Register / Vol. 78, No. 198 / Friday, October 11, 2013 / Rules and Regulations.
[5] Federal Register / Vol. 80, No. 72 / Wednesday, April 15, 2015 / Rules and Regulations.
[6] The TLAC deduction excludes "underwriting positions held for 5 or fewer business days." According to Sandler O'Neill's fixed income trading desk, there is confusion in the market as to the difference between an underwriting position and a market making position. For purposes of this letter and the application of TLAC rules, we have assumed that a market making position would be treated the same as an underwriting position.

Our goal in submitting these comments is to contribute constructively to a rulemaking process that enhances the safety and soundness of U.S. banks without sacrificing orderly markets or damaging the U.S. financial system or the economy.

1) Capital Deductions for Investments in GSIB Senior BHC debt

Current Basel III capital rules require that all banks and BHCs with total assets of $1 billion or more deduct significant and non-signficant investments in another bank's capital securities such as subordinated debt, trust preferred, preferred stock and common stock, subject to certain thresholds. The TLAC rules propose to add covered debt to the list of securities that will be deducted from bank capital using the corresponding deduction approach, effective January 1, 2019[7]. This deduction will apply to all direct, indirect (through investments funds) and synthetic exposures to covered debt instruments with the amount of investment equal to the net long position owned by Board-regulated institutions.

Under this approach, investments in capital instruments are deducted from the capital category corresponding to how the instrument is or would be classified by the issuer. Covered debt would be explicitly treated as Tier 2 capital for purposes of the corresponding deduction approach. To the extent that a Board-regulated institution lacked sufficient Tier 2 capital from which to deduct its investment, the remaining amount would be deducted sequentially from the the next higher category of capital.

In substantially all cases for non-GSIB banks, these investments would be viewed as a non-significant investment (i.e., investing bank would own <10% of the outstanding common stock of the GSIB BHC). In these cases, the investment amount exceeeding 10% of the investing bank's CET1 after Basel III deductions and adjustments, would be deducted from capital using the corresponding deduction approach.

To highlight the potential impact on a community bank's balance sheet of this addtion of covered debt to the securities to be deducted from capital, we have provided a case study of a sample bank with total assets of $5 billon, CET1 of $500 million and subordinated debt of $50 millon. This bank has made investments in senior BHC covered debt of $75 million and $50 million of subordinated debt.

In Column A, the sample bank's investment portfolio currently includes senior BHC GSIB debt and subordinated debt totaling $125 million. Under current Basel III rules, the $75 million of senior BHC GSIB covered debt is not included in the calculation of investments subject to Basel III deduction, and the sample bank would face no capital deduction.

[7] The proposed deduction for investment in covered debt instruments takes effect on January 1, 2019 but the revision in the Regulation Q definition of investment in capital to include covered debt may take effect on April 1, 2016. Federal Register / Vol. 80, No. 229/ Monday, November 30, 2015/ Proposed Rules. Page 74950.

In Column B, the sample bank's investment portfolio includes the $75 million in senior BHC GSIB covered debt under the proposed TLAC rules and would create an excess investment of $75 million that would be deducted from Tier 2 capital. Since the amount of Tier 2 capital at the sample bank of $50 million is less than the deduction amount of $75 million, the difference is deducted from the next highest form of capital which is common equity. This results in a $75 million reduction in total capital with $25 million being deducted from common equity. This 13.64% reduction in capital would not be required under current Basel III capital rules but would be triggered under the proposed NPR.

Case Study: Impact of Capital Deduction for Covered Debt on Sample Bank

Total Assets = $5 Billion Total CET1 = $.500 Billion	A Corresponding Deduction Approach Under Current Rules	B Corresponding Deduction Approach Under TLAC NPR
Non-significant Investment Type	**Investment Amt. ($)**	**Investment Amt. ($)**
Senior BHC Covered Debt (GSIB)	$ 75.0	$ 75.0
Subordinated Debt	$ 50.0	$ 50.0
Trust Preferred Stock		$ -
Preferred Stock	$ -	$ -
Common Stock	$ -	$ -
Total Bank Investments	$ -	$ -
Subject to Basel III Deduction	$ 50.0	$ 125.0
Common Equity Tier 1	$ 500.0	$ 500.0
> 10% CET1	$ 50.0	$ 50.0
Excess Bank Investments	$ -	$ 75.0

CET1 Deduction Amount:			% Total
Senior BHC Covered Debt (GSIB)	$ -	$ (45.0)	60%
Subordinated Debt	$ -	$ (30.0)	40%
Trust Preferred	$ -	$ -	0%
Preferred Stock	$ -	$ -	0%
Common Stock	$ -	$ -	0%
	$ -	$ (75.0)	100%

Current Capital Structure	Before Deduction	Deduction	Adjusted $	(%) Change
Subordinated Debt	$ 50.0	$ (50.0)	$ -	-100.00%
Preferred Stock	$ -		$ -	
Common Stock	$ 500.0	$ (25.0)	$ 475.0	-5.00%
Total Regulatory Capital	$ 550.0	$ (75.0)	$ 475.0	-13.64%

There is currently no required call report or GAAP disclosure on the amount of investment by banks in GSIB senior BHC debt. So to develop an estimate of the impact of the potential deduction on the investment portfolios and capital positions of regional and community banks, Sandler O'Neill selected a sample of 200 regional and community banks with total assets of between $1 billion but less than $50 billion and a mean asset size of approximately $4 billion. We discovered that 112 of the 200 banks (about 56%) owned senior covered BHC debt with an average investment amount of approximately $20.7 million. Of the 112 banks that owned senior covered BHC debt, 29 or roughly 26% of the total owned an amount comprising 10% or more of CET1. In aggregate, the amount of investment totaled $1.4 billion. If we extrapolate those numbers to the broader universe of 639 banks in the U.S. between $1 billion and $50 billion in assets, we can estimate that roughly $7.4 billion of senior covered BHC debt is owned by regional and community banks. (i.e., 56% of 639 x $20.7 million average investment amount).

To put that number in perspective, the amount of bank investment in pooled trust preferred securities at the time of the Volcker Rule announcement in the 4th quarter of 2013 was approximately $5.2 billion but only approximately $2.8 billion was owned by regional and community banks after excluding the amount owned by GSIBs and USAA.[8] This means that the amount of senior covered BHC debt owned by regional and community banks could be over twice the amount of TPS CDOs owned by such banks.

In 2013, the banking regulators agreed to grandfather investment in pooled trust preferred securities that would otherwise not be permitted under the Volcker Rule to avoid large losses potentially incurred by regional and community banks that owned such securities. The logic was that banks should be permitted to own such investment if the Collins Amendment specifically permitted the issuance of trust preferred as Tier 1 capital for banks less than $15 billion.

The original version of the TLAC rules published by the FSB did not include a capital deduction for investment by non-GSIBs in senior covered BHC debt securities.[9] The NPR does include this deduction and the potential large overhang from additional debt issuance could cause unsuspecting regional and community banks to face losses on the sale of such securities and/or capital deductions. The Board clearly anticipated that this deduction would elicit much comment and devoted Questions 66–70 in the NPR to solicit feedback from impacted banks.[10] Given the somewhat capricious nature of the change in rules and the relatively short remaining life of most of the senior covered BHC debt issues, a reasonable path to compromise may be to push back the start date for the capital deduction for non-GSIB investment in covered BHC senior debt from January 1, 2019 to January 1, 2022, which

[8] SNL Financial. Based on September 30, 2013 financial information. TRUPs CDO investments by banks totaled $5.2 billion but only $2.8 billion after excluding amounts owned by HSBC, USAA, WFC, BAC, BBVA, Citi, JPM, MS, and GS.
[9] Financial Stability Board. Adequacy of loss-absorbing capacity of global systemically important banks in resolution. Consultative Document, November 10, 2014. Page 18.
[10] Federal Register / Vol. 80. NO. 229 / Monday, November 30, 2015 / Proposed Rules. Pages 74951-52.

would substantially lessen any potential negative impact on the regional and community bank investment portfolios and capital levels.

A related concern is the TLAC deduction that GSIB's face with market making positions in covered debt held for more than 5 days. Based on the observations of Sandler O'Neill's fixed income trading desk, the 5-day limit on trading account positions could have a significant negative impact on market liquidity for such debt which would likely increase yields and negatively impact borrowing cost not only for the GSIB BHCs but also regional and community banks. We suggest that the 5-day market making period be extended beyond 5 days and potentially up to 30 days to avoid constraints on market liquidity.

2) Disruption to the BHC LTD Market from TLAC LTD Issuance

Covered BHCs currently have about $1,007 billion in total debt outstanding.[11] Of this amount, eligible external LTD that would potentially qualify as "plain vanilla" with a remaining maturity of at least 1 year (50% credit for less than 1 year) approximates $726 to $760 billion.[12] To estimate the volume of senior BHC debt that must be issued by covered BHCs to comply with the external TLAC and LTD requirements, the Board considered outstanding debt as of December 31, 2014 and made several assumptions: (i) covered BHCs were brought compliant with other capital requirements to be in effect in 2019 which necessitated a catch up amount from 5 of the 8 covered BHCs and (ii) all outstanding debt that met the primary requirements for eligible external debt (no derivative linked features and remaining maturity of 1 year or more) was considered eligible LTD.

Based on these assumptions and application of the 2019 TLAC and eligible LTD requirements, the Board estimated an aggregate external LTD need of about $680 billion and the estimated aggregate shortfall for the covered BHCs was approximately $120 billion.[13] This shortfall amount only represents about 16% of the average amount of covered BHC senior debt currently outstanding.

Alternatively, using September 30, 2015 public information and assuming the 2022 TLAC requirements, the covered BHCs would be required to maintain eligible TLAC equal to the greater of (i) 18% of RWA plus the capital conservation buffer of 2.5%, the relevant GSIB buffer, and any counter cyclical capital buffer and (ii) 9.50% of SLAs. The chart below shows an estimate of the total external TLAC requirement of approximately $1.5 trillion of which $876 billion would be comprised of existing CET1 and AT1 leaving a required LTD requirement of approximately $634 billion. Highlighted in red are the external TLAC requirements for JPM, C, BAC, WFC and BK which are higher using the RWA approach than the SLA approach. Note that while GS and MS have substantial excess external LTD, other covered BHCs will need to raise an aggregate of about $112 billion.

[11] Source: Bloomberg. Data compiled as of November 1, 2015 based on GAAP filings as of September 30, 2015.
[12] Source: SNL Financial. Data compiled as of November 24, 2015 based on GAAP filings as of September 30, 2015.
[13] Federal Register / Vol. 80 No. 229/ Monday, November 30, 2015. Page 74938.

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2022 Total TLAC Based on 18% RWAs Buffers

($,MM)	RWA 30-Sep-15	Leverage Exposure 30-Sep-15	TLAC Req. to be Higher of RWA 18.00%	External TLAC Requirement W/ Buffers (1)(2)	External TLAC Requirement w/ Buffers	Current CET1 and AT1 Outstanding	Estimated Required LTD (2)	Estimated LTD Outstanding	Estimated Required LTD Issuance
JPM			272,347	23.50%					33,345
			225 805	22.50%			120,257	97,430	
BAC	1,397,504	2 740 854	251,551	22.00%	307,451	174,631	132,820	115,475	
GS	580,210	1,380,000	104,438	22.00%	127,646	79,750	47,896	156,890	
MS	433,750	1,120,000	78,075	22.00%	95,425	66,071	29,354	119,274	89,920
WFC	1,312,200	2,066,600	236,196	21.50%	282,123	162,200	119,923	82,801	(37,122)
SST	103,887	270 274	18,700	21.50%	22,336	14,520	7,816	7,850	34
BK	173,783	390,123	31,281	21.50%	37,363	18,605	18,758	20,000	(1,242)
					1,510,164	875,933	634,231	723,781	(111,882) (3)

Source: SNL Financial, data as of September 30, 2015

(1) Includes 2.5% capital conservation buffer, and Method 1 GSIB buffer but no counter cyclical capital buffer

(2) Chart includes additional amount of external debt required by applying the method 2 GSIB buffer to the minimum external LTD ratio.

(3) Summary of estimated required issuance excludes estimated surplus at GS, MS and SST.

The chart below shows an estimate of the TLAC requirement using 9.5% of SLAs. Highlighted in red are the TLAC requirements for GS, MS and SST which are higher using the SLA approach than the RWA approach.

There is minimal need for additional LTD using the SLA approach but the covered BHCs are required to use the greater of the RWA approach or the SLA approach, and the RWA approach requires the greater amount of external TLAC for 5 of 8 GSIBs.

2022 Total TLAC Requirement Based on 9.50% SLAs

($,MM)	RWA 30-Sep-15	Leverage Exposure 30-Sep-15	External TLAC Requirement @ 9.50%	External TLAC Requirement	Current CET1 and AT1 Outstanding	Required LTD	Estimated LTD Outstanding	Estimated Required LTD Issuance
JPM	1,513,037	3,116,440	296,062	296,062	198,157	97,905	124,061	26,156
C	1,254,473	2,363,506	224,533	224,533	161,999	62,534	97,430	34,896
BAC	1,397,504	2,740,854	260,381	260,381	174,631	85,750	115,475	29,725
GS	580,210	1,380,000	131,100	131,100	79,750	51,350	156,890	105,540
MS	433,750	1,120,000	106,400	106,400	66,071	40,329	119,274	78,945
WFC	1,312,200	2,066,600	196,327	196,327	162,200	34,127	82,801	48,674
SST	103,887	270,274	25,676	25,676	14,520	11,156	7,850	(3,306)
BK	173,783	390,123	37,062	37,062	18,605	18,457	20,000	(1,543)
				1,277,541	875,933	401,608	723,781	(4,849) 1)

Source: SNL Financial, data as of September 30, 2015

(1) Summary of estimated required issuance excludes GSIBs with estimated surpluses.

These estimates of the external LTD shortfalls of $112 or $120 billion assume that a substantial portion of the outstanding GSIB long term debt excluding structured notes would qualify as eligible long term debt. The amount of external LTD funding shortfall could be as high as $550 billion, according to CreditSights, if the outstanding LTD of covered BHCs was not converted into eligible external LTD but would have to be refinanced in the market.[14] This discrepancy between the Board's estimate of the LTD financing need and the CreditSight's estimate arises from the TLAC requirement that eligible LTD not have a contractual right of acceleration other than insolvency or payment default.

Senior unsecured debt of covered BHCs typically includes rights of acceleration for reasons other than payment default or insolvency and so would NOT qualify as eligible LTD. If the covered BHCs had to replace/refinance the entire $550 billion compared to $112 or $120 billion, that would obviously have a material adverse effect on the entire market for BHC debt. Moreover, the $112 or $120 billion amount assumes the minimum amount of eligible LTD issuance and does not factor in additional cushion that GSIBs may want to maintain to avoid any restrictions on activities.

According to representatives from Sandler O'Neill's fixed income trading desk, market yields on covered BHC senior debt have not widened materially following the TLAC announcement. ***We do not think that market participants have focused on the downside case*** with the requirement for large scale refinancing, restructuring or replacement of this LTD as a result of the Board's disclosure that they assumed substantially all the LTD would remain in place. If this does not happen, we could quickly see deterioration in market conditions as market participants focus on the much larger volume of resulting debt refinancing. With Question 3 in the NPR, the Board clearly understood that this requirement for a substantial amount of TLAC and LTD to be issued could disrupt the markets for senior unsecured debt instruments and requested comments "on the probable impact of the proposed requirements on covered BHCs and on markets for senior unsecured debt instruments".[15]

To avoid a large market disruption, the Board may choose to modify the definition of eligible LTD to exclude acceleration from the final rule or potentially grandfather existing LTD that otherwise meets the eligibility requirements. Alternatively, covered BHCs would have to either amend the indentures of existing debt to remove/modify the acceleration language on bonds extending beyond 2020 (and would likely have to compensate current investors to incent them to agree to this modification) or tender for the outstanding bonds with maturities extending beyond 2020 and reissue bonds with acceptable acceleration and other "plain vanilla" language.

[14] Source: CreditSights. U.S. Banks: TLAC Eligibility of Senior Debt. December 1, 2015. Page 1.
[15] Federal Register / Vol. 80, No. 229 / Monday, November 30, 2015 / Proposed Rules page 74933.

3) Impact of TLAC Requirements and Capital Buffers on Market Making Activity

Overall, the level of capital required to support different types of assets is a complex area that continues to undergo change as the Basel III rules are implemented. The GSIB banks are subject to the higher of the Standardized Approaches or Advanced Approaches risk weighting methodology and are required to measure their trading risk using the Internal Risk Based (IRB) method. Each of the U.S. GSIBs discloses this information and the calculation quarterly. The regulators have realized that the IRB approach may not be applied consistently around the world, causing banks in some countries to have very low risk weighting while banks in other countries have very high risk weighting.

As a result, the TLAC rules include a SLA ratio requirement of 6% in 2019 increasing to 9.5% by 2022 for covered BHCs. For the IHCs, this is 6.0% SLAs increasing to 6.75% in 2022 along with a requirement for 9.00% of average total consolidated assets.

The TLAC NPR proposes a 58% increase in the TLAC/SLA ratio from 6% of SLAs in 2019 to 9.5% of SLAs in 2022. This sharp increase in the TLAC ratio requirements combined with the very large difference in RWAs compared to SLAs as a percentage of GAAP assets, represents a penalty for those covered BHCs such as GS, MS and SST whose business models create a high level of SLAs. As shown in the chart below, there is a wide range of RWA/GAAP assets for the covered BHCs ranging from 42% for State Street to 75% for Wells Fargo with a mean of 59%.

In contrast, the SLA/GAAP assets ratio for the covered BHCs ranges from 103% to 157% with a mean of 126%. The difference between RWAs and SLAs averages about 66% but is largest for GS, MS, and SST that have a high level of relatively low risk weighted trading account assets but also have significant off-balance sheet commitments and exposures. With SLAs to GAAP assets of 156%, 134% and 129%, respectively, GS, MS and JPM face a substantial penalty relative to the other GSIBs when the SLA ratio is increased to 9.50%.

Comparison of SLAs to RWAs

($,MM)	GAAP 30-Sep-15	RWA 30-Sep-15	Leverage Exposure 30-Sep-15	Risk Weighted Assets % GAAP Assets	Supplementary Leverage Assets % GAAP Assets	RWA and SLA Difference
JPM	2,417,121	1,513,037	3,116,440	62.60%	128.93%	66.34%
C	1,808,356	1,254,473	2,363,506	69.37%	130.70%	61.33%
BAC	2,153,006	1,397,504	2,740,854	64.91%	127.30%	62.39%
GS	880,559	580,210	1,380,000	65.89%	156.72%	90.83%
MS	834,113	433,750	1,120,000	52.00%	134.27%	82.27%
WFC	1,751,265	1,312,200	2,066,600	74.93%	118.01%	43.08%
SST	247,274	103,887	270,274	42.01%	109.30%	67.29%
BK	377,371	173,783	390,123	46.05%	103.38%	57.33%
High	2,417,121	1,513,037	3,116,440	74.93%	156.72%	90.83%
Low	247,274	103,887	270,274	42.01%	103.38%	43.08%
Mean	1,308,633	846,106	1,680,975	59.72%	126.08%	66.36%
Median	1,315,912	917,342	1,723,300	63.75%	128.12%	64.36%

Source: SNL Financial, Financial information as of September 30, 2015

As shaded below in grey, if the RWA ratios and SLA ratios remain the same between now and January 1, 2019, the highest levels of TLAC for the covered BHCs would be required based on the 16% RWA plus buffers ratio. But in 2022, with the sharp increase from 6.0% to 9.5% in the minimum TLAC/SLAs, the 9.50% requirement results in higher levels of TLAC for GS, MS and SST. These institutions may choose to decrease investments in lower yielding, lower risk weighted businesses in order to meet profitability and financial return targets given the higher capital requirements. Note that the difference between the RWA approach and the SLA approach to determine the overall required level of TLAC decreases from $670 billion in 2019 to $232 billion in 2022 as a result of the increase in the SLA ratio to 9.50%.

Comparison of TLAC Based on 2019 vs 2022 RWA and SLA Requirements

($,MM)	Risk Weighted Assets % GAAP Assets	Supplementary Leverage Assets % GAAP Assets	RWA and SLA Difference	2019 Comparsion of TLAC Requirements 16% RWA + Buffers	2019 Comparsion of TLAC Requirements 6% SLA	2022 Comparsion of TLAC Requirements 18% RWA + Buffers	2022 Comparsion of TLAC Requirements 9.50% SLA	
JPM	62.60%	128.93%	66.34%	325,303	186,986	355,564	296,062	
C	69.37%	130.70%	61.33%	282,256	141,810	282,256	224,533	
BAC	64.91%	127.30%	62.39%	307,451	164,451	307,451	260,381	
GS	65.89%	156.72%	90.83%	127,646	82,800	127,646	131,100	
MS	50.74%	134.27%	83.53%	93,113	67,200	95,425	106,400	
WFC	74.93%	118.01%	43.08%	282,123	123,996	282,123	196,327	
SST	42.01%	109.30%	67.29%	22,336	16,216	22,336	25,676	
BK	46.05%	103.38%	57.33%	37,363	23,407	37,363	37,062	
				1,477,592	806,868	1,510,164	1,277,541	Total TLAC
					670,724		232,624	Difference

Source: SNL Financial, Financial information as of September 30, 2015

In addition to pressure on reducing SLAs from the TLAC rules, the Board introduced a new method to determine the GSIB buffer for covered BHCs (Method 2) which further reduces the attractiveness of low risk weighted/low return businesses supported by wholesale funding. As shown below, the Method 2 GSIB buffer raises the maximum buffer from 2.50% to 4.50% based on the exposure that a GSIB has to short term wholesale funding (STWF).

Method 1 vs Method 2 GSIB Buffer[16]

	Method 1 BCBS	Method 2 STWF	Increase
JPM	2.50%	4.50%	2.00%
CITI	2.00%	3.50%	1.50%
BAC	1.50%	3.00%	1.50%
GS	1.50%	3.00%	1.50%
MS	1.50%	3.00%	1.50%
WF	1.00%	2.00%	1.00%
STT	1.00%	1.50%	0.50%
BK	1.00%	1.00%	0.00%

The types of transactions the Board appears to be most concerned with include the following: secured financing transactions, unsecured wholesale funding transactions, FMV exchange of assets with differences in liquidity, short positions on all assets, and all brokered deposits and brokered sweep deposits.

As the covered BHCs focus on managing their capital structures to meet the TLAC requirements while minimizing reliance on wholesale funding that could increase the method 2 GSIB buffer, there will likely be increasing pressure on GSIBs to reduce the capital committed to support low RWA businesses that also produce low returns such as market making activities for agency and RMBS trading, credit trading, and securitized products trading. Covered BHCs may have an incentive to take more credit risk on loans funded with stable deposits or other sources of long term funding. ***Changes in the lines of business and targeted financial returns do not happen overnight, but we are already seeing evidence in the market as more covered BHCs reduce their market making activities.***

[16] Method 1 GSIB buffer is based on the Basel GSIB framework relying on 5 measures of systemic risk: size, interconnectedness, complexity, cross-jurisdictional activity, and substitutability (payment activity, assets under custody, and underwritten transactions in debt and equity markets). A GSIBs involvement in market making and trading activity is captured through the complexity score that covers OTC derivatives, AFS securities and level 3 assets. The Method 2 GSIB buffer calculation is applicable to U.S. GSIBs and replaces substitutability with a measure of reliance on short term wholesale funding referred to as the STWF score. The TLAC external LTD requirement is based on the greater of 6% of RWA plus the method 2 GSIB buffer and 4.50% of SLAs.

Where will the liquidity come from to support trading in these businesses with low risk weighting but low returns? There are numerous possibilities including buy side accounts such as hedge funds and other investors, non-GSIB broker dealers, and electronic trading platforms. Covered BHCs are also exploring various technology solutions, such as the application of block chain technology, which could offer a way to substantially reduce the time for trading settlement and clearance, releasing capital by shortening the holding periods. But absent new sources of market making liquidity, the TLAC requirements and other GSIB capital buffers will negatively impact GSIB market making activities.

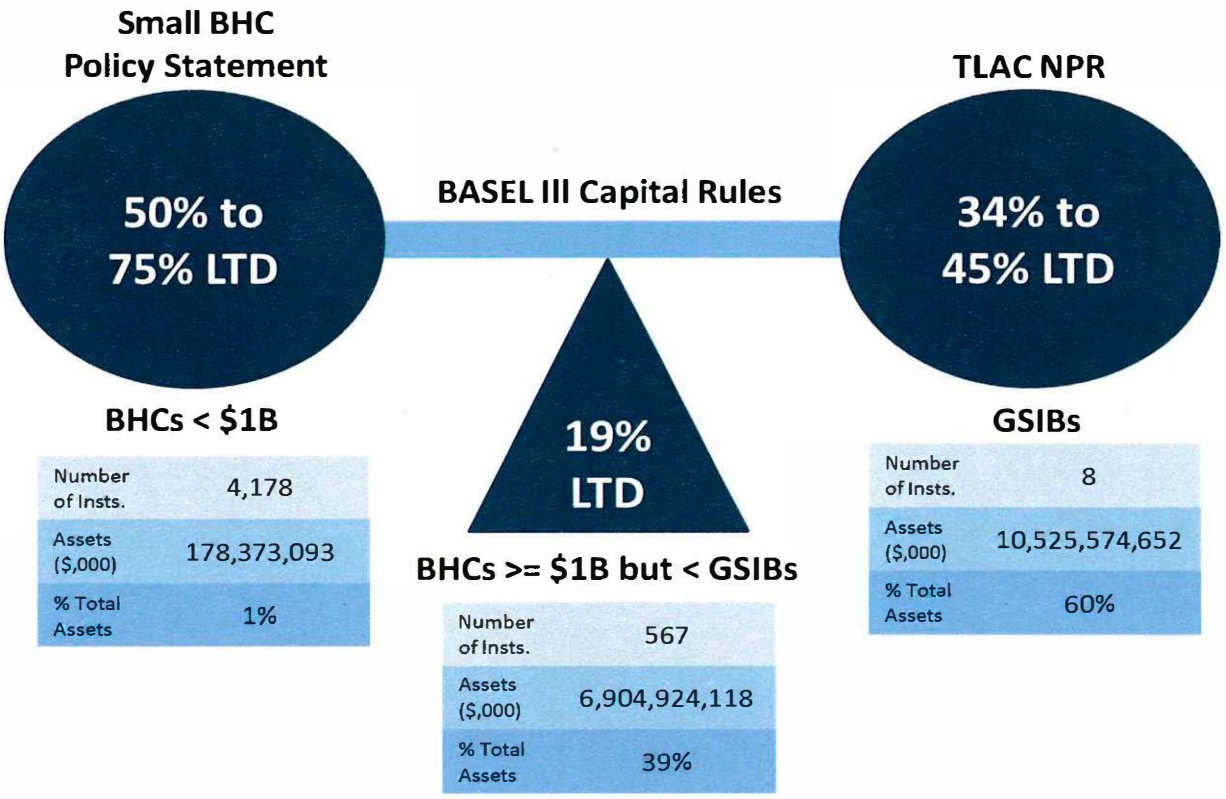
4) Greater Use of Debt in the BHC Capital Structure

When fully phased in on January 1, 2022, the TLAC capital rules will require about 34% to 40% LTD[17] in the total capital structure (including the full counter cyclical capital buffer) and about 38% to 45% LTD[18] in the total capital structure (with NO counter cyclical capital buffer). These higher BHC debt levels contrast sharply with the current Basel III rules (applicable to non-GSIBs with assets of $1 billion or more) which currently only include about 19% in LTD (subordinated debt) as a component of total capital.[19]

The Small Bank Holding Company Policy Statement (Policy Statement) effective in May of 2015 explicitly permits up to 75% LTD in the BHC capital structure and allows up to 50% LTD without restriction on dividend payments or impacting expedited regulatory approval for M&A transactions.[20] In December 2015, the House Financial Services Committee approved a bill (H.R. 3791)[21] to increase the consolidated BHC asset size threshold applicable to the Policy Statement from $1 billion to $5 billion which, if adopted as law, would significantly expand the number of BHCs that could explicitly use more LTD.

As illustrated below, these capital rules differ substantially by asset size and result in a bar bell scenario where the largest and smallest banks in the U.S. can have substantially more debt in their capital structure than Basel III would otherwise permit. GSIBs with about 60% of the U.S. banking assets are required to have 34% to 45% long term debt while small BHCs representing about 87% of the total number of BHCs are currently permitted to have 50% to 75% long term debt. The BHCs in the middle with $1 billion or more in assets but less than GSIBs (representing about 39% of total U.S. banking assets) will have only 19% debt and be at a distinct disadvantage in terms of weighted average cost of capital (WACC).[22]

[17] Please see Appendix A
[18] Please see Appendix B
[19] Basel III Final Capital Rules effective October 2013.
[20] Small Bank Holding Company Policy Statement effective May 2015. Requires that BHC assets are less than $1 billion, no significant non-bank activities, no significant off balance sheet activities done through non-bank subsidiaries, and no material amount of SEC registered debt or equity. Principal ongoing requirements include: parent company debt must be repaid within 25 years, maximum debt to equity ratio of 3:1 (75%) but must be reduced to .3:1 (25%) or less within 12 years, each insured depository subsidiary must be well capitalized under Basel III rules, and no dividends can be paid until debt/equity ratio is less than 1:1 (50%).
[21] http://financialservices.house.gov/uploadedfiles/bills-114hr3791ih.pdf
[22] All data related to number of institutions and total assets for U.S. BHCs and Savings and Loan Holding Companies based on SNL Financial as of December 23, 2015, using data for the quarter ended September 30, 2015.



Each BHC will seek to lower their after-tax WACC as consistent with their requirements under their applicable capital regime whether the Policy Statement, Basel III, or TLAC. Clearly, the Board and other regulators are comfortable with more debt in BHC capital structures and having more loss absorbing capacity in the banking system can add more lending capacity. We have explicit guidance on permitted LTD under the Policy Statement and required LTD under the TLAC requirements, but it would be helpful to get similar guidance on target levels of BHC LTD for the BHCs with assets or $1 billion or more but less than GSIBs.

Summary

On behalf of Sandler O'Neill, we appreciate the opportunity to provide these comments and be part of a constructive dialogue on the implementation of the TLAC requirements. We acknowledge the complication of conforming the TLAC rules developed among the G-20 countries to the U.S. banking market, where we have substantially more banking organizations with a wider range of business strategies and economic concerns. There are few other countries in the world where the rules impacting debt issuance by the locally-based GSIBs could potentially have an influence on market access and cost of capital for thousands of other smaller BHCs in the same country.

We are very concerned about the capital deduction for investment in covered debt by regional and community banks. This was unexpected as this was not included in the original FSB proposal. The amount of investment is difficult to track because there is no required disclosure, but Sandler O'Neill's sampling of regional and community bank investment portfolios suggests that the amount of investment in covered debt could be as much as $7.4 billion which would substantially exceed the investment amount in 2013 by regional and community banks in pooled trust preferred securities of approximately $2.8 billion.

The Board clearly anticipated that this deduction would elicit considerable comments and devoted Questions 66–70 in the NPR to solicit feedback from impacted banks.[23] Given the somewhat capricious nature of the change in rules and the relatively short remaining life of most of the senior covered BHC debt issues, a reasonable path to compromise may be to push back the start date for the capital deduction for non-GSIB investment in covered BHC senior debt from January 1, 2019 to January 1, 2022, which would substantially lessen any potential negative impact on the regional and community bank investment portfolios and capital levels. The 5 day limit on GSIB market making in covered debt could have a significant negative impact on its liquidity and market pricing. As such, we are requesting that the GSIB market making window for covered debt be expanded from 5 days potentially up to 30 days.

We are also concerned about a disruption to the market for BHC long term debt if the TLAC rules are adopted as proposed. The exclusion of GSIB BHC senior debt with an acceleration clause for reasons other than payment default or insolvency would potentially disqualify over $550 billion in outstanding senior GSIB BHC debt, which substantially exceeds the Board's estimate of $120 billion. The refinancing, replacement or restructuring of such a large amount of outstanding senior BHC debt could increase the cost to the GSIB BHCs and potentially disrupt the market for regional and community bank long term debt. For this reason, we are requesting that the Board modify, grandfather, or offer forbearance for outstanding GSIB LTD that generally meets the requirements for eligible LTD except for acceleration clauses.

As the covered BHCs focus on managing their capital structure to meet the TLAC requirements while reducing reliance on wholesale funding that could increase the method 2 GSIB buffer, there will likely be increasing pressure on GSIBs to reduce the capital committed to market making activities. The reduction in GSIB market making activity could reduce liquidity to support trading which will impact all market participants. For these reasons, we are requesting that the SLA buffer be increased in 2022 to 6.75% rather than 9.5%, as this is more consistent with the level required for the intermediate holding companies of foreign GSIS BHCs.

[23] Federal Register / Vol. 80. NO. 229 / Monday, November 30, 2015 / Proposed Rules. Pages 74951-52.

Finally, we are not suggesting a change but rather making an observation about what may become an emerging issue about the lack of comparability of BHC capital regimes between TLAC, the Small BHC Policy Statement and Basel III capital requirements. As explained herein, with the TLAC requirement for approximately 34 to 45% LTD in the BHC capital structure and the Small BHC Policy Statement permitting 50 to 75% LTD, the Board and other regulators have demonstrated that they are comfortable with more LTD at the BHC. BHCs subject to Basel III may be at a distinct disadvantage with only 19% LTD at the BHC. Tax deductible LTD is generally less expensive than equity capital. As such, absent further guidance from the Board and other regulators as to the appropriate level of BHC LTD, we may expect to see greater use of LTD in BHC capital structures.

We greatly appreciate your consideration of our comments and would welcome the opportunity to discuss these further with you or respond to any questions as the Board finalizes the TLAC rules.

Respectfully submitted,

Thomas W. Killian
Principal

tkillian@sandleroneill.com
(212) 466-7709

Thomas Killian has over 37 years of capital markets and M&A transaction execution experience, with a long history at Sandler O'Neill of developing innovative capital instruments and representing the firm in conferences and private meetings with the Board, FDIC, and others to discuss capital structure, restructuring and resolution strategies, and Basel III and DFA related issues.

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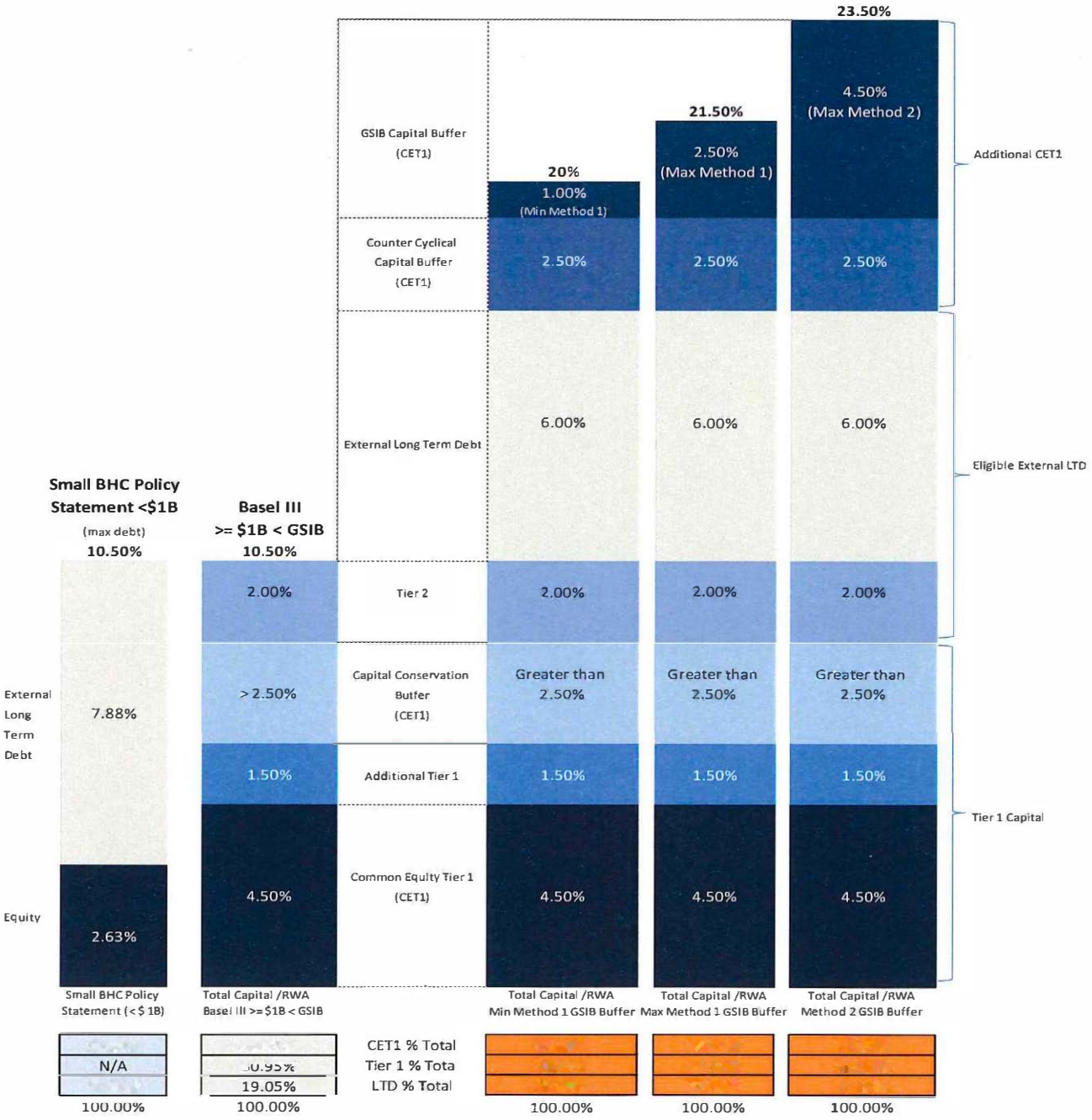
Appendix - A

Covered BHC Capital / RWA with Counter Cyclical Capital Buffer



Sources: Small BHC Policy Statement (April 2015), Basel III Capital Rules (October 2013), TLAC NPR (November 2015)

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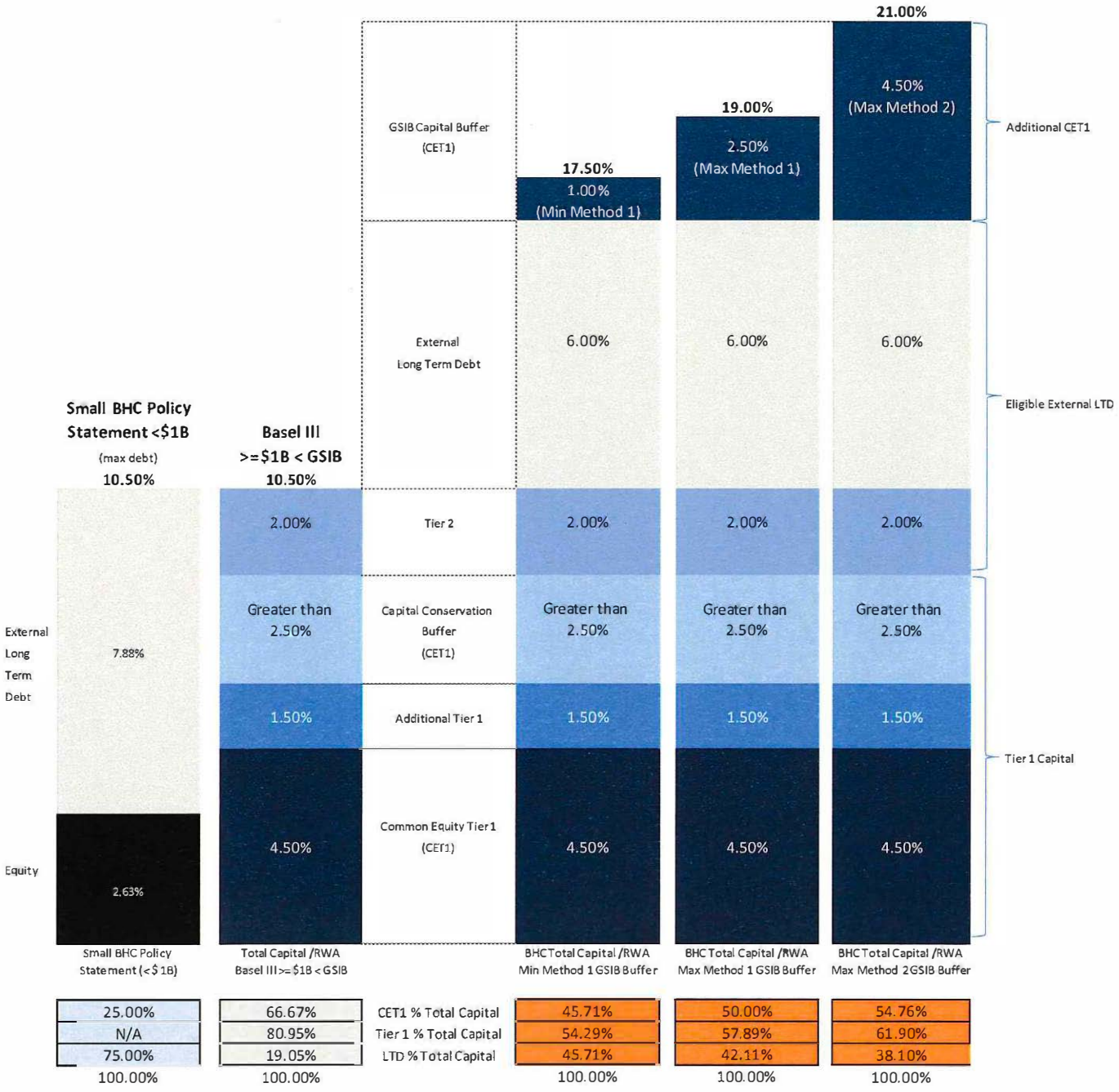
Appendix – B

Covered BHC Capital / RWA with NO Counter Cyclical Capital Buffer



Sources: Small BHC Policy Statement (April 2015), Basel III Capital Rules (October 2013), TLAC NPR (November 2015)