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Statement of the Shadow Financial Regulatory Committee

on

Requiring Large Banks To Issue Subordinated Debt

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As required by the Gramm-Leach-Bliley Act of 1999, the Federal Reserve Board and the Treasury Department issued a report in December 2000 on the desirability and feasibility of requiring large depository institutions to issue at least a minimum amount of uninsured subordinated debt as a means for enhancing market discipline and protecting the deposit insurance funds.

The Report acknowledges evidence that the voluntary issuance of subordinated debt, largely by bank holding companies, encourages market discipline. Nonetheless, it concludes that the "net benefits of a mandatory policy over voluntary issuance are currently too uncertain to justify a mandatory policy." The Report further concludes that additional data must be gathered on the operation of the subordinated debt market before either the Federal Reserve or the Treasury Department can "support a request for legislative authority to impose a requirement that large insured depository institutions or their holding companies maintain some portion of their capital in the form of subordinated debt."

The Shadow Committee disagrees with the Report's conclusion, while applauding the empirical findings of the report – which support the Committee's position that some form of mandatory subordinated requirement be adopted [Statement 160]. Specifically, the Report finds that the vast majority of the largest U.S. banking organizations already issue subordinated debt and that this debt does provide "some market discipline and transparency." The Report also concludes that a 2%

subordinated debt requirement would have little cost on America's largest banks who already maintain large subordinated debt issues. Furthermore, the Report notes that a mandatory debt requirement could reduce the tendency for depository institution supervisors to forbear from resolving troubled institutions.

Nonetheless, the Report declines to endorse a mandatory system because of "uncertainty" about its practicality and potential impact, suggesting instead that more data be gathered. But as other Federal Reserve research has shown, although large depository organizations now voluntarily issue subordinated debt, they have a demonstrated reluctance to do so when encountering financial difficulties. Yet this is precisely the point in time when such debt *should* be issued. Knowing that they must always confront the marketplace – in good times and in bad – banks would be more prudent in their activities. Furthermore, the inability of a bank to sell its debt when required, or to do so only at interest rates substantially higher than the rates on high quality corporate securities of comparable maturity, provides a strong market signal to regulators to take appropriate action under the "prompt corrective action" provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). Accordingly, without mandating some subordinated debt issuance, there is no way for regulators to obtain the information that the Federal Reserve and Treasury ostensibly are seeking: namely, the effectiveness of subordinated debt in encouraging the markets and regulators to discipline banking organizations.

The Committee therefore recommends that the best way to gain information about the workings of the subordinated debt market, while also taking constructive steps to enhance market discipline in the meantime, is to adopt now a simple form of a subordinated debt requirement. In particular, as this Committee has previously recommended, the very largest depository institutions should be required to back at least 2% of their assets with qualifying subordinated debt [See Statement 160]. Because the intent of the requirement is to discipline risky behavior by *banks*, the requirement would apply to banks and not their holding companies.

The subordinated debt mandate can also be implemented in phases, in a fashion that minimizes cost, while data are being assembled to determine whether the requirement should be expanded to cover additional banks, modified to improve its effectiveness, or even abandoned (if evidence shows the requirement not to be providing material benefits). Thus, the size threshold for applying the requirement initially could be quite high in order to limit it to institutions whose debt is easily traded in the marketplace. During the initial phase, the requirement need not be tied to any required supervisory action under FDICIA. Furthermore, to offset any potential costs of the new requirement, institutions subject to it could apply some portion of the newly mandated subordinated debt they issue toward their Tier I risk-based capital requirement.

In sum, the logic of the Federal Reserve/Treasury report points strongly toward one conclusion. If information about how a mandatory subordinated debt requirement would work is desired, there is only one way to find out: test such a requirement now. No further research, without a real world trial, will resolve the alleged uncertainties of the effectiveness of a mandate.