CSBS
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CONFERENCE OF STATE BANK SUPERVISORS

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Robert deV. Frierson
Secretary, Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Docket No. R–1438
RIN 7100 AD 86

Dear Mr. Frierson,

The Conference of State Bank Supervisors (CSBS) appreciates the opportunity to comment on the Federal Reserve Board's (FRB's) proposed rule entitled *Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies* ("FBO proposal," "proposed rule," or "proposal"). State banking departments license, regulate, and supervise state-licensed branches, agencies, and representative offices of foreign banks. The states therefore have significant interest in the FRB's proposed adjustments to the regulatory framework for foreign banking organizations (FBOs).

Sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) require the FRB to establish certain enhanced prudential standards and early remediation requirements for large domestic bank holding companies (BHCs), FBOs with a significant presence in the United States, and non-bank financial companies deemed systemically significant (non-bank SIFIs) by the Financial Stability Oversight Council (FSOC). In 2012, CSBS commented on the FRB's domestic Enhanced Prudential Standards proposal, generally applicable to domestic BHCs with assets greater than $50 billion and domestic non-bank SIFIs. The FBO proposal applies many of the same enhanced prudential standards to FBOs with greater than $50 billion in assets and foreign non-bank financial SIFIs. Aspects of both proposals, namely the annual stress testing and risk committee requirements, apply to institutions with greater than $10 billion in assets. While much of the FBO proposal is mandated by Dodd-Frank, a significant aspect of the proposal would apply new structural and regulatory standardization mechanisms to FBOs that go beyond the scope of the mandate.

With respect to the aspects of the proposal tied directly to the statute, CSBS generally believes the FRB has proposed appropriate measures to implement those requirements and has thoughtfully tailored various aspects of the Dodd-Frank requirements to institutions on the smaller end of the statutory scale that may not have significant systemic potential in the U.S. economy. However, in many cases, we believe the proposed rule does not thoroughly contemplate the interaction of the proposed framework with existing regulatory structures that have traditionally been the jurisdiction of the chartering authority. To that end, we urge the FRB to ensure its proposed framework does not encroach on existing, effective FBO regulatory structures governed by state regulators. The FRB should strive for communication and transparency with other critical supervisory parties. The section-by-section comments below detail specific instances where state-federal coordination is particularly important.

Fundamentally, CSBS endorses equal and fair treatment of banking institutions operating in the United States, and we appreciate the FRB's analysis of the evolution of the FBO business model in the U.S., particularly the recent trends in FBO funding relationships with parent organizations. However, we must balance this with an appropriate acknowledgement of the economic benefit FBOs provide to the American economy, including the countercyclical role they often play. This balance is particularly important in evaluating the aspects of the proposal that go beyond the scope of the Dodd-Frank mandate—those that work to standardize the regulatory structure for FBOs in the U.S. Before promulgating a final rule, the FRB should further analyze the economic risks that may accompany a trend toward a capital ring-fenced regulatory model and systematically forcing U.S. regulatory standardization on institutions based in other countries.

Below we provide an outline of our section-by-section comments. For ease of reference, we refer to various categories of institutions as Category 1, Category 2, and Category 3 institutions. Category 1 institutions are FBOs with global assets greater than $10 billion and a U.S. presence. Category 2 institutions are FBOs with global assets greater than $50 billion and U.S. assets less than $50 billion. Category 3 institutions are FBOs with global and U.S. assets greater than $50 billion. Also, note that we do not reiterate every technical comment we made on aspects of the proposal that are identical between the FBO and domestic Enhanced Prudential Standards proposals but would like to acknowledge that our technical feedback on those aspects of the proposals holds[1].

INTERMEDIATE HOLDING COMPANY (IHC)

The FRB has proposed that FBOs operating in the U.S. through bank subsidiaries and having non-branch U.S. assets exceeding $10 billion will be required to form a U.S. Intermediate Holding Company (IHC) that will be subject to capital and other requirements similar to those applicable to U.S. BHCs.

In general, we believe the FRB should more clearly outline standards for formation and maintenance of the IHC. At the moment, aspects of the proposed IHC framework do not seem fully contemplated. As an example, there is little dialogue explaining expectations for an institution's IHC if the institution falls below the asset threshold that requires formation. We note it is not uncommon for institutions to eclipse, or fall below, the $10 billion threshold. The FRB should clarify whether it expects an institution to continue to maintain an IHC if it dips below the asset threshold or whether they are expected to unwind the IHC. This is a potentially problematic point of ambiguity for institutions that hover around the $10 billion mark. In response to a related FRB question surrounding potential tax issues with the IHC, we believe this possible dormancy scenario could lead to tax complications if institutions fall below the threshold. As another example, the proposal clearly intends the IHC to be a U.S.-based entity;

[1] The CSBS domestic Enhanced Prudential Standards comment letter can be viewed here.

however, the FRB is not explicit about who could sit on the Board of Directors (BOD) of such an entity. Various state laws govern citizenship requirements for BOD members of U.S. institutions. Procedural issues may arise if the FRB does not reconcile BOD expectations for the IHC with existing legal structures in the states.

In order to limit transitional burden, the FRB should consider the interplay between the proposed IHC and certain existing similar structures within the banking organizations and whether those structures would qualify as IHCs. The requirement should be practical and reasonable. However, the FRB should be explicit about what qualifies. Transparency in this area is important. We support the FRB's inclination to use the BHC Act definition of control in determining what should be consolidated in the IHC as a practical, transparent metric for IHC formation. On a separate matter, the FRB outlines an "after the fact framework" for IHC formation, whereby the entity can begin forming the IHC and inform the FRB of its actions after it initiates the process. This is intended to expedite the IHC transition period. Notably, the FRB maintains that it is the only agency that should be notified of IHC formation. There are other critical regulatory bodies that need to know about holding company formation and be involved in the application process, including the state banking regulators in the case of state licensed FBOs.

Further, it is unclear how the IHC structure will affect the day-to-day supervision of the chartered entities. The proposal does not thoroughly outline the interaction of the FRB and other relevant supervisory authorities vis-à-vis the chartered entities. Finally, with an IHC requirement in place, supervisors should monitor the IHC's impact on a foreign institution's inclination toward booking risky assets outside the banking subsidiary and in the branch and agency network. We estimate this is a possible consequence of the IHC requirement, and other similar changes in corporate strategy may result from regulatory adaptation.

Risk-Based Capital and Leverage

The proposal outlines two layers of capital standards for institutions of different asset size ranges. Category 2 FBOs would be required to meet home country capital standards that are broadly consistent with Basel standards. Category 3 FBOs would meet the home country standard and be subject to the FRB's Capital Plan Rule.

CSBS believes the FRB has appropriately tailored the application of the DFA capital standards to institutions of various sizes, particularly in its use of home country certification for FBOs with U.S. assets under $50 billion. CSBS generally supports the notion of capital equivalency for banking institutions operating in the U.S. However, the FRB should be mindful of the traditional method by which a bank manages capital—that is, from the group level down. To the extent these provisions fundamentally alter FBO capital planning, we may see FBOs move businesses or product lines out of the U.S. The FRB should work with the industry to further quantify the potential economic impact of these adjustments. This becomes particularly relevant if the expectation is to move capital planning relevant for U.S. operations to the U.S. IHC.

On a more specific level, we acknowledge the FRB maintains that in implementing any conditions or restrictions, they will coordinate with any relevant U.S. licensing authority. As with other aspects of the proposal that reference other licensing or supervisory authorities, the FRB is not specific about which bodies it will consult. The FRB should ensure it consults with the states in the case of conditions or restrictions for state licensed FBOs. Additionally, the FRB references possible asset maintenance provisions and arrangements it may place on FBOs in certain cases. The state regulators and the OCC currently have asset maintenance authority over their licensed FBOs. We note there are carve outs built into the proposal for branch & agency (B&A) networks in other areas. We do not see the need for the FRB to maintain additional, possibly duplicative asset maintenance authority over state-licensed FBOs.

LIQUIDITY

Once again, the proposal would apply certain liquidity requirements to Category 2 and Category 3 institutions. Category 2 institutions would be required to comply with annual liquidity stress test requirements. Category 3 institutions would have to comply with far more detailed liquidity requirements, including: establishing a liquidity risk management framework; performing monthly liquidity stress tests separately for the U.S. IHC and U.S. B&A network; developing cash flow projections; maintaining contingency funding plans; and maintaining a liquidity buffer of unencumbered highly liquid assets on both the IHC and B&A network.

Generally, from the ground perspective, many of the requirements are formalizing where institutions are already heading. Some of the provisions, such as contingency funding plans, are required by regulators in many cases. We once again believe the FRB has appropriately applied more stringent provisions to institutions with U.S. assets greater than $50 billion. As with many other provisions of the proposed rule, we should consider the notion that historically, FBOs have managed from the top down, but the FRB is considering a more U.S. centric approach in this case. We need to more fully understand the implications of moving liquidity risk management in this direction.

With respect to the FRB's inquiry regarding matching of liquidity risk and the liquidity buffer at the individual branch level rather than allowing the firm to consolidated across the U.S. B&A network, it may be more flexible for an FBO looking at its entities from a system-wide basis to simply require the consolidated option, acknowledging that the states may use their existing authority if issues arise to require something more specific at the individual branch level. The FRB also inquires whether it should adopt a limit on short-term debt. We suggest refraining from implementing a short-term debt limit until determining how the other provisions work out in practice.

SINGLE-COUNTERPARTY CREDIT LIMIT (SCCL)

Under the proposal, Category 2 and Category 3 institutions would generally be subject to a single-counterparty credit limit (SCCL) of 25% of capital stock and surplus. FBOs with U.S. assets greater than $500 billion would be subject to a more stringent SCCL, generally set at 10%.

CSBS largely supports the FRB's implementation of the SCCL and believes the enhanced application to extremely large institutions is appropriate. However, one potential weakness within the proposed SCCL is the absence of any exception potential built into the framework.

This could be problematic for larger institutions headquartered in small countries, where it may be financially prudent to have higher exposures to neighboring countries. Similarly, the FRB should clarify its expectations surrounding exposures to sovereign entities. Institutions headquartered in countries that have close proximity to multiple other countries face a different set of circumstances, including more economic interdependence in many cases, than U.S. institutions. Without permitting unreasonable exposure to sovereign entities, which has proven to be problematic overseas, the FRB should build in some exception capacity that reflects the proximity and interdependence of various economies abroad.

Procedurally, we note that there may be system hurdles in aggregating concentrations across U.S. operations for some institutions on the smaller end of the asset scope. Additionally, we request the states be included in consultations on SCCL compliance for state licensed entities, particularly on the proposed monthly compliance reports.

RISK-MANAGEMENT

Dodd-Frank requires the establishment of risk-management structures for FBOs with greater than $10 billion in global consolidated assets and a presence in the U.S. and heightened risk management for FBOs with greater than $50 billion in U.S. assets. In implementing the Dodd-Frank standards, the FRB has proposed to require Category 1 and Category 2 FBOs to establish and maintain a U.S. Risk Committee with at least one member with appropriate risk management expertise. Category 3 FBOs would establish a U.S. Risk Committee and a U.S. Chief Risk Officer (CRO). The CRO would be in charge of overseeing and implementing the risk management framework of the company's combined U.S. operations and would report directly to the U.S. Risk Committee and the company's global chief risk officer.

CSBS generally supports the risk management requirements and endorses the need for the U.S. Risk Committee and CRO. We believe there should be clear lines concerning the Risk Committee's and CRO's accountability to U.S. regulators. Additionally, CSBS suggests the FRB ensure there is some flexibility in the establishment of the risk management entities considering the global nature of the institutions. Regulators should be aware of the safety and soundness concerns and the "silo effect" that may arise from standardized U.S.-based risk management if the structure is not sufficiently in touch with the global entity.

If there is an expectation that regulators will have input in the establishment of the Risk Committee and CRO, we request the states' input be included. Similarly, the FRB explains that the U.S. CRO would be required to schedule meetings with FRB supervisory staff. Such meetings should be joint meetings between the FRB and other relevant supervisory bodies, including the states in the case of state licensed FBOs.

STRESS TESTING

The FBO proposal would require Category 1 and Category 2 institutions to meet home country stress testing requirements that are broadly consistent with U.S. requirements. Category 3 FBOs would be subject to the same stress testing requirements as US BHCs with assets greater than $50 billion and non-bank SIFIs, including semi-annual company-run stress tests and annual supervisory stress tests.

We endorse the FRB's inclination to rely on home country certification for the stress testing requirements for FBOs with U.S. assets below $50 billion, but we request additional information regarding the FRB's metrics for determining that the home country stress testing framework is consistent with DFA stress testing for institutions with $10-$50 billion in assets.

With respect to the proposed asset maintenance plans for larger companies in the stress testing framework, we reiterate that such arrangements are the purview of the state regulators for state licensed FBOs. The FRB should ensure it is working with the states and not undermining existing authority or duplicating efforts. We have concerns that unilateral FRB action in the case of asset maintenance requirements due to the stress testing standards may result in confusion and undue burden, particularly for those institutions that are already under asset maintenance requirements. Additionally, on a separate matter, the FRB inquires about possible intragroup funding restrictions or local liquidity requirements. In the states' estimation, these may be too onerous if placed on top of an asset maintenance arrangement by seriously limiting the types of assets or investments an institution could hold. Further, if the FRB determines to proceed with such funding restrictions, the proposed timing may be impractical. If there is a serious liquidity issue, 30 days prior notification may be unrealistic, especially considering the additional 14 day petition process in which an institution can engage.

DEBT-TO-EQUITY LIMITS

As required by Dodd-Frank, the FRB has proposed to require FBOs with consolidated assets greater than $50 billion to maintain a debt-to-equity ratio of no more than 15-to-1 upon a determination by the FSOC that such company poses a grave threat to the financial stability of the United States and that the imposition of such requirement is necessary to mitigate the risk that such company poses to the financial stability of the Unites States.

CSBS supports the debt-to-equity limit for such institutions and believes the FRB has appropriately acknowledged the need to achieve such a limit in a safe and sound manner. With respect to the additional 108% asset maintenance requirement the FRB proposes to place on such an institution's B&A network, we reiterate that asset maintenance arrangements are typically the jurisdiction of the state or the OCC. The FRB should not usurp state authority in this area. If the FRB proceeds with establishing this authority, we believe these requirements should be administered jointly between regulators to eliminate duplicate supervisory measures. Additionally, it may be prudent to allow flexibility in the 108% level, rather than mandating specificity.

EARLY REMEDIATION REQUIREMENTS

Section 166 of Dodd-Frank requires the FRB to establish early remediation requirements for FBOs with global consolidated assets greater than $50 billion and a presence in the U.S. To fulfill the Dodd-Frank requirement, the FRB has proposed a set of early remediation standards similar to those contained in the domestic Enhanced Prudential Standards proposal for

Category 2 and Category 3 FBOs. The FRB has proposed to tailor application of the rule so that remediation standards applicable to Category 2 FBOs are discretionary and serve as more of a guide than the non-discretionary standards applicable to Category 3 FBOs.

In general, the FRB should consult with all applicable supervisory authorities and should not act unilaterally on provisions contained in the remediation requirements. The FRB references "primary regulators" throughout the provisions but does not define primary regulators. We request clarity in this area to ensure the states are involved in early remediation provisions for their regulated entities.

Related to more specific aspects of the proposed remediation framework, we endorse aligning the Risk-Based Capital (RBC) and leverage triggers with the capital conservation buffer under Basel III to reduce operational complexity in capital management. Additionally, we believe the FRB should incorporate more precision in its basis point ranges that may trigger remedial action. The ranges may be too broad in some cases. For instance, if an institution falls below 75-125 basis points above any minimum applicable leverage ratio, it would be subject to Level 3 remediation. More precision on such triggers would enhance clarity in expectations about when action would be taken.

The FRB discusses the potential use of market indicators extensively in the proposed early remediation framework. CSBS believes market indicators are excellent tools for safety and soundness supervision, but we are concerned with the concept of using them as public remediation triggers. We believe the FRB is proceeding with appropriate caution in refraining from incorporating market indicators past the Level 1 triggers. Any attempt to incorporate market indicators beyond Level 1 should be thoroughly vetted. Market indicators are not remarkably developed tools. Further, market indicators themselves may react to thresholds that include them as a metric, which may in turn have an impact on public perception and confidence. Extensive use of market indicators may therefore result in a self-perpetuating set of issues.

Regarding the bonus and compensation restrictions outlined in Level 3 remediation, we understand the importance of limiting irrational compensation practices for defunct management teams. However, we note that it may be necessary to allow bonuses and higher compensation for incoming management teams if the goal is to attract remediation experts for distressed companies, particularly considering the FRB discusses replacing management teams at certain stages in the remediation framework.

With respect to the non-public MOU required in Level 2 remediation, we request greater clarity regarding whether these MOUs will be lifted if an institution falls out of the associated remediation level. In many cases, MOUs contain many provisions that go beyond the particular issue at hand. Institutions would benefit from clarity surrounding whether the MOU spans the life of the institution's presence in a certain stage of remediation or whether it is not lifted until all the provisions of an MOU are fulfilled. Importantly, all functional regulators should have the opportunity to join an MOU with the FRB as they see appropriate, including the states in the case of state-licensed FBOs. Similarly, any actions against management that are referenced in the early remediation framework should be coordinated with the other appropriate supervisory authorities. We also request clarity on whether the FRB is proposing to replace or supplement its existing authority to institute growth limits, limits on acquisition, etc. Typically, these provisions are addressed under 4M agreements today. Finally, considering the liquid asset buffer arrangements outlined in the remediation requirements, we once again note that these arrangements have typically been administered at the state or OCC level. We urge the FRB to coordinate with the states on this matter in the case of state licensed FBOs.

<u>OTHER ISSUES</u>

The FRB inquires about general burden for supervised institutions. As discussed in various aspects of our remarks, within the context of the proposed framework, it will be more difficult for institutions to manage U.S. operations at the group level. We should strive to encourage institutions to have a company-wide view of risk. The FRB may need to further analyze the costs of standardizing the regulatory framework for the domestic portion of these foreign entities.

On a separate matter, the FRB maintains that it intends to consult with each FSOC member agency that primarily supervises a functionally regulated subsidiary or depository institution subsidiary of a foreign banking organization subject to this proposal before imposing prudential standards. CSBS notes that the state banking regulators have a non-voting seat on the FSOC. In addition to consulting with the state banking regulator on the FSOC, we suggest the FRB consult with an advisory group of states with substantive FBO activity before imposing FBO standards, as the state FSOC representative may not represent a state with a significant FBO presence.

Thank you for the opportunity to engage on this highly important topic.

John W. Ryan

President and CEO