

COMMITTEE ON CAPITAL MARKETS REGULATION

April 24, 2013

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

VIA ELECTRONIC MAIL: regs.comments@federalreserve.gov

Re: Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations; Proposed Rule (Docket No. R-1438; RIN 7100 AD 86)

Dear Mr. deV. Frierson:

The Committee on Capital Markets Regulation (the “**Committee**”) is grateful for the opportunity to comment on the proposed rule (the “**Proposed Rule**”) implementing the enhanced prudential standards and early remediation requirements of Sections 165 and 166, respectively, of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “**Dodd-Frank Act**”) ¹ with respect to foreign banking organizations (“**FBOs**”) supervised by the Board of Governors of the Federal Reserve System (the “**Board**”). We would encourage the Board to consider our comments in conjunction with our letter of April 30, 2012, ² in which we addressed the Board’s proposed enhanced prudential standards and early remediation requirements with respect to U.S. bank holding companies and certain covered nonbank financial companies. ³

Founded in 2006, the Committee is dedicated to enhancing the competitiveness of U.S. capital markets and ensuring the stability of the U.S. financial system. Our membership includes thirty-two leaders drawn from the finance, investment, business, law, accounting, and academic communities. The Committee is chaired jointly by R. Glenn Hubbard (Dean, Columbia Business School) and John L. Thornton (Chairman, The Brookings Institution) and directed by Hal S. Scott (Nomura Professor and Director of the Program on International Financial Systems, Harvard Law School). The Committee is an independent and nonpartisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations.

While the Committee commends the Board for its focus on the critical objective of stemming systemic risk, we would like to highlight three concerns with the Proposed Rule. First, we believe that the Proposed Rule’s heightened capital and liquidity requirements for FBOs will not materially contribute to reducing the risk of another contagious run on the U.S. financial system. Second, the Proposed Rule imposes requirements in excess of the Third Basel Accord (“**Basel III**”), resulting in additional burdens on FBOs and impeding U.S. and world economic growth. Third, the Proposed Rule threatens to provoke retaliatory “ring-fencing” of capital and

¹ Pub. L. No. 111-203, 124 Stat. 1376 (2010).

² Letter from Committee on Capital Markets Regulation to Jennifer J. Johnson, Sec’y Fed. Reserve Bd. (Apr. 30, 2012) available at http://capmktsreg.org/pdfs/2012.04.30_Fed_Enhanced_Prudential_Standards.pdf.

³ Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594 (proposed Jan. 5, 2012) (Docket No. 1438, RIN 7100-AD-86).

liquidity by foreign regulators, potentially impairing the stability of U.S. banks in the event of another financial crisis.

Rationale of the Proposed Rule

The Proposed Rule subjects FBOs with global total consolidated assets over \$50 billion and operations in the United States to enhanced prudential standards.⁴ If implemented, FBOs with U.S. assets of \$10 billion or more (excluding U.S. branch and agency assets) would be required to form U.S. intermediate holding companies to hold all U.S. bank and nonbank subsidiaries. Such U.S. intermediate holding companies would themselves be subject to enhanced prudential standards, including capital, leverage ratio, and liquidity requirements. Furthermore, the Proposed Rule would require, *inter alia*, U.S. branches and agencies of FBOs to maintain a liquidity buffer of “highly liquid assets” sufficient to meet “net stressed cash flow need” over a 30-day period, of which the first 14 days of liquidity must be held in the United States.⁵ Additionally, the Proposed Rule includes an early remediation framework, arguably increasing capital and liquidity pressures across the global operations of FBOs through (i) the “cross-triggering” of single counterparty credit limits, whereby if either an intermediate holding company or the combined U.S. operations of an FBO exceeds a 25% exposure limit with respect to a single counterparty, neither the intermediate holding company nor the FBO’s U.S. branches and agencies would be permitted to increase its exposure to the counterparty absent specific Board approval, and (ii) the imposition of additional capital burdens above and beyond the Basel III minimum requirements.

In a November 28, 2012 speech setting forth the policy rationale of the Proposed Rule, Governor Daniel K. Tarullo emphasized the importance of counteracting the systemic risk associated with “reliance [by FBOs] on less stable, [U.S. dollar] short-term wholesale funding.”⁶ Governor Tarullo argued that such risk is exacerbated by the upstreaming of funding from the U.S. operations of FBOs to the foreign parent level. From a supervisory perspective, Governor Tarullo expressed concern that U.S. regulators do not have timely access to information about the global activities of FBOs that may derive their funding from the United States. In addition, from a U.S. financial stability perspective, Governor Tarullo’s main concern appears to be that insufficient local maintenance of capital and liquidity could, in the event that an FBO and its U.S. operations were to fail, have destabilizing effects on U.S. creditors and the U.S. economy generally. In remarks on December 14, 2012, Governor Jeremy C. Stein stated the Proposed Rule “will not disadvantage [FBOs] relative to domestic U.S. banking firms, but rather...seek[s] to maintain a level playing field.”⁷

⁴ The enhanced prudential standards include “risk-based capital and leverage requirements, liquidity standards, risk management and risk committee requirements, single-counterparty credit limits, stress test requirements, and a debt-to-equity limit for companies that the Financial Stability Oversight Council has determined pose a grave threat to financial stability.” Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77 Fed. Reg. 76,628 (proposed Dec. 28, 2012) (Docket No. R-1438, RIN 7100 AD 86).

⁵ *Id.* at 76,643.

⁶ Gov. Daniel K. Tarullo, Regulation of Foreign Banking Organizations, Remarks at the Yale School of Management Leaders Forum 5 (Nov. 28, 2012) *available at* <http://www.federalreserve.gov/newsevents/speech/tarullo20121128a.pdf>.

⁷ Gov. Jeremy C. Stein, Dollar Funding and Global Banks, Remarks at the Global Research Forum, International Finance and Microeconomics, Sponsored by the European Central Bank, Frankfurt am Main, Germany (Dec. 17, 2012) *available at* <http://www.federalreserve.gov/newsevents/speech/stein20121217a.htm>.

The Committee believes that the premises of the Proposed Rule are flawed and will engender an “every nation for itself” attitude that will severely hamper the development of international capital markets and global economic prosperity. We are also skeptical of arguments that the so-called “upstreaming” of funding from U.S. branches to foreign head branches poses systemic risk. U.S. branches of FBOs form part of the same legal entity as their foreign main branch; such paper “transfers” of funding are therefore akin to moving funds from a bank’s left pocket to its right pocket.

We further note that the Proposed Rule would also apply enhanced prudential standards to systemically important nonbank financial institutions supervised by the Board. While the Financial Stability Oversight Council has yet to issue any systemic designations of foreign nonbank financial institutions, and while the Board has indicated that it will clarify the application of the Proposed Rule to this class of entities in later rulemakings, we would urge the Board to consider the basic incongruity of applying banking-specific prudential standards to a diverse array of nonbank financial institutions.⁸

With respect to Governor Stein’s “level playing field” concerns, we note that once the Basel III capital requirements are adopted and implemented in all relevant jurisdictions, both U.S. banks and FBOs will be subject to consistent capital requirements on a consolidated basis.

FBO Failure Poses Little Risk of Public Bailout

U.S. branches and agencies of FBOs, which are merely offices of their foreign main branch located in the United States, are ineligible to accept insured deposits in the United States and thus result in no U.S. insurance exposure. Bailouts of such entities would typically take place at the foreign parent level and be provided by the relevant home country regulator. Aside from access to the Board’s discount window, which is generally extended to U.S. branches and agencies of FBOs, U.S. taxpayers’ bailout exposure to these entities is limited. The exposures of U.S. banks to the U.S. branches and agencies of FBOs—whether through funding, derivatives, or otherwise—are generally not of a degree that would warrant a U.S. government bailout. For example, U.S. branches and agencies of FBOs provide U.S. banks with less than \$100 billion in funding per year, representing only 0.56% of the loans made by U.S. branches and agencies of FBOs.⁹ Thus, we do not believe that these entities pose systemic risk resulting from “liability interconnectedness.”¹⁰

U.S. regulators have jurisdiction over the U.S. banking subsidiaries of FBOs, and, if warranted, enhanced regulation can be applied to those entities. However, given the reputational

⁸ See Letter from Committee on Capital Markets Regulation to Jennifer J. Johnson, Sec’y, Fed. Reserve Bd., *supra* note 2, at 2–3.

⁹ See William Goulding & Daniel E. Nolle, *Foreign Banks in the U.S.: A Primer* (Bd. of Governors of the Fed. Reserve Sys. Int’l Fin. Discussion Papers, No. 1064r, 2012), available at <http://www.federalreserve.gov/pubs/ifdp/2012/1064/ifdp1064r.pdf> (noting that in 2010–2011 only 0.56% of the loans made by U.S. branches and agencies of FBOs were interbank loans to U.S. banks).

¹⁰ “Interconnectedness” can relate to assets or liabilities, and generally refers to the phenomenon in which the failure of, or large losses borne by, one firm precipitates the failure of, or large losses borne by, a second firm because the second has an exposure to the first failed institution that exceeds its capital. “Liability interconnectedness” refers to a funding problem, where the failure of a firm providing funding to others, e.g., clearing banks, deprives many other financial institutions of funding. See Hal S. Scott, *Interconnectedness and Contagion* 16 (2012), available at http://www.capmksreg.org/pdfs/2012.11.20_Interconnectedness_and_Contagion.pdf.

risk posed to a foreign parent bank by the failure of its U.S. banking or broker-dealer subsidiary, as well as the legal and economic impact from cross-default provisions or guarantees from the parent organization, we believe that under virtually all circumstances, a foreign parent bank would, if solvent, provide the necessary support to a failing U.S. subsidiary. We know of no examples of the failure of a systemically important U.S. subsidiary of an FBO. Indeed, quite the contrary is true: foreign parent banks have provided support to their U.S. operations in past crises.¹¹ We therefore do not consider the “source of strength” rationale underlying the Proposed Rule’s capital and liquidity requirements to be a compelling justification for subjecting these entities to the Proposed Rule.

Capital Requirements Do Not Adequately Address Contagion Risk

The Committee shares Governor Tarullo’s concern that over-reliance by FBOs and their subsidiaries on short-term U.S. wholesale funding poses systemic risk.¹² Even relatively minor shocks may cause “contagion” or run behavior with short-term funding withdrawn from banks and other financial institutions due to widespread fear of impending failure. Without government intervention, contagion forces banks and financial institutions to liquidate assets at fire-sale prices, thus exacerbating the stress on such institutions.

However, the requirements under the Proposed Rule to maintain local capital do not address the risk of contagion. Indeed, insofar as the Proposed Rule prevents a foreign parent from gaining access to “trapped” capital and liquid assets of its U.S. operations, the Proposed Rule may in fact increase contagion risk, since the failure of a foreign parent could as easily spark contagion in the United States as could the failure of a U.S. branch or subsidiary. Moreover, if foreign regulators respond with reciprocal requirements for the foreign operations of U.S. banks, the Proposed Rule may have the unintended effect of also reducing U.S. banks’ available capital and liquid assets, further exacerbating contagion risk.

Although heightened local capital requirements may cushion losses, the Committee believes that the Proposed Rule is unlikely to be sufficient to stop a run by short-term wholesale creditors of the U.S. operations of an FBO. As the International Monetary Fund (the “IMF”) has indicated, a run on a foreign parent bank typically spreads rapidly to other parts of the bank and affiliated entities,¹³ notwithstanding the creation of a local intermediate holding company.

Liquidity Requirements Do Not Adequately Address Contagion Risk

Enhanced local liquidity requirements may appear to represent a more promising regulatory approach than enhanced local capital requirements, since contagion originates in runs that are fundamentally liquidity-driven. The stock of high-quality assets on which private

¹¹ See Ricardo Correa, Horacio Sapriza, and Andrei Zlate, *Liquidity Shocks, Dollar Funding Costs and the Bank Lending Channel During the European Sovereign Crisis*, (Bd. of Governors of the Fed. Reserve Sys. Int’l Fin. Discussion Papers, No. 1059-2012 (Nov. 2012) (describing how parent banks and other offices of Eurozone banks provided financial support to their U.S. branches after money market mutual funds and other large time depositors withdrew funding from U.S. branches of Eurozone banks during the European sovereign debt crisis).

¹² See Letter from Committee on Capital Markets Regulation to Financial Stability Oversight Council 2 (Feb. 15, 2013), available at http://capmksreg.org/wp-content/uploads/2013/02/FSOC.non-bank.SIFI_.comment.ltr_.pdf.

¹³ Jonathan Fietcher et al., *Subsidiaries or Branches: Does One Size Fit All?* 4 (Int’l Monetary Fund, Staff Discussion Note 11/04, 2011), available at <http://www.imf.org/external/pubs/ft/sdn/2011/sdn1104.pdf>.

liquidity requirements depend is, however, necessarily limited. A persistent disruption to short-term borrowing markets could eventually overwhelm even the strongest portfolio of liquid assets. Short-term creditors of a financial institution subject to such liquidity requirements would thus still have an incentive to accelerate their exit, after waves of outflow have resulted in the sale of the most liquid assets. Only a central bank lender of last resort can provide sufficient liquidity to stop an irrational bank run.

Further, like the Proposed Rule's local capital requirements, the local liquidity requirements may also exacerbate the U.S. financial system's exposure to contagion. The Proposed Rule's liquidity requirements would reduce an FBO's ability to divert liquid assets from U.S. operations to address a shock abroad, reducing the FBO's ability to withstand withdrawals by short-term wholesale creditors. Thus, because the failure of a large FBO could spark contagion in the United States, the Proposed Rule's local liquidity requirements may increase the U.S. financial system's exposure to contagion.

Capital and Liquidity Requirements in Excess of Basel III

The Proposed Rule's capital requirements would go beyond the Basel III capital requirements,¹⁴ because an FBO's U.S. intermediate holding company would have to maintain its own capital, in addition to the capital required to be held by the U.S. bank subsidiary, U.S. broker-dealer, and foreign parent. For example, two large European banks that currently hold capital in excess of Basel III requirements are expected to have to raise significant amounts of capital if the Proposed Rule is implemented.¹⁵ Additionally, the Proposed Rule includes capital planning requirements that require maintenance of a 5% Common Equity Tier 1 ratio over a nine-quarter stress horizon and an early remediation framework that arguably increases liquidity and capital pressures across the global operations of the FBO by the operation of its cross-trigger provisions. These "hidden buffers" will require significant amounts of capital above and beyond the Basel III minimum requirements.

Numerous studies by the Basel Committee on Banking Supervision and the IMF have found that requiring banks to hold substantially increased amounts of capital has a significant negative long-term impact on economic growth.¹⁶ A recent Goldman Sachs research note finds that the Proposed Rule's capital requirements will cost one European bank \$2.5-3.0 billion and that FBOs are expected to substantially reduce lending by their U.S. operations in response to the Proposed Rule.¹⁷

The Proposed Rule's liquidity requirements would also go beyond the Basel III liquidity coverage ratio. Intermediate holding companies and U.S. branches and agencies would be

¹⁴ Basel Committee on Banking Supervision, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (Dec. 2010, rev. June 2011), available at <http://www.bis.org/publ/bcbs189.pdf>.

¹⁵ Goldman Sachs Global Investment Research, *Action: Sell Deutsche Bank (DBKGn.DE)*, Goldman Sachs Group, Inc., Mar. 1, 2013, at 11, exhibit 6, 21.

¹⁶ See, e.g., Basel Committee on Banking Supervision, *An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements* (2010), available at <http://www.bis.org/publ/bcbs173.pdf>; Macroeconomic Assessment Group, Bank for Int'l Settlements, *Assessing the Macroeconomic Impact of the Transition to Stronger Capital and Liquidity Requirements* (2010), available at <http://www.bis.org/publ/othp12.pdf>; Scott Roger & Jan Vleck, *Macroeconomic Costs of Higher Bank Capital and Liquidity Requirements* (IMF Working Paper No. 11/103, 2011), available at <http://www.imf.org/external/pubs/ft/wp/2011/wp11103.pdf>.

¹⁷ Goldman Sachs Global Investment Research, *supra* note 15, at 13, 18.

required to maintain their own separate pools of liquid assets. Neither of these pools would be accessible to the foreign parent to address global liquidity risks, and essentially separate pools must be maintained to address internal and external net cash flows (unlike the single pool required for U.S. bank holding companies). For example, in order to comply with the Proposed Rule's liquidity requirements, one large European bank with U.S. operations would be required to hold an estimated additional \$73 billion in short-term liquid assets in the United States that would no longer be available to its foreign parent.¹⁸

Moreover, holding liquid assets entails costs to financial institutions and to the economy, since every dollar of capital allocated to low-yield, liquid, short-term securities is unavailable to finance long-term lending to borrowers, lowering the amount of new credit that financial institutions can create and raising the overall cost of capital. Complying with the Proposed Rule's liquidity requirements would cost one large European bank an estimated \$1 billion in additional annual funding.¹⁹

Reciprocal Ring-Fencing to Protect U.S. Creditors and Its Potential Effects

A stated purpose of the Proposed Rule is to protect uninsured U.S. creditors of an FBO in the event of its failure by ensuring that sufficient assets are held in the United States to satisfy claims. We question whether this is a proper object of Board policy. Uninsured creditors, whether of foreign or domestic banks, should generally be at risk of failure. Protecting U.S. creditors at the expense of foreign creditors is the very definition of "beggar thy neighbor" protectionism and antithetical to fair, free, and open markets.

It is highly likely that foreign regulators will respond to the Proposed Rule by imposing their own comparable capital and liquidity requirements on the foreign operations of U.S. banks. Indeed, Michel Barnier, the European Commissioner for Internal Market and Services, has expressed reservations at the Proposed Rule's tendency toward ring-fencing of capital and liquidity, recently referring to the potential for "reciprocal measures on the European side."²⁰ Such reciprocal measures could materially reduce the ability of U.S. banks to withstand future financial crises.²¹

As recently as the 2008 financial crisis, U.S. banks relied on their foreign affiliates for over \$500 billion in net funding.²² According to the IMF, subsidiary structures similar to the Proposed Rule's intermediate holding company requirement "might prevent a parent bank from taking swift action [to withstand a shock] due to certain restrictions on moving capital and liquidity from a subsidiary in one country to a parent or a subsidiary in a different country."²³ According to Goldman Sachs, restrictions like the Proposed Rule would reduce the accessibility of capital and liquid assets and likely lead to downgrades by credit rating agencies of banks subject to such restrictions.²⁴ The Federal Advisory Council is similarly concerned about the potential for retaliatory ring-fencing, arguing that the Proposed Rule "opens the door for the

¹⁸ *Id.* at 15.

¹⁹ *Id.* at 18.

²⁰ Douwe Miedema, *EU Bank Rules Boss Scolds Lack of U.S. Cooperation*, Reuters (Feb. 15, 2013, 3:39 PM), <http://www.reuters.com/article/2013/02/15/us-financial-regulation-idUSBRE91E0XS20130215>.

²¹ Fietcher et al., *supra* note 13, at 8–9.

²² See Goulding & Nolle, *supra* note 9, fig.14a.

²³ Fietcher et al., *supra* note 13, at 8.

²⁴ Goldman Sachs Global Investment Research, *supra* note 15, at 5–6.

Balkanization of capital regimes globally.”²⁵ Consistent with the concerns of foreign regulators,²⁶ the Committee notes that the Proposed Rule could undermine attempts at resolving a cross-border banking organization if U.S. regulators were to initiate a resolution of the U.S. intermediate holding company before foreign regulators had initiated a resolution of the consolidated bank. Doing so would likely trigger an “uncontrolled sequence of defaults on a global basis”²⁷ that could pose systemic risk to the United States.

The Committee would encourage the Board to collaborate with foreign regulators to improve the level of banking coordination globally rather than risk provoking a cycle of retaliatory protectionism

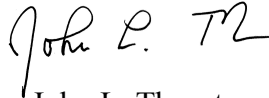
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Thank you very much for your consideration of the Committee’s opinion. Should you have any questions or concerns, please do not hesitate to contact the Committee’s Director, Prof. Hal S. Scott (hscott@law.harvard.edu), at your convenience.

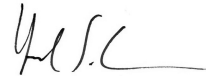
Respectfully submitted,



R. Glenn Hubbard
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²⁵ Federal Advisory Council, *Domestic Regulation of Foreign Banking Organizations* (Feb. 8, 2013), http://www.federalreserve.gov/SECRS/2013/March/20130304/R-1438/R-1438_022713_110980_576250983880_1.pdf.

²⁶ Duncan Wood, *US Foreign Bank Plans Threaten Bail-In System, Says Finma*, Risk (Apr. 5, 2013), <http://www.risk.net/risk-magazine/news/2259110/us-foreign-bank-plans-threaten-bailin-system-says-finma>.

²⁷ *Id.* (quoting Mark Branson, Finma Head of Banking Supervision) (internal quotation mark omitted).