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Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, N.W.
Washington, DC 20551
Attn: Robert deV. Frierson, Secretary

Re: **Proposed Rule on Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies; Docket No. R–1438; RIN 7100 AD 86**

Dear Sirs and Mesdames:

With appreciation for the opportunity to comment, I am writing with respect to the proposed rule (the "Proposal") issued by the Board of Governors of the Federal Reserve System (the "Board") on December 12, 2012, which seeks to implement Sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") for foreign banking organizations ("FBOs") and foreign nonbank financial companies supervised by the Board ("FNFCs").[1]

Although implementing Sections 165 and 166 for foreign firms is undoubtedly a complex undertaking, I would urge the Board to reconsider the intermediate holding company ("IHC") requirement that the Proposal would impose for all FBOs with $50 billion or more in total global consolidated assets and $10 billion or more in total U.S.

[1] The Proposal was published in the Federal Register on December 28, 2012 (77 Federal Register 76,628).

nonbranch assets, for three principal reasons.[2] First, in imposing a blanket IHC requirement, the Board has likely exceeded its legal authority to interpret Sections 165 and 166 of Dodd-Frank. Second, if implemented, the IHC requirement will have the tendency to increase, rather than reduce, financial instability both in the United States and globally, and to lead to such adverse effects as undue concentration of resources, decreased competition, and unsound banking practices. Third, even when analyzed in terms of the "lessons learned" from the Financial Crisis that the Board has cited in its support, the IHC requirement will not be an effective supervisory response.

I. Legal Authority Under Sections 165/166

The Board's authority to issue rules imposing enhanced prudential standards is set forth in Section 165(a)(1) of Dodd-Frank, which provides:

> The Board [of Governors] shall . . . establish prudential standards for nonbank financial companies supervised by the Board [of Governors] and bank holding companies with total consolidated assets equal to or greater than $50,000,000,000 that – (A) are more stringent than the standards and requirements applicable to nonbank financial companies and bank holding companies that do not present similar risks to the financial stability of the United States; and (B) increase in stringency, based on the considerations identified in subsection (b)(3).[3]

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[2] This letter does not address the IHC requirement as it relates to FNFCs, given that the Release accompanying the Proposal notes that no such company has been designated by the Financial Stability Oversight Council. *Id.* at 76,634. Many of the same policy arguments, however, that counsel against a blanket IHC requirement for FBOs also counsel against imposing an IHC on FNFCs. In addition, the Proposal provides such little guidance on the contents of an FNFC IHC requirement that potential FNFCs cannot be said to have been given due notice under the Administrative Procedure Act. *See, e.g., USW v. Marshall*, 647 F.2d 1189, 1221 (D.C. Cir. 1980).

[3] 12 U.S.C. § 5365(a)(1).

By "subsection (b)(3)," the statute refers to Section 165(b)(3) of Dodd-Frank. This provision requires the Board to "take into account differences among nonbank financial companies supervised by the Board and bank holding companies described in [Section 165(a)]" based on:

- The factors described in Sections 113(a) and 113(b) of Dodd-Frank;
- Whether the company owns an insured depository institution;
- Nonfinancial activities and affiliations of the company; and
- Any other-risk related factors that the Board deems appropriate.[4]

The prudential standards that the Board ***must*** establish are listed in Section 165(b)(1)(A) of Dodd-Frank. They are five in number: (i) risk-based capital requirements and leverage limits; (ii) liquidity requirements; (iii) overall risk management requirements; (iv) resolution plan and credit exposure report requirements; and (v) concentration limits.[5] In addition, section 165(b(1)(B) authorizes, but does not require, the Board to establish additional prudential standards, including (i) a contingent capital requirement; (ii) enhanced public disclosures; (iii) short-term debt limits; and (iv) such other prudential standards as the Board deems appropriate.[6]

Foreign firms are addressed in Section 165(b)(2) of Dodd-Frank, which provides that, with respect to "applying" the standards "establish[ed]" under Section 165(a)(1) to

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[4] *Id.* § 5365(b)(3).

[5] *Id.* § 5365(b)(1)(A).

[6] *Id.* § 5365(b)(1)(B).

"any foreign nonbank holding company supervised by the Board [of Governors] or foreign-based bank holding company," the Board "***shall***":

- give due regard to the principle of national treatment and equality of competitive opportunity; and
- take into account the extent to which the foreign financial company is subject on a consolidated basis to home country standards that are comparable to those applied to financial companies in the United States.[7]

Taken together, these provisions, by their terms, require that for any prudential standard "established" by the Board under Section 165(a)(1), and "applied" to an FBO under Section 165(b)(2):

> (1) The standard must be more stringent than the standards and requirements applicable to less-than-$50 billion bank holding companies.
>
> (2) The standard must reflect a gradation of stringency, based on the considerations set forth in Section 165(b)(3) of Dodd-Frank.
>
> (3) Application of the standard must give due regard to the principle of national treatment and equality of competitive opportunity.
>
> (4) Application of the standard must take into account the extent to which a particular FBO is subject on a consolidated basis to comparable home country standards.

In the Release accompanying the Proposal, the Board characterizes the IHC requirement as a "supplemental enhanced standard."[8] As such, the IHC requirement must satisfy the four criteria immediately above. Although the requirement does satisfy the

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[7] *Id.* § 5365(b)(2) (emphasis added).

[8] 77 Federal Register 76,628, 76,632 (December 28, 2012).

first of these criteria – FBOs with less than $50 billion in worldwide assets are not subject to an IHC mandate – the remaining three criteria are not satisfied at all.[9]

First, rather than reflecting a tailored consideration of the factors set forth in Section 165(b)(3), the IHC requirement is a one-size-fits-all requirement for all FBOs that have $50 billion or more in total global consolidated assets and $10 billion or more in total U.S. nonbranch assets. As such, the IHC requirement does not, as Section 165(b)(3) of Dodd-Frank requires, appropriately "take into account differences among" $50 billion-or-greater FBOs.[10] More critically, in promulgating the IHC requirement, the Board did not address any of the Section 165(b)(3) "considerations" that Section 165(a)(1) of Dodd-Frank requires: the factors set forth in Sections 113(a) and 113(b); the differences between those FBOs that "own[] an insured depository institution" in the United States and those FBOs that only operate U.S. branches or agencies; or, for that matter, any other risk-related factors that differentiate $50 billion-or-greater FBOs from one another.[11]

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[9] Independent of the IHC requirement, the Proposal unreasonably applies enhanced prudential standards on the basis of an FBO's ***global*** assets, so that an FBO with $50.01 billion in global assets would be subject to certain prudential standards even if it had an insubstantial amount of U.S. assets (for example, a U.S. bank subsidiary with $500 million in assets and a branch with $150 million in assets). No such FBO could possibly pose a threat to U.S. financial stability, and therefore Section 165 cannot be appropriately applied to it. *See* 12 U.S.C. § 5365(a)(1) ("***In order to prevent or mitigate risks to the financial stability of the United States that could arise*** from the material distress or failure, or ongoing activities, of large, interconnected financial institutions, [the Board shall establish prudential standards].") (emphasis added).

[10] 12 U.S.C. § 5365(b)(3).

[11] *Id.*

Instead, the Release accompanying the Proposal sets forth a number of policy justifications for the IHC mandate: (1) because FBOs currently operate in the U.S. under a variety of corporate structures, applying the Section 165 standards across the U.S. operations of FBOs and in comparable ways to both large U.S. bank holding companies and FBOs would be "challenging" in the absence of such a requirement;[12] (2) it would be difficult to rely solely on home country implementation of enhanced standards because several "are not subject to international agreement;"[13] (3) the Board has limited access to timely information on the global operations of FBOs;[14] and (4) a U.S. IHC could help facilitate the resolution or restructuring of the U.S. subsidiary operations of an FBO by providing one top-tier U.S. legal entity to be resolved.[15] The Release also noted certain issues raised by developments in the U.S. business of FBOs and in international supervision generally in the last decade – "growth over time in U.S. financial stability risks posed by [FBOs] individually and as a group, the need to minimize destabilizing pro-cyclical ring fencing in a crisis, persistent impediments to effective cross-border resolution, and limitations on parent support."[16]

Even if these policy rationales and industry and regulatory analysis were correct on all fronts – and one may reasonably question whether they are – they are not

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[12] 77 Federal Register 76,628, 76,637 (December 28, 2012).

[13] *Id.*

[14] *Id.*

[15] *Id.*

[16] *Id.* at 76,631.

appropriate understudies for the statutorily required factors the Board must consider under Section 165(b)(3). Indeed, they are not understudies at all: because they focus on the U.S. operations of FBOs generally and the state of supervision globally, and not, as the statute legitimately requires,[17] the attributes differentiating $50 billion-or-greater FBOs from one another, they are characters from an entirely different play. An administrative agency, however, is charged with implementing the statute that Congress enacted, not a substantively revised alternative.[18]

Second, the IHC requirement does not comply with the statutory requirement that the Board give "due regard to the principle of national treatment and equality of competitive opportunity."[19] The principle of national treatment, which has lain at the heart of U.S. regulation of foreign banks since Congress enacted the International Banking Act of 1978, requires "parity of treatment between foreign and domestic banks in like circumstances."[20] Similarly, equality of competitive opportunity means that FBOs operating in the United States should not be competitively disadvantaged by regulation when compared with U.S. bank holding companies ("BHCs").

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[17] For example, in Section 165(b)(3), Congress included the factor of "whether the company owns an insured depository institution" for good reason. The failure of a systemically significant parent of a U.S. insured depository institution would be highly likely to impose costs on the Deposit Insurance Fund and could raise contagion worries for U.S. retail depositors.

[18] *See, e.g., Detroit Edison Company v. FERC,* 334 F. 3d 48, 54 (D.C.Cir. 2008).

[19] 12 U.S.C. § 5365(b)(2)(A).

[20] S. Rep. No. 1073, 95th Cong., 2nd Sess. 2 (1978), *reprinted in* 1978 U.S.C.C.A.N. 1421.

The blanket IHC requirement imposes very substantial competitive disadvantages on FBOs, as may be seen by considering the following simplified example of a U.S. and foreign institution "in like circumstances": U.S. BHC "X," which has $300 billion in U.S. assets, and holds an insured depository institution through an intermediate holding company and a broker-dealer directly; and FBO "Y," which has $300 billion in U.S. assets, and holds an insured depository institution through an intermediate U.S. holding company and a broker-dealer directly.

If the Board implements Section 165 as it has proposed, BHC X will not be required to make any changes to its corporate structure; Regulation YYs' heightened risk-based capital and leverage, capital planning, stress testing, risk management, and early remediation requirements will apply only at the parent BHC level; and Regulation YY's liquidity requirements and single-counterparty credit limits will be based on the BHC's global operations.[21]

FBO Y, by contrast, must restructure its U.S. operations by moving the broker-dealer under the intermediate bank holding company, with attendant tax and other transaction costs;[22] comply with both home country capital and leverage standards at the parent level and U.S. capital and leverage standards at the IHC level;[23] comply with home

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[21] *See generally* Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies; Proposed Rule, 77 Federal Register 594 (January 5, 2012).

[22] 12 C.F.R. Part 252 Subpart K (proposed).

[23] *Id.* Subpart L.

country rules with respect to a liquidity buffer and single counterparty credit limits at the parent level and the analogous requirements of Regulation YY at the IHC level;[24] and comply with the requirements of its home country at the parent level and Regulation YY at the IHC level with respect to risk management, capital planning, stress testing, and early remediation.[25]

This competitive disadvantage is even greater if FBO Y, as do many $50 billion-or-greater FBOs, carries out its banking operations through a branch as opposed to an insured depository institution. Because, as proposed, Regulation YY imposes separate liquidity and early remediation requirements with respect to the U.S. branches of FBOs, there will be yet another set of requirements with which FBO Y must comply and BHC X need not.[26] In addition, because the IHC will hold only FBO Y's broker-dealer, that broker-dealer will be required to operate in accordance with the Proposal's capital requirements, which, when applied to a U.S. broker-dealer, are punitive. Far from giving "due regard" to the principle of national treatment and equality of competitive opportunity, the Proposal gives short shrift to it.

The Release contends that appropriate regard has been given to national treatment and equality of competitive opportunity because an FBO's IHC is subject to requirements

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[24] *Id.* Subparts M & N.

[25] *Id.* Subparts O, P & R.

[26] *Id.* Subparts M & R.

similar to a U.S. BHC with $50 billion or more in total consolidated assets. In addition to not being wholly correct – an IHC is required if total U.S. nonbranch assets are ***$10 billion or greater*** – this comparison assumes away the parent FBO, which is subject to broad-ranging regulation by its home country supervisor.[27] Such an assumption is glaring enough in a rule the very subject of which is parent FBOs, but it is all the more inappropriate because the Proposal is implementing a statute that directs the Board to "take into account" the extent to which a particular FBO is subject to comparable home country standards.[28]

Third, in applying the IHC requirement to all FBOs that meet the Proposal's dollar thresholds, the Board has ignored Congress's directive to "take into account the extent to which the [FBO] is subject on a consolidated basis to home country standards that are comparable to those applied to financial companies in the United States."[29] As a textual matter, Section 165(b)(2)'s requirement clearly demands a consideration of home country standards applied to a particular consolidated entity, because the statute consistently uses the singular person when referring to foreign firms – "[i]n applying the standards set forth in paragraph (1) to ***any*** . . . foreign-based bank holding company, the

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[27] Generally speaking, before an FBO may own a U.S. bank, the Board must determine that it is from a country that subjects the country's banks to "comprehensive consolidated supervision," *see* 12 U.S.C. § 1842(c)(3)(B), and an FBO that operates a U.S. branch or agency office must either be from such a country or a country that the Board determines is "actively working" toward comprehensive consolidated supervision of its banks, *see* 12 U.S.C. 3105(d).

[28] 12 U.S.C. § 5365(b)(2)(B).

[29] *Id.*

Board shall . . . take into account the extent to which ***the*** financial company is subject [to comparable home country standards on a consolidated basis]."[30] Although it would certainly have been possible for Congress to express its intent that consideration of home country standards be done severally, not individually – namely, "the Board shall take into account the extent to which foreign financial companies are subject to comparable home country standards" – Congress did not choose such language. Because Section 165(b)(2) requires a particularized approach to each FBO, it is not an appropriate method of agency interpretation effectively to take the blanket position that no home country standards are sufficiently protective that every single FBO that meets the $50 billion/$10 billion asset thresholds must create an IHC.

In addition to Section 165 itself, other provisions of Dodd-Frank demonstrate that the Board's IHC requirement is not an appropriate exercise of agency interpretation. First, two ***other*** sections of Dodd-Frank, Sections 167(b) and 626, explicitly authorize the Board to require the creation of IHCs – for systemically significant nonbank financial companies and for grandfathered unitary thrift holding companies.[31] Both sections, however, permit such IHCs to be required only under certain circumstances. Under Section 167(b), an IHC may be required "[i]f a [systemically significant] nonbank financial company . . . conducts activities other than those that are determined to be

[30] *Id.* (emphasis added).

[31] 12 U.S.C. § 5367(b); 12 U.S.C. § 1467b.

financial in nature or incidental thereto under Section 4(k) of the Bank Holding Company Act of 1956."[32] Similarly, Section 626 provides that "[i]f a grandfathered unitary savings and loan holding company conducts activities other than financial activities, the Board may require such company to establish and conduct all or a portion of such financial activities in or through an intermediate holding company."[33] Each section also ***requires*** the Board to mandate the establishment of an IHC if the Board makes a determination that establishment is necessary "to appropriately supervise activities that are determined to be financial activities; or to ensure that supervision by the Board does not extend to activities of such company that are not financial activities."[34]

The fact that in other sections of Dodd-Frank, Congress explicitly authorized, and even required, the Board to require the establishment of an IHC in limited circumstances demonstrates that the Proposal's blanket IHC requirement is not an appropriate "supplemental enhanced standard" under Section 165. In addition, congressional authorization of an IHC requirement in Sections 167(b) and 626 of Dodd-Frank underscores the fact that mandating changes to the structure of banking organizations is a legislative and not administrative function. Indeed, the only real precedent for the Proposal's required changes to the U.S. structures of FBOs is the 1991 mandate requiring

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[32] 12 U.S.C. § 5367(b).

[33] 12 U.S.C. § 1467b.

[34] *Id.* § 1467b(b)(1)(B); *see also* 12 U.S.C. § 5367(b)(1)(B) (establishment of IHC required if Board makes a determination that IHC is necessary to "(i) appropriately supervise activities that are determined to be financial in nature or incidental thereto; or (ii) to ensure that supervision by the Board [of Governors] does not extend to the commercial activities of such nonbank financial company").

foreign banks that wish to accept U.S. retail deposits to create separately capitalized, FDIC-insured bank subsidiaries to do so – a requirement that was imposed by Congress statutorily and not by the Board through administrative action.[35]

Finally, it is difficult to square the Proposal's IHC mandate with Congress' direction in Section 175(c) of Dodd-Frank that the Board shall "consult with . . . foreign counterparts and through appropriate multilateral organizations to encourage comprehensive and robust prudential supervision and regulation for all highly leveraged and interconnected financial companies."[36] The Release accompanying the FBO Proposal seems to take the position that consulting with the supervisors of systemically significant FBOs for the purpose of "comprehensive and robust supervision" may not prove as useful as in the past because international banking supervision has become more protectionist in the aftermath of the Financial Crisis.[37] Judgments as to the utility of foreign consultation, however, should not stand in the way of following Congress's directive in enacting Section 175(c).[38]

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[35] *See* 12 U.S.C. § 3104(d).

[36] 12 U.S.C. § 5373(c).

[37] *See* 77 Federal Register 76,628, 76,630 (December 28, 2012) ("[A] foreign bank regulatory regime designed to accommodate centralized management of capital and liquidity . . . can increase the chances of home and host jurisdictions placing restrictions on the cross-border movement of assets at the moment of a crisis, as local operations come under severe strain and repayment of local creditors is called into question. Resolution regimes and powers remain nationally based . . . .").

[38] *See, e.g., Alabama Power Company v. EPA*, 40 F. 3d 450, 456 (D.C.Cir. 1994).

For the foregoing reasons, consideration of Section 165's language and structure, as well as other provisions of Dodd-Frank, demonstrates that a blanket IHC requirement for FBOs meeting the $50 billion/$10 billion asset tests is not an appropriate interpretation of the statute, and therefore the blanket requirement should be dropped in the final rule.[39]

II. Policy Considerations

Policy considerations also militate against the Proposal's blanket IHC requirement. The IHC requirement will not increase financial stability in the United States or globally, and it will lead to adverse effects in the United States – ironically,

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[39] To accept this point, however, does not mean conceding that, as a statutory matter, an IHC could *never* be an appropriate "supplemental" enhanced standard, because Section 165(b)(1)(B) does grant the Board discretion to impose additional prudential standards that it determines are appropriate. Rather, it is to understand that, in order to require the establishment of an IHC, the Board must follow the implementing directives imposed by Section 165.

First, the Board would be required to take into account the factors described in Sections 113(a) and 113(b) of Dodd-Frank; whether the firm owned an insured depository institution; any nonfinancial activities and affiliations; and any other risk-related factors the Board deemed appropriate. Under such an analysis, only a very small subset of firms should *potentially* ever require an IHC – that is, only those firms that the Board determined still threatened U.S. financial stability after all existing Section 165 enhanced prudential standards had been applied to them.

With the foregoing principle as the baseline, the Board's "application" of an IHC requirement to a particular FBO would be required to follow the requirements of Section 165(b)(2). The Board would be required to "give due regard to the principle of national treatment and equality of competitive opportunity," which would mean that in imposing a mandatory IHC, the Board should seek to reduce as much as possible the competitive disadvantages imposed on the FBO when compared to a U.S. BHC "in like circumstances." Then, the Board would be required to "take into account the extent to which the [FBO] [wa]s subject on a consolidated basis" to comparable home country standards – that is, the IHC would be imposed on a particular FBO only if the Board determined that, when combined with all U.S. standards, including Section 165's enhanced standards, the FBO's home country standards did not appropriately insulate against U.S systemic risk.

some of the very adverse effects that are key considerations for the Board to avoid under the Bank Holding Company Act.

First, the IHC requirement has a tendency toward instability because it interferes with the ability of an FBO to allocate capital and liquidity in a manner it determines most efficient, and this in turn negatively influences the availability of credit, the fuel of economic growth. In its Release, the Board acknowledges this fact,[40] but takes the position that other factors – such as aiding in an FBO's resolution – compensate for it. At a time when much of the global economy is suffering from anemic growth and high long-term unemployment, however, the financial stability risk of externally-imposed artificial constraints on the availability of credit delaying recoveries or exacerbating downturns cannot be minimized. Poor economic performance results in rising numbers of nonperforming loans and the weakening of bank balance sheets, each destabilizing factors.[41] The negative economic side effects of the IHC requirement, moreover, may well be global in scope, because by creating a capital and liquidity trap in the United States, the requirement may reduce the flexibility of FBOs to lend in their home jurisdictions. It would be ironic indeed if, at a time of sluggish global growth, restrictive

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[40] *See* 77 Federal Register 76,628, 76,629 ("The structural diversity and consolidated management of capital and liquidity permitted under the current approach has facilitated cross-border banking and increased global flows of capital and liquidity.").

[41] One observer has estimated that in the Eurozone, total non-performing loans as a percentage of total loans will have increased from 5.6% in 2011 to 6.8% in 2012 to 7.6% in 2013, reaching a Euro-era high of €932 billion. *See* "Bad loans and regulation will squeeze Eurozone banks in 2013," Ernst & Young, January 7, 2013, available at www.ey.com/GL/en/Newsroom/News-releases. *See also, e.g.*, Lorenzo Totaro, "Italian Corporate Bad Loans Rising on Slump, Central Bank Says," Bloomberg Businessweek, April 29, 2013, available at www.businessweek.com/news/2013-04-29 .

central bank regulatory policy undermined expansionary central bank monetary policy and thereby prolonged recessionary tendencies.

Trapping capital and liquidity in particular jurisdictions also is likely to make systemically significant financial institutions less resilient at a time of crisis. It is precisely when markets are threatening to collapse that it is most important for a financial institution to have the flexibility to deploy capital and liquidity to areas that require the most shoring, and those areas, for an FBO, may not be the United States. The Release to the Proposal recognizes this fact, stating that certain FBOs were helped "by their ability to move liquidity freely during the [Financial Crisis]."[42] A likely effect of the IHC requirement, therefore, is that although it may protect the creditors of the U.S. operations of FBOs in resolution, it will also deprive FBOs of resources that could be used to ward off resolution in the first place. As a "financial stability" provision contained in Title I of Dodd-Frank, Section 165 should be implemented in a manner that avoids the resolution of a systemically significant FBO, rather than increases the possibility of such a resolution occurring.

In addition, implementing the Proposal is likely to result in retaliation against U.S. banking organizations by the home country regulators of certain FBOs. Certain

[42] *See* 77 Federal Register 76,628, 76,630 (December 28, 2012).

international supervisors have already raised concerns about the Proposal,[43] and it is difficult to see how, if the principal regulator of systemic firms in the United States continues to take the position that prophylactic *ex ante* ring-fencing of the U.S. operations of FBOs is necessary to safeguard the U.S. financial system because of the difficulty of obtaining appropriate information about those organizations' overall operations, other home country regulators will not follow suit. What is then likely to follow is a carry-on effect as concerned host countries impose their own capital and liquidity requirements on U.S. banking organizations or move to required full subsidiarization. This, of course, will raise the cost of maintaining an international business, and U.S. banking organizations that have substantial operations abroad[44] may retreat from certain jurisdictions in the same manner as FBOs may retreat from the United States. It is hard to see how financial stability is well served by the inefficient allocation of capital and liquidity and retrenchment by financial intermediaries to their home jurisdictions occurring on a global basis.

By raising the specter of retaliation in a manner reminiscent of a trade war, the IHC requirement also undermines the principle of international cooperation that has been

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[43] *See, e.g.*, Letter from Michel Barnier, Commissioner for Internal Market and Services, European Commission, to Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, April 18, 2013.

[44] *See, e.g.*, Suzanne Kapner, "Citi's Profit Soars as Shift Pays Off," The Wall Street Journal, April 15, 2013, available at http://online.wsj.com/article/SB10001424127887324345804578424352331419788.html (noting that increased profits from Citigroup's international operations allowed it to offset slowing growth in the United States in the first quarter of 2013).

at the heart of cross-border supervision and regulation for decades. It may be true that in the years following the Financial Crisis, certain national regulators have taken a more parochial view of the efficacy of international standards and turned to a more "Home Country First" approach to regulation. The more national regulators that adopt this view, however, the greater the incentives for others to join them, and the more national regulators that do join, the less likely the chances for continued cross-border recognition of comparable supervisory standards. The Board, as a leader in international bank supervision, has the authority to buck this protectionist trend, and the prospects for global regulatory cooperation – and increased global economic growth – will be much better if the Board does buck the trend rather than join it.

In addition to threatening greater financial instability and a breakdown in international cooperation, the IHC requirement will have the tendency to trigger other adverse effects. Foremost among them is decreased competition and a resulting undue concentration of banking and financial resources in the United States.[45] If the Proposal is finalized in its current form, FBOs will undertake a cost/benefit analysis of complying with the IHC requirement versus reducing or eliminating their U.S. banking and financial presence. Compared with the significant restructuring costs of moving all U.S. subsidiaries other than 2(h)(2) subsidiaries under an IHC, the costs of trapped capital and liquidity, and the costs of systems necessary to comply with single counterparty credit

[45] *Cf.* 12 U.S.C. § 1843(j)(2).

limits imposed on multiple levels, debanking from the United States or reducing the size of a broker-dealer business could well be a preferable economic alternative.[46]

Reducing the number of significant banking and broker-dealer entities in the United States will inexorably lead to less competition, given the barriers to entry and obstacles to effective side-by-side competition with the largest U.S financial institutions. The gaps created by the downsizing of the U.S. operations of FBOs, therefore, will not be filled by new entrants, but rather by the sizeable institutions that remain in the market – institutions that, as has been widely commented, have seen their resources increase and concentrate notwithstanding the Financial Crisis. In addition, by providing disincentives for FBOs to remain committed to the United States, the IHC requirement will reduce the number of available sound institutions that may come to the aid of weakened U.S. banks should the industry undergo a future crisis.

There is also a risk that the IHC requirement will lead to less sound banking practices. Currently, FBOs are not required to comply with a leverage ratio for their U.S. operations. Under the Proposal, once an IHC is established, however, the IHC must maintain a leverage ratio above the minimum applicable leverage requirements for BHCs if it is to avoid early remediation.[47] Being subject to a leverage ratio, however, does

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[46] *Cf.* Paul J. Davies, "UniCredit not trading in OTC with US groups," Financial Times, April 29, 2013, at 16 (noting a trend among foreign banks to decide not to trade swaps with U.S. banks due to the costs of Dodd-Frank compliance).

[47] *See* 12 C.F.R. Subpart R (proposed).

provide an incentive for an institution to increase the risk of its balance sheet, because assets that do not draw a risk-based capital charge due to their relative safety do incur a capital cost. The IHC requirement, therefore, may lead to FBOs increasing the risk profile of their U.S. operations.[48]

III. "Lessons Learned" From the Financial Crisis

The IHC requirement is an inappropriate response to the developments that the Board perceives in the structure of FBOs' U.S. operations and the global regulatory environment. Although the text and structure of Section 165 suggest that such considerations are not relevant to the Board's implementation of enhanced prudential standards, the Release seeks to justify the IHC requirement in part by emphasizing how the U.S. operations of FBOs and the regulation of internationally active banks have evolved over time. Even if these developments were relevant to the implementation of Section 165, however, the Proposal's blanket IHC requirement does not effectively address them.

The developments that the Board notes are: (i) although originally the U.S. operations of FBOs were net recipients of funding from their home offices and confined their business to traditional lending activities, over time their role developed into raising

[48] FBOs from Basel III countries will be subject to the Basel III leverage ratio when it is implemented, and so the policy question is whether the imposition of a U.S. leverage ratio at the IHC level will mitigate financial stability risks generally in a manner that compensates for its incentive to increase balance-sheet risk.

dollar funding (often short-term dollar funding) to be used for activities abroad, including investing in risky U.S. asset-backed securities;[49] (ii) in the Financial Crisis, FBOs that relied heavily on short-term U.S. dollar liabilities were forced to sell U.S. dollar assets rapidly when that funding source evaporated, compounding the risks to U.S. financial stability;[50] (iii) the increasing complexity of FBO operations led to the totality of the risk profile of their U.S. operations being obscured;[51] (iv) U.S. operations of many FBOs have focused on capital markets activities, with five of the top ten U.S. broker-dealers being currently FBO-owned;[52] (v) in certain foreign bank failures, home country supervisors engaged in pro-cyclical ring-fencing, trapping capital and liquidity at the home entity;[53] and (vi) since the Financial Crisis, certain non-U.S. jurisdictions have modified or are considering modifying their regulatory regimes in ways that constrain the ability of FBOs to provide support to their U.S. operations.[54] None of these developments justifies the Proposal's blanket IHC requirement.

First, assuming that FBOs continue to use their U.S. operations primarily for dollar funding of operations abroad, imposing an IHC is at best an indirect means of addressing the financial stability risks that this tendency presents. An IHC does not

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[49] 77 Federal Register 76,628, 76,630 (December 28, 2012).

[50] *Id.*

[51] *Id.*

[52] *Id.*

[53] *Id.*

[54] *Id.* at 76,631.

directly impose any limitations on the amount of dollar funding that may be provided to an FBO's non-U.S. operations, nor does it affect at all the activities of FBO branches, which are among the most likely entities to borrow U.S. dollars. Nor does an IHC provide any means of addressing a FBO's overreliance on short-term dollar funding, which the Board identifies as the most destabilizing pre-Financial Crisis practice at the U.S. operations of FBOs. Much more effective in limiting dollar funding of riskier overseas operations would be the traditional supervisory tool of limiting U.S. offices' "net due from" positions.

If this tool did not suffice, however, there are more effective enhanced standards to impose on an FBO's U.S. operations than the proposed IHC requirement. Indeed, on the issue of overreliance on short-term funding, Section 165 refers specifically to "short-term debt limits" as an enhanced standard that the Board is authorized to establish.[55] The fact that the Proposal does not contain an enhanced standard that both directly addresses the regulatory issue that the Release identifies as most destabilizing and is one that Section 165 expressly authorizes the Board to impose suggests that an overreliance by FBOs on short-term dollar funding is not really the motivating force behind the IHC requirement.

[55] 12 U.S.C. § 5365(b)(1)(B). Like the other Section 165 standards, if such a standard were established, it would be required to be applied in a tailored manner to particular FBOs based on the risks of their U.S. operations and the lack of risk mitigation supplied by their particular home country standards.

Second, there is no direct correlation between establishing an IHC for a FBO's U.S. operations and obtaining greater clarity on the "totality of the risk profile" of those operations. According to the Release, the factor obscuring such risk profiles in recent years was the practice of FBOs using their U.S. operations to fund activities outside the United States, such as purchases of U.S. dollar-denominated asset-backed securities and international project and trade finance.[56] Rolling up an FBO's U.S. operations under an IHC, however, itself neither places limits on the amount of dollar funding that may be on-lent to non-U.S. operations, nor does it create greater transparency at the global operational level. Indeed, given the statements of alarm being made by the home country regulators of FBOs since the Board released the Proposal, and the rising prospects for retaliation if the IHC requirement is maintained, it appears that the Proposal is likely to diminish the chances of the Board's receiving timely information on the global operations of FBOs, not increase them. In order to improve its information flow with other home country supervisors, the Board should remain committed to the path of international cooperation.

Third, imposing an IHC requirement is not an appropriate response to the growth in the U.S. broker-dealer activities of FBOs. The Board has not cited any evidence that broker-dealers owned by FBOs pose greater financial stability risks than those owned by

[56] 77 Federal Register 76,628, 76,630 (December 28, 2012).

U.S. BHCs, which, as discussed above, can own a broker-dealer directly.[57] In addition, just as a U.S. broker-dealer owned by a U.S. BHC benefits from the BHC's consolidated capital and liquidity, so too a U.S. broker-dealer owned by an FBO benefits from the FBO's consolidated capital and liquidity.

To the extent that the Board has concerns about the capital adequacy of U.S. broker-dealers generally, moreover, its authority must be exercised consistently with congressional policy. Congress has made a clear determination that, as a general matter, a U.S. broker-dealer subsidiary of a BHC that operates in compliance with the capital standards imposed by the Securities and Exchange Commission ("SEC") is sufficiently capitalized for financial stability purposes. For although in Dodd-Frank Congress amended many provisions of federal banking law in an effort to strengthen U.S financial stability, it did not amend Section 5(c)(3) of the BHC Act, which prohibits the Board from prescribing or imposing, "by regulation, guideline, order, or otherwise . . . any capital or capital adequacy rules, guidelines, standards, or requirements" on such subsidiaries.[58]

Fourth, the IHC requirement is a counterproductive answer to the "pro-cyclical ring fencing" that the Board identified as occurring in certain Financial Crisis failures. What the Proposal seems to intend in this regard is to create a comprehensive U.S. group

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[57] Although, as the Release notes, five of the ten largest U.S. broker-dealers are currently owned by FBOs, those FBOs are all from countries with highly developed bank regulatory regimes.

[58] 12 U.S.C. § 1844(c)(3).

under one umbrella company that may be put into resolution in the event of an FBO's failure, and thereby insulate the United States from ring-fencing by the FBO's home country regulator. The logical effect of this prophylactic, *ex ante* ring fencing, however, will be to make the home country regulators of FBOs even more likely to "plac[e] restrictions on the cross-border movement of assets at the moment of a crisis,"[59] because they may anticipate that the U.S. will be the first jurisdiction to pull the resolution trigger. The IHC requirement therefore will actually have the tendency to increase pro-cyclicality in future crises, not reduce it.

Finally, the IHC requirement is not an effective remedy for the perceived constraints on FBOs' ability to support their U.S. operations. As a threshold matter, it is not clear that the international regulatory developments identified in the Release really do call into question the ability of FBOs to act as a source of strength to their U.S. operation. Certain of the developments that the Board identifies are proposals only and will not to come into effect for several years, and so it is difficult, if not impossible, accurately to characterize their impact; certain do not directly touch on the question of home country support for an FBO's U.S. operations.[60] In addition, for those FBOs whose material financial distress or failure would be most likely to affect U.S. financial stability, their U.S. operations are important strategic assets, given the significance of the U.S. financial

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[59] 77 Federal Register 76,628, 76,630 (December 28, 2012).

[60] A prime example of both countervailing considerations is the recommendation, accepted by the U.K. government, of the Independent Commission on Banking, to split U.K. banks' retail and investment banking operations.

markets to global banks. A home country resolution strategy designed, as one would expect, to maximize enterprise value would logically not seek to cut loose one of the brightest jewels in an FBO's crown.

Even if one concedes, however, that international developments are diminishing the likelihood of parent FBO support at a time of crisis, and that an FBO in distress would abandon its systemically significant U.S. operations, there are less costly means of protecting U.S. financial stability than the IHC requirement. First, the Board has the legal authority to impose Section 165's heightened prudential standards to any FBO-controlled U.S. BHC that itself has $50 billion in assets or more, as well as relevant heightened prudential standards – such as a liquidity buffer – on an FBO's branch and agency operations. In addition, the Board has the legal authority to impose Section 165's heightened prudential standards if the U.S. non-banking operations of a particular FBO threaten systemic risk, subject to the restriction on imposing "capital or capital adequacy rules, guidelines, standards, or requirements"[61] on U.S. broker-dealer subsidiaries that are in compliance with SEC capital rules.

In all cases, however, the Board would do so only after taking into account the extent of consolidated home country supervision of the FBO and giving due regard to the

[61] *See* 12 U.S.C. § 1844(c)(3).

principle of national treatment and the equality of competitive opportunity.[62] Targeted application of Section 165's standards to those FBO operations in the United States that actually threaten U.S. financial stability would make up for any source-of-strength shortcomings resulting from nationally based home country regulation, and it would do so without imposing substantial restructuring costs and other burdens on FBOs.[63]

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For the foregoing reasons, the Proposal's IHC requirement likely exceeds the Board's legal authority in implementing Section 165 of Dodd-Frank, has the tendency to increase financial instability, threatens other adverse effects, and is not an effective response to recent developments in the U.S. operations of FBOs and international banking supervision.

The Board should therefore remove the IHC requirement when it finalizes Regulation YY for FBOs and instead provide for a regulatory regime in which enhanced prudential standards may be imposed on the U.S. operations of particular FBOs, where those U.S. operations, due to their size and interconnectedness, pose a threat to U.S

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[62] *See* footnote 39 for a discussion of how, under Section 165's text and structure, its enhanced standards are appropriately to be applied to particular FBOs.

[63] Because the Board has the legal authority to impose tailored prudential standards on the U.S. operations of those FBOs that would threaten U.S. financial stability at a time of distress, there should be little concern about any potential "extraterritorial application of U.S. prudential standards." 77 Federal Register 76,628, 76,632 (December 28, 2012).

financial stability and where applicable home country standards do not sufficiently mitigate such financial stability risk.

I very much appreciate the Board's consideration of these comments.

Very truly yours,

Arthur S. Long