June 21, 2019

Appendices to IIB Letter on International Bank Tailoring Proposals

To appropriately tailor the EPS to the unique attributes of the U.S. operations of international banks, additional modifications to the underlying regulations should be made, to further complement the categorization framework of the Proposal.

The Appendices itemize recommendations for modifications that our members believe would improve the efficiency and effectiveness of the various post-crisis regulations applicable to international banks. In addition, these Appendices also include recommendations for modification of certain elements of the risk-based indicators, if the indicator relies on existing reporting or calculation requirements that our members believe could be refined.

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<u>Appendix A: CJA</u>

Certain metrics embedded within the CJA indicator are in particular need of tailoring to international banks' specific circumstances. The CJA calculation incorporates elements of the FFIEC 009—a report on which the IIB has previously commented because of its centrality to the "foreign exposure" definition in existing rules.

When used in the manner incorporated into the Proposal, the purpose of CJA departs significantly from the purpose for which the FFIEC 009 was designed. In particular, additional "units" of CJA become potential penalties, pushing an international bank toward a higher categorization under the Proposal. This shift in purpose is exacerbated by the use of CJA as a threshold for Category II rather than Category III.

Therefore, importing the FFIEC 009 calculations (as expanded upon by the form's instructions), without first analyzing whether the calculation actually serves as an "indicator of risk" (in contrast to a manner of reporting regulatorily required "information"), distorts this indicator and results in the CJA indicator not being fit for this purpose. Our comments in the accompanying letter, and in this Appendix, should be understood in that light – while it may be helpful from a reporting perspective for the instructions to signal some international exposure present in a complicated transaction, importing that report without also filtering for whether an international exposure "should" be incorporated into the categorization Proposal as a measure of risk may be wholly incorrect.

In addition to those elements of the CJA risk-based indicator on which we have commented in the accompanying letter, we recommend that the CJA calculation be revised as follows:

- Exclude exposures to U.S. entities or projects that have a foreign guarantee or foreign insurer, unless the U.S. direct counterparty does not meet an appropriate measure of creditworthiness.
  - While a foreign guarantee or insurer may be helpful information to "report" from a regulatory perspective, seeking a guarantee or additional protection actually reduces risk and should not be penalized by resulting in additional CJA.
- Treat investments in co-issued collateralized loan obligations ("<u>CLOs</u>") (U.S. issuer and offshore issuer, with loan pool primarily consisting of U.S. loans, asset managers/trustee being U.S. financial institutions and U.S./NY law governing) as U.S. exposure.
  - The underlying loan pool, managers, trustees and governing law are all U.S. Informal guidance from the Reserve Banks received by some IIB members has raised ambiguity about how to incorporate co-issued CLO exposure. The offshore co-issuer does not serve as an indicator of risk but merely serves a specific purpose in the transaction in relation to investor choice.
- Modify the calculation so that certain claims with multiple guarantors or a mix of guarantors and collateral are no longer required to be shifted to exposure to the country of the entity or collateral that bears the highest rating for reporting on an "ultimate-risk" basis.
  - The calculation rule appears arbitrary and unrelated to risk, given that the presence of multiple guarantors or sources of collateral should be a risk-mitigating element of the transaction. Again, the risk-reduction element of these transactions should remove them from the CJA indicator, even if there is some benefit to having them reported on the FFIEC 009 in a particular manner.

- Presume that exposures created through negotiations with agents or managers create exposure based on the jurisdiction of location of the agent or manager for an undisclosed principal, unless, based on the exercise of reasonable diligence, the banking organization knew or should have known that it would have foreign exposure.

  - Many investment managers negotiate broad securities or swap transactions for their complex/suite of funds. Financial service providers often do not learn of the allocation among the managed funds until right before or right after the transaction is executed.

  - If CJA is to result in a potential penalty (in the form of a higher category with more stringent EPS), then an institution should not be penalized in situations where it could not reasonably have known that it was incurring such a penalty.

- Assets or transactions that satisfy another regulatory requirement should be scrutinized before inclusion in CJA. For example, transactions involving the purchase of, or the receipt of, foreign HQLA should not count toward CJA. This change would have the benefit of promoting diversification of the liquidity buffer.

Appendix B: Liquidity Requirements

General Recommendations

- With regard to IHC and CUSO liquidity stress testing, risk management and buffer requirements under Regulation YY, the negative treatment of internal flows (including those between CUSO and parent/non-U.S. affiliates, and those between IHC and all affiliates (including U.S. branches/agencies)) should be revised. Liquidity stress testing and buffer requirements should treat internal and external flows in the same manner, such that inflows from affiliates can be used to offset external outflows at both the IHC and branches/agencies.
    - The Regulation YY requirements penalize flows between an international bank's parent/non-U.S. affiliates and its U.S. operations, as well as flows inside the U.S. between an international bank's U.S. subsidiaries and its U.S. branches/agencies. This results in higher buffer requirements than would otherwise need to be the case for an international bank's U.S. operations. U.S. BHCs, in contrast, do not have to manage this segregation of cash flows among affiliates, which in our view results in a lower buffer than for a similarly situated IHC or CUSO. Particularly in relation to the short, 30-day buffer horizon, inflows from all sources should be counted as they can be relatively certain in that short period.

- Neither the LCR nor the NSFR should apply to subsidiaries of international banks that are not required to be under an IHC.

- Public disclosure requirements corresponding to subpart J of the LCR rule and subpart N of the proposed NSFR should be reconsidered for international banks. International banks are already required to make such disclosures on a consolidated basis under rules implementing the Basel Committee Pillar 3 disclosure requirements in their home jurisdictions. Accordingly, such disclosure requirements are needlessly burdensome and duplicative without providing any meaningful increase in market discipline. The Agencies have recognized that such Pillar 3 disclosures by the U.S. subsidiaries of international banks that are subject to comparable home country public disclosure requirements are unnecessary under the Agencies' capital rules,[1] and there is no compelling reason why the same approach should not be applied under the Agencies' liquidity rules.

NSFR-Specific Recommendations

- Should the Agencies apply the NSFR to any of the U.S. operations of international banks,[2] the Agencies should align implementation of the NSFR in the United States with implementation in other jurisdictions. Although the NSFR was finalized by the Basel Committee in 2014 and set to come into force in January 2018, implementation has been significantly delayed in many major jurisdictions. The European Union agreed to a final text of the NSFR in April 2019, but the NSFR-

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[1] See 12 C.F.R. § 217.61.

[2] We recommend, in Section IV.E of the accompanying letter, that the NSFR not be applied to IHC or CUSO operations of international banks.

related provisions of the revised Capital Requirements Regulation ("CRR II")[3] are not due to come into force for European banks until mid-2021.

- Should the Agencies apply the NSFR to any of the U.S. operations of international banks,[2] we believe that revisions to the proposed NSFR rules are necessary:
  - The Agencies should first undertake a comprehensive impact analysis that evaluates its effect on all covered banking organizations including international banks and their IHCs. The Agencies' initial impact assessment was conducted as of December 31, 2015, before the date on which international banks were required to establish IHCs. Accordingly, this impact assessment, which focused on bank holding companies and their subsidiary banks, could not possibly provide an accurate assessment of the impact of the proposed NSFR requirements on international banks or their IHCs.
  - If the Agencies ultimately adopt the NSFR, particular areas of the proposed rule should be revised to align better with the underlying economic substance of covered assets, liabilities and related transactions, to reflect more accurately the reality of market dynamics, and to mitigate some of the unwarranted costs of the NSFR.
    - Supervisors in other jurisdictions have undertaken review of issues that were not subject to consultation in the Basel process before proceeding with their own rulemakings. The European Banking Authority, for example, examined several of these issues, noting the lack of effective consultation during the development of the global standard, and recommended several significant adjustments to the NSFR in its European implementation.[4] These adjustments were reflected in the CRR II to ensure that the NSFR does not hinder financing of the European economy.[5] The Agencies should similarly ensure that the NSFR is implemented in the United States in a manner consistent with Basel III standards with appropriate adjustments to align with the European implementation of the NSFR in order to minimize the potential adverse effects on U.S markets.
    - The treatment of derivative assets and liabilities under the NSFR should be consistent with other jurisdictions. The Agencies' NSFR proposal would impose an add-on equal to 20% of a covered company's gross derivatives liabilities when determining the total Required Stable Funding ("RSF") amount. This add-on is an overly blunt mechanism, with no empirical basis, that would drive up costs for derivatives end users without commensurate benefits in risk reduction or financial stability. Accordingly, this add-on should be reduced to 5% in line with the

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3 Regulation 2019/876 of the European Parliament and the European Council of 20 May 2019 amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements, and Regulation (EU) No 648/2012, 2019 O.J. (L 150) 1 ("CRR II").

4 European Banking Authority ("EBA"), Report on Net Stable Funding Requirements under Article 510 of the Capital Requirements Regulation (Dec. 15, 2015).

5 European Commission, Fact Sheet: Adoption of the banking package: revised rules on capital requirements (CRR II/CRD V) (Apr. 16, 2019), available at http://europa.eu/rapid/press-release_MEMO-19-2129_en.htm.

discretion afforded to national supervisors in the Basel NSFR framework and consistent with the application of such discretion by supervisors in other jurisdictions.[6]

- The final NSFR should not unduly penalize sources of funding that that are low risk and that enable critical market functions, such as direct holdings of HQLA or securities financing transactions involving U.S. Treasuries, government agency securities or other HQLA.

  - International banks play an important role in providing critical market functions to the U.S. economy: international banks comprise 65% of current primary dealers and an estimated 49% of the provisionally registered swap dealers.[7] Increasing the costs to international banks of holding HQLA and engaging in securities financing transactions involving HQLA would undermine their critical function as market makers.

  - Consistent with the implementation of the NSFR in other jurisdictions, the U.S. NSFR should assign a 0% RSF factor for elements of RSF that are low risk, including HQLA such as government securities.[8]

- The final NSFR rule must also be appropriately calibrated to align with actual risks on banks' balance sheets. For instance, the asymmetrical treatment between reverse repos and repos is overly punitive, does not accurately reflect collateral quality, discourages prudent liquidity risk management, and would cause a further contraction of the repo market. The Agencies should reduce the RSF factors for repos and reverse repos in any final NSFR in line with other jurisdictions to avoid adverse impacts on the liquidity of the securities used as collateral in these short-term transactions.[9]

- Moreover, the final NSFR rule should be appropriately calibrated to reflect its purpose as a measurement of a bank's liquidity under business-as-usual conditions. For example, under the proposed NSFR rule, certain deposits are treated more punitively than under the LCR, notwithstanding the fact that the LCR – as opposed to the NSFR – is designed to be a stressed measure.

- The Agencies have introduced additional resolution planning requirements since issuing the NSFR proposal in 2016. As a general matter, two new requirements applicable to international bank July resolution plan filers – the Resolution Liquidity Execution Need ("RLEN") and the Resolution Liquidity Adequacy and Position ("RLAP") – should provide additional assurance that international banks' liquidity risk is properly addressed. RLEN is the amount of liquidity an international bank would need during resolution to keep critical operations and core business lines operational or sufficiently funded to be wound down

6 CRR II at Art.428s.2 and Recital 48.

7 See SIFMA, Insights: The Importance of FBOs to US Capital Markets (Apr. 2019).

8 CRR II at Art.428r(1)(a); Art. 510(8); Recital 50 (reducing RSF for HQLA to 0%).

9 CRR II at Art.428r(1)(g);428s(1)(b); 428v(a); Art. 510(8); Recitals 49 and 138 (reducing RSF for repos secured by HQLA to 0%, for other repos and reverse repos to 5% or 10% until June 28, 2025).

safely. Similar to the NSFR, which addresses liquidity needs over a one year time horizon, RLEN also has a relatively long time horizon: a resolution period of between 12 and 24 months. However, the RLEN requirements assume severe stress – RLEN is calculated against a backdrop of the Federal Reserve's "severely adverse" economic conditions – and bank failure, whereas the NSFR is a business-as-usual metric. Consequently, an NSFR that is inadequately tailored or made even more stringent is both unnecessary and duplicative.

Appendix C: Capital and Stress Testing

- iTLAC and LTD should be permitted to be counted as converted to common equity tier 1 capital if needed during the nine-quarter stress horizon of the CCAR and DFAST.[10]
    - The purpose of iTLAC and LTD is to serve as a preplaced resource to bolster capital in a stress situation, as well as a vehicle to support single-point-of-entry resolution. The Federal Reserve has powers sufficient to force conversion in cases of severe undercapitalization, which is exactly the scenario tested under DFAST and CCAR.
    - There are no "investor concerns" with the Federal Reserve permitting conversion to be triggered, as the sole holder is the IHC's parent or affiliates.
    - In addition to its value as a direct resource, iTLAC also creates an additional financial incentive for the parent to support its subsidiary.
- The Board should implement as soon as possible the changes to the DFAST and CCAR processes proposed alongside the stress capital buffer proposal,[11] including:
    - elimination of the unrealistic assumption that a firm will engage in capital distributions even when such distributions would in fact be prohibited under the capital conservation buffer, and
    - elimination of the unrealistic assumption of balance sheet growth during a sharp economic downturn.
- As recommended in the Department of Treasury's banking report,[12] the Board should subject its stress-testing and capital planning review frameworks to public notice and comment, including with respect to its models, economic scenarios and other material parameters and methodologies; methodologies for creating these scenarios and the degree of change from prior scenarios also should be subject to notice and comment. In the recent final rule on the Amendments to Policy Statement on the Scenario Design Framework for Stress Testing, the Board noted that it is continuing to "conside[r] comments and weig[h] the costs and benefits of publishing the scenarios for comment."[13]

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[10] See IIB Letter to Federal Reserve Board (June 25, 2018) (the "IIB Stress Buffers Letter"). We also reiterate this recommendation in "Appendix D: iTLAC and LTD," where we further explain that this recommendation should apply to the extent that the LTD requirement is not eliminated (we believe it should be eliminated) or to the extent that LTD is elected to be issued by an IHC.

[11] "Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules," 83 Fed. Reg. 18160 (Apr. 25, 2018).

[12] See U.S. Department of the Treasury, A Financial System that Creates Economic Opportunities: Banks and Credit Unions (Oct. 2017).

[13] "Amendments to Policy Statement on the Scenario Design Framework for Stress Testing," 84 Fed. Reg. 6651 (Feb. 28, 2019).

- Supervisory scenarios in CCAR continue to stretch credibility. While we understand they need to reflect an appropriate element of conservativism and counter-cyclicality, we believe that the severity is unrealistic.

- The CCAR stress test is the binding capital constraint on most organizations, and therefore, the scenarios, which so far have been solely within the discretion of the Board, are as important as a rule, if not more so.

- Before implementing a stress capital buffer, the Board should modify the stress capital buffer, as well as the CCAR and stress testing frameworks, with the following recommendations in mind:

  - As a matter of sequencing, all of the recommendations above should be put into place and data from stress test cycles post-implementation of those measures should be collected before a stress capital buffer is put into place.

  - In addition, we urge that the Federal Reserve collect and take into account data on the unique issues faced by IHCs in relation to stress testing and stress buffer methodology.

    - In relation to the stress capital buffer proposal, the Board acknowledged that it did not have sufficient data to test the concept on IHCs, and therefore used U.S. BHC data only.

    - IHCs will incur significant costs because of the unique nature of the stress capital buffer, and because their parent international banks will not be calibrating their capital based on a stress capital buffer framework. IHCs would be required to maintain parallel but distinct bespoke systems, controls, models and data that cannot be used across the consolidated international bank.

  - Adjust for the ways in which IHCs occupy a distinct status relative to other entities. These include but are not limited to:

    - differences in disclosure requirements (and, therefore, market pressures) for a non-public entity such as a subsidiary IHC;

    - the speed with which capital may be placed in, and assets taken out of, an IHC in contrast to going to market; and

    - internal/affiliate transfer pricing issues.

  - Eliminate the dividend prefunding component of the stress capital buffer for IHCs.

    - IHCs' "subsidiary dividends" are very different from the "corporate dividends" of publicly traded U.S. BHCs. Publicly traded U.S. BHCs have strong incentives to maintain dividend levels. In contrast, IHCs are not under market pressure to distribute steady subsidiary dividends. Nevertheless, the dividend prefunding requirement stands to interfere with IHCs' internal business planning processes.

    - In addition, the exemption of share repurchases is unfairly biased against IHCs that, as subsidiaries, do not typically use share repurchases to effect distributions. Also, there may be tax, accounting, or home country legal and regulatory considerations (not market pressures) motivating the use of a dividend as opposed

to a share repurchase or return of capital action. The dividend prefunding requirement would arbitrarily incentivize an IHC to avoid distributing to its parent because "subsidiary dividends" (and not share repurchases) would artificially inflate publicly disclosed stress buffers. On the other hand, an IHC that does include its subsidiary dividends could also present a distorted picture of its financial condition, if its publicly disclosed stress buffers are much larger than a peer domestic BHC, which would not be required to reflect its share repurchases in its stress buffer and could appear to have a lower risk profile.

- Vice Chairman Quarles recently indicated that there are likely more efficient ways to address coverage for expected dividends,[14] and we urge that the special circumstances of IHCs be considered when formulating revised approaches to dividend issues.

- Remove the global market shock ("GMS") and large counterparty default ("LCD") components from the stress capital buffer and from CCAR for IHCs.

    - Previously provided data[15] indicates that the trading books of IHCs are both significantly smaller and made up of a greater proportion of less risky assets (such as U.S. government and agency securities) than the trading books of the U.S. GSIBs with larger trading operations that are subject to GMS and LCD. These CCAR shocks should not be applicable to any IHC. These shocks have only been applied to U.S. GSIBs, and no IHC is deemed a U.S. GSIB. In addition, the application to IHCs is a recent change that has not been fully phased in and can be easily reversed.[16]

    - Alternatively, those firms to which the GMS and LCD would apply should be defined more clearly and more publicly, by using trading account and counterparty thresholds that trigger the application of these shocks. Reasonable triggers should recognize that such attributes of IHCs are small in comparison to U.S. BHCs and that IHCs should not be subject to these shocks.

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[14] See Vice Chairman Quarles, A New Chapter in Stress Testing (Nov. 9, 2018); Vice Chairman Quarles, Beginning Stress Testing's New Chapter (Nov. 16, 2018) (together with the Nov. 9, 2018 speech, the "Stress Test Speeches").

[15] See IIB Letter to Federal Reserve Board (Aug. 8, 2017) (appendices).

[16] We note that the modifications to the criteria for application of the GMS specifically were designed, in a discriminatory manner, to scope in only certain IHCs that do not have attributes that rise to the level of the U.S. GSIBs already covered. See "Agency Information Collection Activities: Announcement of Board Approval Under Delegated Authority and Submission to OMB," 82 Fed. Reg. 59608, 59609 (Dec. 15, 2017) ("As a result of the proposed change, based on data as of June 30, 2017, six U.S. IHCs would become subject to the [GMS], and the six domestic bank holding companies that meet the current materiality threshold would remain subject to the exercise under the proposed threshold.").

- Eliminate the stress leverage buffer. We support Vice Chairman Quarles' statements on the advisability of eliminating the stress leverage buffer from the stress capital buffer proposal.[17]

- Eliminate the requirement for approval of changes to an entity's distribution plan after CCAR.

  - The Board indicates that the key innovation of the stress buffers proposal is a fully integrated approach that is intended to have CCAR firms operate with the stress buffers on a business-as-usual daily basis. The Board should not need to continue individual approval over each CCAR firms' capital distributions. If a banking organization maintains capital levels above its stress buffer requirements on a continuous basis, it should be able to freely determine whether to increase its capital distributions so long as these new capital actions would not cause its capital ratios to decline below its buffer requirements.

- Eliminate the application of a new stress test upon material change. In the case of a material change post-CCAR, there does not appear to be any additional benefit to changing the supervisory stress test from the one that the CCAR firm recently went through.

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[17] See the Stress Test Speeches.

Appendix D: iTLAC and LTD

- The LTD requirement should be eliminated. IHCs should be permitted to choose to issue LTD to satisfy iTLAC requirements (and it should remain tax deductible), but should not be required to do so.
  - Additional LTD, above required capital and iTLAC amounts (including amounts pre-positioned to address stress test losses), is costly to maintain.
  - Elimination of the U.S. LTD requirement would be consistent with the standards established by the FSB that did not include an LTD standard.[18]
  - The existing iTLAC standard chosen by the Board is already at the highest end of the range suggested by the FSB, and LTD is above and beyond that requirement.
  - Vice Chairman Quarles indicated that both the iTLAC amounts and the LTD would be revisited by the Board, in order to more effectively balance home-host interests. We would recommend that the iTLAC requirements be set at 75% of external TLAC. Vice Chairman Quarles also has indicated that simplifying the loss absorbency requirements framework is another area of focus for the Board.[19]
- iTLAC – and to the extent not eliminated or to the extent elected to be issued by an IHC – LTD should be permitted to be counted as converted to common equity tier 1 capital if needed during the nine-quarter stress horizon of the CCAR and DFAST.[20]
  - The purpose of iTLAC and LTD is to serve as a preplaced resource to bolster capital in a stress situation, as well as a vehicle to support single-point-of-entry resolution. The Federal Reserve has powers sufficient to force conversion in cases of severe undercapitalization, which is exactly the scenario tested under DFAST and CCAR.
    - Given that qualifying internal LTD is deeply subordinated and typically private, it makes sense for it to be eligible to be converted into equity if needed under CCAR and DFAST.
  - There are no "investor concerns" with the Board permitting conversion to be triggered, as the sole holder is the IHC's parent or affiliates.
  - In addition to its value as a direct resource, iTLAC also creates an additional financial incentive for the parent to support its subsidiary.

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[18] Financial Stability Board, "Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution: Total Loss-absorbing Capacity (TLAC) Term Sheet" (Nov. 9, 2015).

[19] See Quarles Early Observations; Brand Your Cattle Speech.

[20] See IIB Stress Buffers Letter.

Appendix E: Risk Management

- Board Expectations Proposal[21]
  - The Federal Reserve did not apply the board expectations proposal to boards of directors of IHCs. The board expectations proposal would have applied to all bank and savings and loan holding companies with greater than $50 billion.
    - Consistent with the Regulatory Relief Act, this threshold for U.S. BHCs should be increased.
    - When/if guidance is proposed for IHC boards of directors, the threshold for application to an IHC should match the threshold arrived at for U.S. BHCs and should not be dependent upon the size of an international bank's global assets, CUSO assets or GSIB status.
  - As the IIB has stated in previous comments,[22] when the Federal Reserve issues guidance on supervisory expectations for boards of directors and senior management of IHCs and CUSO, the Federal Reserve should take the unique characteristics of international banks, IHCs and their boards into account.
  - Any board expectations proposal for IHCs should be issued in conjunction with a reproposed senior management expectations proposal for international banks' CUSO, and then they should be finalized together.
- Senior Management Expectations Proposal[23]
  - The senior management expectations proposal would apply to management of an international bank's CUSO, if the international bank has $50 billion or greater of CUSO assets. The board expectations proposal would apply to all bank and savings and loan holding companies with greater than $50 billion.
    - Consistent with the Regulatory Relief Act, this threshold should be increased, and the applicable threshold for application to an international bank's CUSO should match the threshold arrived at for U.S. BHCs and should not be dependent upon the size of an international bank's global assets or GSIB status.
  - Similarly, as the IIB has also previously commented:[24]
    - Any guidance must be tailored to the unique circumstances of an international bank's CUSO, as part of a larger international organization with "higher" level management and risk management.

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21 "Proposed Guidance on Supervisory Expectation for Boards of Directors," 82 Fed. Reg. 37219 (Aug. 9, 2017).

22 See IIB letter to Federal Reserve Board (Feb. 15, 2018).

23 "Proposed Supervisory Guidance," 83 Fed. Reg. 1351 (Jan. 11, 2018).

24 See IIB letter to Federal Reserve Board (Mar. 15, 2018).

- The manner in which the proposed guidance applies to international banks that do not have an IHC and international banks that do have an IHC is not clear, particularly with regard to the way in which "senior management" is defined.

- The language of the proposal creates ambiguity as to whether the proposal applies to the combined U.S. operations of covered international banks or extraterritorially; this language should be revised to clarify that the proposal does not apply extraterritorially.