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BANK POLICY INSTITUTE

August 13, 2019

The Honorable Randal K. Quarles
Vice Chairman for Supervision
Michael S. Gibson
Director, Division of Supervision and Regulation
Mark E. Van Der Weide
General Counsel
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Foreign Banking Organization Tailoring Proposals

Dear Sirs:

We are writing to supplement our comment letters on the agencies' proposals to tailor enhanced prudential standards ("EPS") for foreign banking organizations ("FBOs").[1] In this letter, we offer some further suggestions regarding the treatment of inter-affiliate transactions for purposes of applying the agencies' proposed risk-based indicators ("RBIs"), which would be used to categorize the intermediate holding companies ("IHCs") and combined U.S. operations ("CUSO") of FBOs into tiers for application of EPS. Specifically, we propose an alternative should the agencies decide not to exclude inter-affiliate transactions from the RBIs.

We continue to urge the Board of Governors of the Federal Reserve System (the "Federal Reserve") and the other agencies to exclude inter-affiliate transactions from all the RBIs as applied to an IHC or CUSO of an FBO. The agencies proposed a limited exclusion of inter-affiliate transactions in the context of cross-jurisdictional activity ("CJA"). In our view, the exclusion should be expanded to eliminate all inter-affiliate transactions without condition in the context of CJA, and that expanded exclusion should be extended to all the RBIs, in each case for the reasons discussed in our comment letters.

This issue is critical for the many FBOs that operate using integrated global risk management, funding and capital models. For these institutions, like many large U.S.-headquartered banking organizations, inter-affiliate transactions between subgroups in a particular jurisdiction and the parent banking organization are an inevitability and are integral to prudent risk and liquidity management.

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1 See Institute of International Bankers comment letters, dated June 21, 2019; Bank Policy Institute and American Bankers Association comment letter, dated June 21, 2019. A copy of this letter will be submitted with a properly formatted (docket numbers, etc.) transmittal letter for inclusion in the agencies' comment files.

Treating these transactions in a way that aligns with the risk-sensitivity goals of the agencies' proposals is therefore one of the highest priority issues addressed in our comment letters.

This issue also has important ramifications for the real economy. FBOs with surplus funding in their home countries lend or contribute that funding to their U.S. operations and should be encouraged to continue to do so. This activity promotes the availability of credit in the United States for infrastructure projects and other important investment and development, and enhances the depth of U.S. financial markets. As proposed, however, the RBIs would discourage these important FBO contributions to the U.S. economy and the U.S. financial system.

From a financial stability perspective, transactions between an IHC or CUSO and its FBO parent or foreign affiliates are fundamentally less risky than third-party transactions. For example, while short-term wholesale funding from unaffiliated lenders can present heightened run risks in certain circumstances, funding provided by a parent FBO is demonstrably less likely to run than third-party funding. Indeed, it is more likely to replace third-party funding.[2] In addition, treating FBO parents as if they pose the same risks as unrelated third parties perpetuates the inconsistent treatment of IHCs (or an FBO's CUSO) as part of global banking organizations in some respects but as deemed top-tier organizations in other respects. And, for this reason, treating an IHC or FBO's CUSO's lower-risk transactions with its affiliated parent in the same manner as transactions with unaffiliated counterparties represents a denial of national treatment, because inter-affiliate transactions would be treated very differently for U.S. IHCs compared to top-tier U.S. BHCs. Vice Chairman Quarles has indicated that the Federal Reserve "contemplated from the outset that [the unique] circumstances [of FBOs] may require application of the rule's requirements to be adjusted [and] . . . we will continue to provide flexibility where appropriate to accommodate these differences."[3] In our view, the RBIs require further adjustment to achieve this flexibility.

To the extent that the agencies' inclusion of inter-affiliate transactions for IHCs and CUSO of FBOs was designed to achieve neutrality across affected FBO U.S. funding models (whether those models incorporate predominately (i) local, third-party funding, (ii) funding from an FBO parent, or (iii) net funding to an FBO parent), we respectfully submit that this neutrality is not necessary to achieve the agencies' risk categorization objectives. Across all FBO U.S. operations, establishing a framework that assumes, *a priori*, that an FBO parent presents the same risks as those associated with unrelated third parties would be inconsistent with the proposals' policy focus on the actual safety and soundness and financial stability risks associated with these transactions.

If, however, the agencies were to determine not to exclude inter-affiliate transactions from the RBIs entirely, we would reiterate that including them in full for purposes of categorizing the U.S. operations of FBOs is simply misaligned with the financial stability risks that the EPS are designed to address. We would therefore suggest that, instead, the agencies consider weighting inter-affiliate transactions, for purposes of all of the RBIs, substantially less than 100% relative to transactions with unrelated third parties. If the agencies were to adopt a weighting approach, in our view the differential in

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2 For example, according to Federal Reserve research, net funding inflows from international banks to their own U.S. bank subsidiaries increased during the financial crisis. See William Goulding and Daniel E. Nolle, "Foreign Banks in the U.S.: A Primer," Federal Reserve International Finance Discussion Papers No. 1064, fig. 13b (Nov. 2012) (noting that inflows rose by 50% over pre-financial crisis levels).

3 Vice Chairman for Supervision Randal K. Quarles, "The Federal Reserve's Regulatory Agenda for Foreign Banking Organizations: What Lies Ahead for Enhanced Prudential Standards and the Volcker Rule" (March 5, 2018).

risk profile of inter-affiliate transactions and third-party transactions would dictate that inter-affiliate transactions be weighted no higher than 50%.

There is ample precedent to support a weighted approach. Specifically, the concept of weighting internal transactions less than unrelated third-party transactions has been used in other contexts, such as internal total loss-absorbing capacity ("iTLAC") and the treatment of affiliate-brokered deposits and commitments to affiliated banks in the liquidity coverage ratio rules. The case for a weighted approach is even more compelling in this context because of the integral role that inter-affiliate transactions play in the enterprise-wide management of risk and liquidity at all global banking organizations, and the clearly mitigated financial stability and interconnection risks that inter-affiliate transactions present in relation to unrelated third-party transactions. We also note that, for those FBOs that have provided iTLAC and iTLAC-eligible long-term debt into their IHCs, the pre-positioning of inter-affiliate convertible capital in effect collateralizes inter-affiliate transactions among the same affiliated counterparties, thus also supporting a weighting approach and implying a weight substantially less than 50%.

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We appreciate your consideration of our supplemental comments. Please contact either of us, if we can provide any additional information.

Sincerely,

Briget Polichene
Chief Executive Officer
Institute of International Bankers

John Court
SVP & General Counsel
Bank Policy Institute

cc: The Honorable Joseph M. Otting
Travis J. Hill
Doreen R. Eberley
Nick Podsiadly
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The Honorable Jelena McWilliams
Vance S. Price
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