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By Electronic Mail

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Attention: Jennifer J. Johnson, Secretary
Docket No. 1438; RIN 7100-AD-86

Re: Enhanced Prudential Standards and Early Remediation Regulations under Dodd-Frank 165/166

Ladies and Gentlemen:

The Royal Bank of Scotland plc ("**RBS**") is pleased to submit this comment to the notice of proposed rulemaking (the "**NPR**") issued by the Board of Governors of the Federal Reserve System (the "**Federal Reserve**") to implement the enhanced prudential standards and early remediation provisions of Sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**").[1] RBS and its parent, The Royal Bank of Scotland Group plc, are financial holding companies that are registered bank holding companies as a result of their ownership of RBS Citizens Financial Group Inc. and its two wholly owned FDIC-insured depository institutions, RBS Citizens Bank, N.A., and Citizens Bank of Pennsylvania.

Executive Summary

RBS endorses the specific recommendations and suggestions made jointly by The Clearing House Association L.L.C., the American Bankers Associations, The Financial Services Forum, The Financial Services Roundtable and the Securities Industry and Financial Markets Association (together, the "**Associations**"), and by the Institute of International Bankers ("**IIB**"), with respect to the entire NPR. RBS's comment letter is limited to Subpart D of the proposed rule – Single-Counterparty Credit Limits ("**SCCL**"). Specifically, RBS urges the Federal Reserve:

1. To exempt exposures to high-quality non-U.S. sovereigns from the definitions of "exposure" in the SCCL rules; and
2. To the extent that exposures to such sovereigns are covered by the rule, not to require aggregation of exposures to the sovereign with exposures to a company controlled by the sovereign, at least not unless the sovereign controls the company with an intent to hold the shares other than as a temporary measure.

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[1] 77 Fed. Reg. 594 (Jan. 5, 2012).

Detailed Comments

RBS acknowledges, as did comments made by the Associations and the IIB, the need for robust supervision and regulation to enhance the stability of the U.S. and global financial systems. At the same time, however, RBS urges the Federal Reserve to avoid adopting rules where the adverse consequences that may be reasonably expected to follow from the adoption of such rules are likely to outweigh the benefits of safety, soundness and financial stability that may be realized from the rules.

Non-U.S. Sovereign Obligations

The proposed SCCL rules would apply the 25% (or 10%, for the very largest banks) limit to aggregate exposures to sovereigns. RBS agrees with the Associations that the final rule should exempt exposures to high-quality non-U.S. sovereign obligations. The European Commission's large exposure regime, which is implemented by member countries, excludes from the applicable credit limit exposures to sovereigns with a 0% risk-weight and certain CCPs.[2] Foreign governments have submitted comments to the Federal Reserve's proposed regulation to implement the Volcker Rule on the grounds that it unfairly interferes with liquidity of non-U.S. sovereign debt while leaving U.S. sovereign debt unaffected.[3] The proposed SCCL rules would, if adopted in their current form, compound the impact on the liquidity of non-U.S. sovereign debt. RBS agrees with the recommendations made by both the Associations and the IIB that the following exposures be exempt:

- sovereign debt securities that are assigned a specific risk-weighting factor of 1.6 or less (equivalent to a risk-weighting of 20% or less under the U.S. banking agencies' Basel I-based capital rules) under the market-risk rules as they are amended; and

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2 *See* Capital Requirements Directive IV (July 20, 2011).

3 See letters from: Office of the Superintendent of Financial Institutions Canada, available at http://www.federalreserve.gov/SECRS/2012/January/20120111/R-1432/R-1432_122811_88639_481623396475_1.pdf; Canadian Minister of Finance, available at http://www.federalreserve.gov/SECRS/2012/February/20120228/R-1432/R-1432_021312_104923_519924448346_1.pdf; Deutsche Bundesbank and BaFin, available at http://www.federalreserve.gov/SECRS/2012/February/20120221/R-1432/R-1432_021312_104929_536151947408_1.pdf; U.K. Financial Services Authority, available at http://www.federalreserve.gov/SECRS/2012/February/20120228/R-1432/R-1432_022212_105560_462867299076_1.pdf; EU Council of Ministers (ECOFIN), available at http://www.federalreserve.gov/SECRS/2012/February/20120228/R-1432/R-1432_022212_105564_326398330626_1.pdf; Mexico CNBV, available at http://www.federalreserve.gov/SECRS/2012/March/20120305/R-1432/R-1432_021312_105416_439625820801_1.pdf; Banco de Mexico, available at http://www.federalreserve.gov/SECRS/2012/March/20120309/R-1432/R-1432_030512_105861_508765807767_1.pdf; The Reserve Bank of Australia, available at http://www.federalreserve.gov/SECRS/2012/March/20120309/R-1432/R-1432_022112_105565_411082456530_1.pdf; Chairmen of the *Autorite de controle prudentiel* and the *Autorite des marches financiers* of France and the Head of the French Treasury, available at http://www.federalreserve.gov/SECRS/2012/March/20120305/R-1432/R-1432_021412_104999_542080131636_1.pdf.

- obligations of the government of a country that is a full member of the Organization for Economic Cooperation and Development or that has concluded special lending arrangements with the International Monetary Fund.

Aggregation of Exposures

Section 252.92(k) of the proposed SCCL rules defines "counterparty" for purposes of the SCCL rules to include a foreign sovereign entity and all of its "instrumentalities." The NPR includes the following Question 25:

> **<u>Question 25</u>**: . . . Should exposures to a company controlled by a foreign sovereign entity be included in the exposure to that foreign sovereign entity?[4]

Question 25 raises interpretive questions given that the term "instrumentalities" has varying meanings under U.S. law.[5]

RBS recommends that the final SCCL rules clarify that credit exposures to companies (including banks) controlled by a sovereign as a temporary measure to promote financial stability should not be aggregated with exposures to the sovereign for purposes of the rules. Failure to provide this clarification could create at least the following four adverse consequences without compensating benefit:

- Reduce the ability of the controlled company to obtain funding from and transact as a counterparty with banking organizations subject to the SCCL rules (**"Covered Companies"**);
- Undermine the ability of the controlled company to conduct the contingency funding planning required in section 252.58 of the proposed rule by making it impossible for the controlled company to assess its continued ability to transact business with Covered Companies;
- Interfere with the liquidity of the sovereign's debt securities because every dollar (or other currency unit) of exposure to the controlled company would reduce the ability of the Covered Company to hold the sovereign's debt – and possibly to accept it as collateral for third parties' obligations; and
- Restrict the Covered Company's ability to conduct operations in the jurisdiction of the sovereign, if the banking organization would be required to hold deposits with the central bank or hold debt of the sovereign of that jurisdiction.

At a minimum, the Federal Reserve should distinguish between a situation where a sovereign owns a company with a view toward operating the entity as part of a permanent enterprise, from a situation where a sovereign obtains control of a company as part of an effort to

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[4] 77 Fed. Reg. at 615.

[5] *See, e.g., Lebron v. Nat'l R.R. Passenger Corp.*, 513 U.S. 374 (1995) (Amtrak is an instrumentality of the U.S. government for some purposes but not for others); *Dole Food Co. v. Patrickson*, 538 U.S. 468 (2003) (only first-tier subsidiary of a foreign sovereign entity is an "instrumentality" for purposes of the Foreign Sovereign Immunities Act, 28 U.S.C. § 1603(b)(2)).

promote financial stability with a stated intention to return ownership of the entity to the private sector as soon as possible. The latter situation is analogous to acquiring property in satisfaction of a debt previously contracted, and the Federal Reserve has exempted such holdings from the restrictions of Sections 23A and 23B of the Federal Reserve Act and the Bank Holding Company Act.[6] Moreover, the distinction is consistent with the longstanding Federal Reserve policy of avoiding restrictive impacts on the ability to operate in the United States of "a foreign government-owned bank [that] is in fact operated independently from other banks and commercial enterprises that are subject to common government ownership . . . ." *Banca Commerciale Italiana*, 68 Fed. Res. Bull. 423 (1982).

Analogizing to the U.S. government's Troubled Asset Relief Program, had other countries adopted an aggregation requirement like that in the proposed SCCL rules, each U.S. bank that the U.S. government would have been deemed to control would immediately have suffered restrictions to its ability to obtain funding from and transact with other major financial institutions, especially if such other countries also did not exempt holdings of U.S. Treasury securities and deposits with the Federal Reserve from the definition of "credit exposure" for these purposes.

An analogous situation could occur in the future. One of the principal ways that Dodd-Frank seeks to address "too-big-to-fail" is by giving the FDIC orderly liquidation authority over systemically significant financial institutions in Title II. Title II anticipates that the FDIC may seek to preserve the going concern value of a SIFI entering the OLA process by keeping all or part of the institution operating through receivership. *See* Dodd-Frank Section 210(a)(1)(B) – "Operation of the Covered Financial Company During the Period of Orderly Liquidation". Again, if other countries were to adopt rules similar to the proposed SCCL rules, the financial company under a Title II orderly liquidation would be deemed to be "controlled" by the U.S. government, its exposures would become aggregated with those of the U.S. government, and undoubtedly its ability to transact with other major non-U.S. financial institutions would be dramatically curtailed. The U.S. should assume that other countries will adopt orderly liquidation regimes under which the sovereign would be deemed to control the company in receivership. If they do, and if the proposed SCCL rules are adopted, U.S. Covered Companies – and systemically important financial institutions globally if other countries also adopt the SCCL rules -- may be forced to radically reduce or even terminate business with the bridge entity.

Exempting from aggregation exposures of companies controlled by a high-quality sovereign would also be in harmony with European Union treatment, as evidenced by the following issued by the Committee of European Banking Supervisors ("**CEBS**"):

> For entities where the majority of the shares are directly owned by the central government . . . , and where exposures to the central government receive a 0% risk weight under Directive 2006/48/EC, there is no requirement to group these entities as a group of connected clients. . . . . In such cases, even though the owner has control over each entity,

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[6] *See, e.g.,* 12 C.F.R. §§ 223.2(b)(5) and 225.22(d)(1).

> the risk connected with the exposure to one entity is normally not related to the risk of the exposures to other entities.[7]

This EU policy is based on an acknowledgment that the adverse consequences of requiring such aggregation would outweigh the benefits. The CEBS has stated that:

> . . . there could be . . . events that would not cause a marginal contribution to the negative externalities already imposed by the default of the counterparty that should be excluded from the large exposures limits. It would be the case when the event we are trying to protect against is of such a nature that the failure of the credit institution becomes a secondary issue (e.g., the failure of a big OECD country is likely to impose negative externalities of such a magnitude on the system that the failure of the bank does not add much in terms of negative effects) . . . .[8]

The EU treatment of sovereign debt is consistent with the Federal Reserve Board's treatment of high-quality sovereign debt under its capital rules. *See* Capital Adequacy Guidelines for Bank Holding Companies: Risk-Based Measure,[9] Part III.C (assigning zero percent risk weight to obligations of the OECD countries); Capital Adequacy Guidelines for Bank Holding Companies: Internal Ratings-Based and Advanced Measurement Approaches,[10] § 31(d) (a bank holding company may assign a probability of default of less than 0.03% to obligations of a sovereign entity).

Conclusion

RBS urges the Federal Reserve to exempt exposures to at least high-quality sovereigns from the definitions of "exposure" in the SCCL rules. To the extent that exposures to sovereigns

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[7] Committee of European Banking Supervisors, *Guidelines on the Implementation of the Revised Large Exposures Regime,* ¶ 37, p. 11 (Dec. 11, 2009, available at http://eba.europa.eu/documents/Publications/Standards---Guidelines/2009/Large-exposures_all/Guidelines-on-Large-exposures_connected-clients-an.aspx) (footnote omitted). This concept was repeated by CEBS in 2008. Committee of European Banking Supervisors, *Second Part of CEBS' Technical Advice to the European Commission on the Review of the Large Exposures Rules,* ¶ 87, p. 19 (Mar. 27, 2008, available at http://www.eba.europa.eu/getdoc/6003aab2-fece-4e02-9e3a-d1af8252e4a7/2nd-LE_advice.aspx, and hereinafter referred to as *CEBS Technical Advice Part II*) (noting that ownership by a sovereign is the **one** exception to the principle that exposures to an entity should be aggregated with those to majority owned subsidiaries of that entity).

[8] Committee of European Banking Supervisors, *First Part of CEBS' Technical Advice to the European Commission on the Review of the Large Exposures Rules,* ¶¶ 82-83, p. 17 (Nov. 6, 2007, available at http://www.eba.europa.eu/getdoc/ef8e4be3-7c7a-47a4-9713-2870db4ae53d/LE_Part1adviceonlargeexposures.aspx. *See also* CEBS Technical Advice Part II, ¶¶ 143-144, p. 29 ("For instance, if something so unpredictable happened to make the government of a major developed country default, then, probably, the financial chain of effects could not be stopped by a large exposures regime. Therefore, it is CEBS's view that such events fall outside the definition of the plausible unforeseen event risk that the large exposures regime seeks to cover.").

[9] 12 C.F.R. 225, App. A.

[10] 12 C.F.R. 225, App. G.

are covered by the rules, the Federal Reserve should not require aggregation of exposures to the sovereign with exposures to a company controlled by the sovereign, at least not unless the sovereign controls the company with an intent to hold the shares other than in a temporary manner.

RBS appreciates the opportunity to provide comments on the NPR. If you have any questions about the matters discussed in this letter, please contact Michael Kadish at (203) 897-3015, email: michael.kadish@rbs.com; or Paul Stevelman at (203) 897-2756, email: paul.stevelman@rbs.com.

Respectfully submitted,

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