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April 30, 2013

Mr. Daniel K. Tarullo
Governor
Board of Governors of the Federal Reserve System

Subject: Comments on the proposal for Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations (FBOs)

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Dear Mr. ~~Tarullo~~,

1. Overview

We appreciate the opportunity to provide our comments on the proposed rules for Foreign Banking Organizations (FBOs). The objective of the proposal, as we understand it, is to enhance the resilience of the U.S. operations of large FBOs, and to minimize any systemic impact on the U.S. financial system and the U.S. economy, if and when an FBO fails. To the extent that those measures are proposed as a means to contain the systemic impact of the failure of a bank, we share those objectives and look forward to working with the FRB to fulfill those objectives.

It is, however, our strong request that the proposal be finalized in a way that would enhance the effectiveness of ongoing efforts towards stronger international cooperation in supervision and resolution of internationally active banks. There should be a possibility of deference to home country regulation and supervision, if the FBOs are subject to broadly comparable home country standards of regulation and supervision based on outcome, and are closely monitored by the home authorities.

We suggest, therefore, that the requirements in the proposal should not be applied across-the-board solely on the basis of the size of balance sheets. Too much focus on the asset size could lead to distortion and misinterpretation of the risk characteristics of FBOs. The requirements should be proportionate and tailored to the differences in business models and risk characteristics of the relevant FBOs. The risks to the financial system posed by traditional commercial banks would be much lower compared to highly leveraged investment banks with large amounts of trading assets on their balance sheets. Therefore, with respect to both capital and liquidity requirements, measures applicable to commercial banks should be less onerous compared to those applicable to investment banks; i.e. investment banks that rely more on short-term wholesale funding should be placed under stronger capital and liquidity requirements.

The differentiated treatment should be determined by an assessment of each FBO based on such criteria as: (a) the asset size of the U.S. broker-dealer relative to the combined U.S. assets of an FBO; (b) the use of dollar funds raised in the U.S., that is, whether it is for lending or trading activities; (c) the proportion of stable funding (e.g. core deposits) for the U.S. operations; and (d) the proportion of funds raised and invested in the U.S. Based on such a multi-faceted assessment, the applicable measures should be made less onerous or waived for an FBO that poses less risk to the U.S. financial system.

2. Specific issues

While the U.S. authorities are invited to take a holistic review in applying differentiated treatment to FBOs of lower risk, and apply less onerous measures whenever the FBO is considered to be less risky, some specific issues need to be considered further:

2.1 Liquidity requirements

The ability to provide dollar funding to the global lending operations of the bank is crucial for an FBO conducting traditional commercial banking services, since the U.S. dollar is the reserve currency worldwide. On the other hand, such FBOs would tend to be less susceptible to runs, if they rely more on funding by deposits and less on wholesale funding on a consolidated basis, and/or use the proceeds from the funding in the U.S. for lending as opposed to trading activities etc. Therefore, if the balance-sheet structure of an FBO is such that they pose less liquidity risk on a consolidated basis, then the FBO should be exempted from, or placed under less onerous, liquidity requirements in the U.S.

2.2 Reporting requirements on the U.S. branch network concerning the home country stress test on a consolidated basis

For the same reasons as above, an FBO that relies more on funding by deposits and less on wholesale funding at the consolidated level, and/or use the proceeds for lending as opposed to trading activities etc., would generally be more resilient during periods of stress. Such FBOs would tend to suffer less capital depletion as higher liquidity alleviates the stress on capital adequacy during such periods. The home country supervisor is best-placed to conduct stress tests on a consolidated level for such FBOs. Therefore, if the home country supervisor applies robust stress tests taking into account relevant factors broadly comparable to U.S. stress tests, such reporting requirements should be waived for the FBOs.

2.3 Triggers of remedial action

It would be essential that remedial actions of host authorities are well-coordinated and consistent with those of the home authority, including the timing of the respective remedial actions. Hence it would be necessary for the U.S. authority to retain a certain margin of discretion over its remedial actions, both in terms of content and timing, and refrain from mechanical or automatic application of such measures. In particular, the level 2 remedial action regarding liquidity of the U.S. branch network, i.e. the requirement to maintain a net-due-to position to the head office during periods of stress, should be conditional upon prior consultation with the home authority. Since any such action taken by the U.S. authority would materially affect the integrity and soundness of the FBO as a whole, such coordination would be crucial in developing and operationalizing a credible recovery and resolution plan for internationally active FBOs.

2.4 Criteria in determining the entities to be organized under an intermediate holding company (IHC)

There are cases in which the global governance structure of an FBO could better function if organized along business lines. The effectiveness of risk governance and management of the FBO could be undermined if the IHC complicates management of the business segments, and/or reporting lines. Therefore, the requirement to establish IHCs should be applied with some room for flexibility in tailoring the structure to the particular business model and risk characteristics of the U.S. operations of the FBO.

2.5 Single-counterparty exposure limit

In order to ensure effective and consistent supervision of the home country authority over the FBO group, it would be desirable to defer to the home authority any applicable standards regarding large exposure rules etc. to the extent that the home authority applies broadly comparable rules based on outcome. Duplicative and inconsistent requirements applied by the host authority would appear not only redundant, but also more costly and difficult to ensure compliance by the FBO. Applicable rules should be based on internationally agreed standards, as agreed by international standard-setters such as the Basel Committee. In this respect, the single-counterparty exposure limit would be a rule amenable to deference to the home authority, as those limits are normally measured against the consolidated capital base of the FBO.

We hope that you would find these recommendations useful in finalizing the rules, and look forward to further discussing them with you, as necessary.

Sincerely yours,

All the best,

河野 正道 M.K.

Masamichi Kono
Vice Commissioner for International Affairs
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