NEW YORK STATE
DEPARTMENT *of*
FINANCIAL SERVICES

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April 30, 2013

Via Email to Comment Portal

Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Re: Rule on Enhanced Supervision of Foreign Banking Organizations (Docket No. R-1438; RIN 7100 AD 86)

Dear Mr. deV. Frierson:

We have reviewed the Board of Governors' (the "Board") notice of proposed rulemaking concerning the enhanced supervision of Foreign Banking Organizations ("FBOs") (the "Proposed Rule"). We strongly support enhanced prudential standards, early remediation requirements, and improved corporate governance rules for FBOs. As discussed more fully below, however, we also believe the Proposed Rule should target its approach to focus on the largest, most interconnected financial institutions that could pose a systemic risk to the U.S. financial system.

The New York State Department of Financial Services ("DFS") has a long history supervising FBOs. We license, supervise and regulate more than 100 FBOs operating through branches, agencies, and subsidiaries, with assets under supervision exceeding $1.7 trillion. These institutions play an important role in New York's economy. As the world's leading financial center, New York has attracted most major international banks. The FBOs operating in New York represent all regions of the globe and embody a range of business models—from globally significant financial institutions to smaller and less complex branches and agencies. FBOs employ over 60,000 people in New York State, representing approximately 25 percent of all people directly employed by FBOs' U.S. operations, with a total payroll close to $2 billion. As many as 162,000 additional New York jobs in other industries have been generated as a result of FBOs' presence here.

Most of the measures included in the Proposed Rule are necessary responses to the recent financial crisis and will improve the safety and soundness of the financial system. As detailed more fully below, we believe the Board should take a targeted approach that focuses more closely on risk, avoids "one-size-fits-all" measures, and preserves State supervisory flexibility.

- Most significantly, we believe that the Proposed Rule should be targeted so that only FBOs that pose systemic risk to the U.S. financial system should be required to form a U.S. IHC. One potential threshold that the Board could set is U.S. non-branch assets of

$50 billion or more, including consideration of off-balance sheet exposure at the U.S. top-tier holding company. Such an approach would focus more appropriately on an institution's U.S. risk profile. Further, we propose that the Board take a hybrid approach to the inclusion of U.S. subsidiaries under the U.S. IHC. We also support the Proposed Rule's provision allowing FBOs to seek permission to create an alternative organizational structure to hold U.S. subsidiaries.

- With respect to remediation, the Proposed Rule sets forth certain automatic triggers that may impact our ability to tailor supervisory steps to a particular institution's recovery or resolution at varying stages. DFS would propose a remediation structure more consistent with its own supervisory authority, which would enable us to allow certain critical banking activities to continue for a longer period of time, prior to the Superintendent invoking NYS Banking Law 606.

- We also urge the Board to consider certain aspects of the Proposed Rule that may unintentionally restrict New York State's supervisory powers. DFS's supervisory flexibility is a tremendous asset that allows us to act quickly, nimbly and responsibly in times of financial stress. Many of our supervisory tools may be invoked prior to resolution, including asset maintenance or mandating a "Due To" position. With that in mind, we ask the Board, where appropriate, to implement guidelines—rather than prescriptive measures—to preserve our ability to direct recovery or resolution in a way that best serves our overall financial stability.

- We also believe it may be prudent for the Board to adopt additional liquidity requirements after the Liquidity Coverage Ratio standard under Basel III is finalized. In the *interim*, functional regulators could impose liquidity requirements through the ordinary supervisory process.

- We believe the application of the single-counterparty credit limit to state-licensed branches of FBOs is unnecessary because they already are subject to state lending limits. In addition, we have some concerns about the potential financial impact of an institution's non-compliance due to an easily-correctible technical exception. We would recommend that institutions be required to report breaches of single-counterparty credit limits to regulators, along with a plan of how and when compliance will be achieved, rather than be subject to immediate halt in counterparty lending that could unnecessarily impact economic activity through a sudden shock.

- We fully support the Board's proposed corporate governance rules for FBOs, including the proposed requirements for a U.S. risk committee and a U.S. chief risk officer for FBOs of a certain size. We would emphasize that in our experience the location of the U.S. risk management function is less important than its effectiveness and accessibility to U.S. operations and U.S. supervisors or regulators.

- Finally, we believe certain adjustments should be made to the Proposed Rule's implementation period. We believe that institutions may require more time to undertake the legal entity rationalization and realignment prompted by the U.S. IHC requirement, but that reforms relating to corporate governance could be implemented more quickly than proposed.

I. Formation of a U.S. Intermediate Holding Company

A. Alternative Asset Thresholds

Question 7 (77 Fed. Reg. 76338) requests comment on whether the Board should consider an alternative asset threshold for purposes of identifying the companies required to form a U.S. Intermediate Holding Company ("IHC") subject to enhanced prudential standards. One potential asset threshold for requiring the formation of an IHC could be combined U.S. assets (excluding U.S. branch and agency assets) of $50 billion or more, including consideration of off-balance sheet exposure at the U.S. top-tier holding company. Such an approach would both provide a more complete picture of an institution's U.S. risk profile by including off-balance sheet exposures and better target the Proposed Rule on the financial institutions most likely to pose systemic risk to the U.S. economy. The mechanism for assessing an institution's off-balance sheet risk could be the Risk-Weight Assets entry (Line 4) of the FR Y-7Q form, which provides valuable information regarding an institution's consolidated risk profile, inclusive of consolidated off-balance sheet exposure. However, the Risk-Weighted Assets entry (Line 4) would need to be supplemented with additional information regarding the institution's derivatives and off-balance sheet exposure, particularly in the areas of guarantees, credit derivatives, interest rate, foreign exchange, equity, and commodity contracts, or other material off-balance sheet exposures.

B. Inclusion of U.S. Subsidiaries

Question 8 (77 Fed. Reg. 76638) requests comment on whether the Board should provide an exclusive list of exemptions to the U.S. IHC requirement or provide exceptions on a case-by-case basis. DFS recommends that the Board establish a hybrid approach that does both in order to take into account the varying nature of the operating subsidiaries within the U.S. footprint (inclusive of operating subsidiaries that may exist under the consolidated branch/agency network). The Board should establish an exempt list of certain types of operating subsidiaries from inclusion under the U.S. IHC, while also creating a case-by-case application process for those subsidiaries that fall outside the categories of the exempt listing.

Certain types of operating subsidiaries should be exempted from the U.S. IHC outright. For example, although DFS permits its licensed foreign branches to have operating subsidiaries, in practice very few New York FBO branches have operating subsidiaries. Those that do exist are limited to narrow functions—*i.e.*, to manage foreclosed properties (and limit liabilities) arising from defaulted loans or to consolidate back-office functions to reduce cost, increase efficiency,

better allocate resources, and improve customer service. Many of these subsidiaries are short-lived, single purpose entities that are engaged in orderly wind-down of business transactions or segments and are bankruptcy remote. Typically, the functions performed by these subsidiaries are closely tied to the branch's core business and are supervised by DFS through its foreign branch licensing authority. As such, these types of operating subsidiaries should be exempted from the U.S. IHC.

DFS also recognizes, however, that operating subsidiaries may be numerous and varied across the FBO's U.S. footprint, with many subsidiaries not receiving the direct supervision of a primary regulator (*e.g.*, leasing companies, special purpose vehicles ("SPVs")). That is why we recommend that FBOs also be able to apply for exemptions on a case-by-case basis. Such an approach would allow for flexibility in supervisory oversight as business strategies that give rise to these (and other) types of operating subsidiaries evolve.

Moreover, while domestic financial institutions are required to hold capital at the bank holding company as well as any functional subsidiary, FBOs are required to hold capital at three levels—the parent company, the intermediate holding company, and certain functional subsidiaries. Because of the lack of uniform capital requirements at the consolidated level and all the functional subsidiaries, the judicious use of an entity exemption process could level the playing field by excluding certain subsidiaries from the IHC's capital calculations. In some instances, it may be more appropriate to place capital at the FBO's functional subsidiaries.

C. Consolidated Branch/Agency Network Approach

The Proposed Rule excludes FBO branches and agencies from inclusion in the U.S. IHC but maintains that branches and agencies be subject to enhanced prudential supervisory standards at a consolidated network level. DFS agrees that branches and agencies should not be included in the U.S. IHC. Branches and agencies are closely tied to their parent companies and are not part of the U.S. capital structure. DFS also agrees that branches and agencies should be subject to enhanced prudential supervision. DFS has certain concerns, however, with respect to the consolidated branch/agency network approach proposed by the Board.

Because branches and agencies are separately licensed, supervised, and examined by a federal or state licensing authority, they follow a separate resolution path outside the single-entry resolution proposal. DFS's supervisory powers could be invoked at the individual branch or agency level before any institutional weaknesses are quantified and noted at the consolidated branch/agency network level and will play a significant role in any resolution involving a New York-licensed foreign branch, as is detailed further below. We urge the Board to ensure that the Proposed Rule leaves intact what have proven to be effective state supervisory tools in this area.

i. Due To/From

DFS closely monitors the "Due To/From" accounts of the individual branches and agencies we regulate. Although a stable "Due To" position at the branch or agency level is the optimal regulatory scenario, we understand that business is not—and cannot—be conducted in such a restricted manner in every instance. As a result, our focus is not just on the level of the "Due

To/From" position, but also its volatility—*e.g.*, whether the account swings from a "Due To" to a "Due From" position overnight, the size of swings between the "Due To" and "Due From" positions, and whether volatility occurs on a weekly, month-end, or quarterly basis. We typically also analyze whether the "Due From" position is arising from within U.S. operations or as part of a larger cross-border business strategy of the FBO.

Due to the numerous questions and uncertainty surrounding the management of the "Due To/From" position, we typically engage in a dialogue with individual branches and agencies on this issue, with a particular focus on corporate governance. We inquire, amongst other things, about the business strategy surrounding the "Due To/From" position, the expected level and volatility of the position, and the beneficiaries of any "Due From" position (within or outside the United States), as well as the planned exit strategy out of a "Due From" position, including the anticipated timeframe. Where "Due To/From" volatility is high and corporate governance surrounding the "Due To/From" position is weak, DFS may access its supervisory toolbox. DFS may require a branch or agency to implement a plan for the "Due To/From" position, mandate a "Due To" position, or require asset maintenance.

Without an understanding of the corporate governance surrounding the "Due To/From" position of any particular branch or agency, we do not believe the "Due From" levels set forth by the Board's proposal are prudent. The Proposed Rule requires branches and agencies "to remain in a net due to funding position or a net due from funding position with non-U.S. affiliated entities equal to no more than 25 percent of third-party liabilities of its combined U.S. operation on a daily basis." (77 Fed. Reg. 76653) Unless institutions demonstrate an effective management and exit strategy from their "Due From" position, we recommend that a much lower percentage—*e.g.*, 5 or 10 percent—be allowed or that institutions be required to maintain a "Due To" position.

ii. Asset Maintenance

The Proposed Rule subjects the U.S. branch and agency network to a 108 percent or 105 percent asset maintenance requirement, depending on the size of the FBO. (77 Fed. Reg. 76662–76663) Question 75 (77 Fed. Reg. 76663) requests comment on whether the Board should consider alternative asset maintenance requirements. We understand that the Board views asset maintenance primarily as a method for injecting stability into the financial system. As a functional regulator, a key concern is protecting third-party liability holders, *i.e.*, New York third-party liability holders.

As an initial matter, DFS believes asset maintenance requirements should be the same irrespective of whether an FBO has assets greater than $50 billion or between $10 billion and $50 billion. We believe that factors such as the risk profile of the branch or agency and its rate of asset value deterioration provide a better guide as to whether the asset maintenance percentage should be increased than its total asset size.

Further, DFS is concerned that the proposal seeks to calculate asset maintenance on a consolidated branch/agency network basis. This fails to consider that eligible assets may reside in different state jurisdictions or those assets in different jurisdictions may be experiencing

varying rates of deterioration under times of stress. For example, the Superintendent might seek to impose asset maintenance on an FBO's New York branch due to deteriorating conditions there—notwithstanding the fact that the FBO's other state branches, over whose assets the Superintendent has no authority, are not experiencing financial distress. The Proposed Rule is unclear as to how its approach would operate in conjunction with the state's existing authority in this area.

Question 76 (77 Fed. Reg. 76663) requests comment on whether the proposed asset maintenance requirements pose any conflict with any asset maintenance requirements imposed on a U.S. branch or agency by another regulatory authority. In New York, DFS may invoke asset maintenance as part of its supervision under NYS Banking Law 202-B. This is a vital and flexible tool that allows DFS to impose state asset maintenance levels much sooner and at much higher levels, if necessary, than the Proposed Rule. The Proposed Rule is unclear as to whether the consolidated branch/agency network asset maintenance requirements would pre-empt any state asset maintenance requirements. DFS urges the Board to ensure that the State's power to impose asset maintenance remains intact and without restriction. This will enable the Superintendent to act quickly and nimbly if a New York-licensed branch or agency experiences financial distress. Additionally, it will prevent the New York branch or agency from acting as a contagion to the institution as a whole or to other jurisdictions, particularly those located in the United States.

II. Liquidity

Questions 20 and 21 (77 Fed. Reg. 76643) request comment on whether the Board's approach to enhanced liquidity standards for FBOs with significant U.S. operations is appropriate or whether other approaches would more effectively enhance liquidity standards.

The Basel Committee on Banking Supervision ("BCBS") announced in January 2013 that it planned to review and recalibrate its Liquidity Coverage Ratio ("LCR") standard under Basel III, whose implementation at the national level is expected on a phased-in basis beginning on January 1, 2015. We believe it would be reasonable for the Board to await the outcome of that review before adopting any additional liquidity buffer requirement. That would provide an opportunity for clarity and harmonization of standards, which will enable institutions to manage their liquidity requirements in a more efficient and orderly manner than they could under an inconsistent patchwork of multiple standards and definitions. In the *interim*, liquidity requirements may still be imposed by the functional regulator through the ordinary supervisory process—particularly as may be applicable through the U.S. branch and agency network. As illustrated at the branch/agency network, the functional regulator habitually monitors liquidity and typically mandates a contingent funding plan that takes into account liquidity needs long before signs of institutional stress are evident.

Finally, the Proposed Rule requires that the U.S. branch and agency network hold a 30-day liquidity buffer in the United States during the initial remediation stage (Level 2). (77 Fed. Reg. 76635) We believe it would be more appropriate to tailor the liquidity buffer to the individual institution's stress situation at the time early remediation is invoked, which could be as early as Level 1 remediation. An individually tailored liquidity buffer, which may be larger or smaller

than any predefined liquidity buffer, would provide greater flexibility to the functional regulator than a "one-size-fits-all" approach and result in a more efficient use of liquidity under "business as usual" circumstances.

III. Single-Counterparty Credit Limits

Questions 35 to 39 (77 Fed. Reg. 76654–76655) request comment on the Board's proposal to impose single-counterparty credit limits on FBOs that exceed the $50 billion asset threshold. We believe the application of the single-counterparty credit limit to state-licensed branches of FBOs is unnecessary because they already are subject to state lending limits—*i.e.*, New York Banking Law § 202-f.

In addition, we are concerned about the potential financial impact of an institution's non-compliance with single-counterparty credit limits—in particular, when non-compliance results from an easily-correctible technical exception. Section 252.245(c) mandates that if either the U.S. IHC or the FBO is not in compliance with the single-counterparty credit limits then neither the U.S. IHC nor the FBO's combined U.S. operations, inclusive of the branch/agency network, may engage in any additional credit transactions with such a counterparty without a determination by the Board that such credit transactions are necessary or appropriate to preserve the safety and soundness of the FBO or U.S. financial stability. (77 Fed. Reg. 76693) As such, non-compliance could trigger an abrupt halt in counterparty lending, slowing or eliminating transactions necessary for financial intermediation and economic activity. Instead, we recommend that institutions be required to report breaches of single-counterparty credit limits to the Board and their functional regulators, along with a plan of how and when compliance will be achieved. Transactions to counterparties should continue to flow unless the Board or functional regulator determine that (1) the submitted plan is deemed unacceptable, (2) the institution has entered a stage of early remediation, (3) the additional credit transactions are deemed to threaten the safety and soundness of the FBO, or (4) the Board determines that the additional transactions are deemed a threat to U.S. financial stability.

IV. Remediation

A. Remediation Levels

Question 98 (77 Fed. Reg. 76672) requests comment on the proposed actions that would occur at each level of remediation and inquires whether any additional or different restrictions should be imposed by the Board on distressed FBOs or their U.S. operations. The Proposed Rule envisions four remediation levels: (1) heightened supervisory review, (2) initial remediation, (3) recovery, and (4) recommended resolution. DFS would propose five slightly different remediation levels: (1) heightened supervisory review, (2) initial remediation, (3) recovery, (4) orderly wind-down (voluntary or involuntary), and (5) liquidation.

The levels proposed by DFS would more accurately reflect the Superintendent's remediation ability. Prior to liquidation, including during orderly wind-down, DFS maintains its full ability to implement all tools within its supervisory toolbox. Once the Superintendent takes possession of a banking organization for purposes of liquidation under NYS Banking Law 606, DFS is

bound by statutory procedures designed to ensure that local-jurisdiction assets are used to satisfy New York third-party liability holders. Accordingly, certain critical banking activities become prohibited—*e.g.*, U.S. dollar clearing can take place during orderly wind-down, but not liquidation.

The inclusion of an additional remediation level for orderly wind-down, which would be reflected in an institution's resolution plan, also would provide transparency and clarification of potential remediation outcomes, promoting market stability over the long run. In contrast, a swift jump from recovery to liquidation could lead to a lack of market confidence.

B. Automatic Remediation Triggers

DFS agrees that early remediation triggers for FBOs are necessary, but urges caution with respect to setting automatic, as opposed to discretionary, triggers. In order to maintain flexibility for institutions and state regulators to address specific challenges as they arise, the Board should emphasize that early remediation triggers are guidelines that may be invoked at any stage, depending on the circumstances. For example, asset maintenance may be necessary as early as Level 2 (Initial Remediation) and a review of U.S. management compensation and bonus structure may be required prior to reaching Level 3 (Recovery).

C. Resolution Planning

Any remediation triggers imposed on FBOs should be incorporated into the resolution plans of FBOs. We also recommend, based on our experience regulating foreign branches and agencies, that resolution plans be stress-tested specifically for these triggers in order to better prepare institutions for their impact. For example, in the context of our own supervisory toolbox, we have advised FBOs that asset maintenance may be imposed at the branch level at increasing percentages to recognize a scenario in which a rapid devaluation of assets occurs. By asking FBOs to stress-test their resolution plans for various asset maintenance levels, we have learned how our supervisory tools influence decision-making and at what level. More importantly, such stress-testing provides insight as to the point at which supervisory tools become extraneous because they can no longer make the institution's resolution plan viable.

V. Corporate Governance

Questions 57 to 66 (77 Fed. Reg. 76658–76659) request comment on various aspects of the Board's proposed corporate governance rules for FBOs. DFS fully supports the Board's efforts to codify recent supervisory trends in this area, including but not limited to the requirement of a U.S. risk committee for FBOs with global assets of $10 billion or more and a U.S. chief risk officer for FBOs with combined assets of $50 billion or more.

A. U.S. Risk Committee and Alternatives

DFS fully supports the Board's proposal requiring FBOs with global assets of $10 billion or more to form a U.S. risk committee.

Question 59 (77 Fed. Reg. 76659) requests comment on whether the Board should consider, as an alternative to the proposed U.S. risk committee requirement, requiring each FBO with combined assets of $50 billion or more to establish a risk management function solely in the United States, rather than permitting the U.S. risk management function to be located in the company's head office. In our experience, the location of the U.S. risk management function is less important than its effectiveness and accessibility to U.S. operations and U.S. supervisors or regulators.

This notwithstanding, were the Board to adopt the alternative proposed in Question 59, DFS agrees that it is appropriate for FBOs with combined assets of $50 billion or more to maintain a risk function in the United States rather than in the company's head office. As a practical matter, the vast majority of FBOs already employ "country risk" functions in some form, depending on their size and complexity, with very large FBOs implementing "regional risk" management functions that encompass areas as large as the Americas.

B. U.S. Chief Risk Officer

DFS fully supports the Board's proposal requiring FBOs with combined U.S. assets of $50 billion or more to appoint a U.S. chief risk officer. We believe that the U.S. chief risk officer should have significant stature within the organization and that his or her performance evaluation be independent of U.S. operations and business lines.

We also agree that the U.S. chief risk officer should oversee regular meetings with supervisory staff, inclusive of functional regulators, and develop appropriate processes and systems for identifying and reporting U.S. risks and risk management deficiencies. In addition, we recommend that the Board's final rule provide guidance concerning the escalation procedures to be followed by the U.S. chief risk officer when U.S. risk levels accelerate rapidly or when significant U.S. risk management deficiencies arise. In such circumstances, the U.S. chief risk officer should be required to notify the FBO's executive management and board of directors and also inform the FBO's functional federal and state regulators about any concerns—in particular if these concerns fail to be addressed through the internal escalation process.

Question 70 (77 Fed. Reg. 76660) seeks comment on whether the Board should consider specifying by regulation the minimum qualifications, including educational attainment and professional experience, for a U.S. chief risk officer. DFS believes that the U.S. chief risk officer should have significant education and experience in risk management and be well versed in U.S. legal and regulatory compliance requirements, including supervisory expectations. Practically speaking, however, the number of candidates qualifying for these positions in the initial period will be limited in number and in high demand. As such, DFS would utilize the supervisory process to assess the quality of prospective candidates, rather than impose specific minimum qualifications by regulation. This will enable FBOs some flexibility in finding and developing qualified candidates from within the organization or from outside sources. In light of the potential challenges associated with finding qualified candidates, DFS would permit FBOs to have expatriates serve or to hire locally.

VI. Implementation Period

Questions 4 and 5 (77 Fed. Reg. 76637) request comment on the challenges associated with the phase-in schedule for the proposed requirements and any considerations the Board should address in developing any phase-in of the proposed requirements. Under the Proposed Rule, FBOs that meet the asset threshold criteria as of July 1, 2014 are required to comply with the proposed requirements by July 1, 2015. Any FBOs that meet the criteria after July 1, 2014 must be compliant 12 months after reaching the consolidated asset threshold.

DFS believes that certain portions of the proposed enhanced supervision standards, such as the requirements surrounding corporate governance, could be implemented even sooner, while other aspects, such as the legal entity realignment prompted by the U.S. IHC requirement, which will require significant effort on the institutions' part, may require a more extended time period. In particular, FBOs qualifying for enhanced supervision should be able to present a compliance plan within 180 days of reaching the designated threshold. Similarly, corporate governance requirements should be implemented within a 12-month period after an FBO reaches the consolidated asset threshold.

This recommendation of planning and early implementation of corporate governance recognizes that the potential risk to the U.S. financial system already exists when the threshold is reached. A waiting period of 12-months is too long a period not to receive information about that risk or how it will be addressed. Early implementation of corporate governance measures will also go a long way to keeping that U.S. risk in check. As we are all aware, institutions' risk profiles change rapidly so that the process of planning needs to be dynamic to capture the FBO's ever-changing risk profile.

Conclusion

DFS appreciates the efforts on the part of the Board to implement rules for the enhanced supervision of FBOs pursuant to Dodd-Frank and hopes that its comments regarding the Proposed Rule prove useful in that process. We would welcome the opportunity to provide additional information from the perspective of a New York regulator and to assist the Board in amending the Proposed Rule to reflect our experience as a longtime regulator of FBOs.

Sincerely,

Benjamin M. Lawsky
Superintendent of Financial Services