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regs.comments@federalreserve.gov

Ann E. Misback
Secretary
Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Re: Federal Reserve Policy on Payment System Risk; U.S. Branches and Agencies of Foreign Banking Organizations (Docket No. OP-1589)

Dear Ms. Misback:

The Institute of International Bankers ("IIB") appreciates the opportunity to comment on the changes proposed by the Board of Governors of the Federal Reserve System (the "Board") to the procedures governing the provision of intraday credit to U.S. branches and agencies of foreign banking organizations ("FBOs").[1] Given the Proposal's potential impact on their U.S. branches' net debit caps and eligibility to request a streamlined procedure to obtain maximum daylight overdraft capacity (the "Streamlined Procedure"), IIB member banks are keenly interested in the Proposal.

The Proposal would revise Part II of the Board's Payment System Risk ("PSR") Policy to remove references to an FBO's Strength-of-Support Assessment ("SOSA") rankings and financial holding company ("FHC") status as bases for determining a U.S. branch's net debit cap and maximum daylight overdraft capacity (the "Max Cap"). In their place, the Board proposes an approach based on an FBO's capital ratios as determined under home country standards. Specifically, an FBO whose home country adheres to the Basel Capital Accords ("BCA") would base its creditworthiness self-assessment on (i) its U.S. Operations Supervisory Composite Rating (the "U.S. Composite Rating") and (ii) the "prompt corrective action" ("PCA") designation that would apply to the FBO if it were subject to the Board's Regulation H (the

[1] 82 Fed. Reg. 58764 (Dec. 14, 2017) (the "Proposal"). Capitalized terms used in this letter have the meanings ascribed in the Proposal, except where otherwise indicated or required by the context. Hereinafter, U.S. branches and agencies of FBOs will be collectively referred to as "U.S. branches".

"Equivalent PCA Designation"). The FBO would determine its Equivalent PCA Designation by calculating its ratios for total risk-based capital, tier 1 risk-based capital, common equity tier 1 risk-based capital and leverage under its home country standards. FBOs whose home countries do not adhere to the BCA would be ineligible for the self-assessment process and would be required to perform a full assessment.

Only FBOs whose Equivalent PCA Designation is "well-capitalized" would be eligible to request the Streamlined Procedure; those that are not well-capitalized would be required to use the general procedure for requesting a Max Cap. In addition to these revisions, the Proposal would prescribe for all FBOs, whether or not eligible for the self-assessment process, a U.S. Capital Equivalency measure equal to 10 percent of their worldwide capital.

The Board believes that the Proposal would better align FBOs' net debit caps to their actual usage of intraday credit and would not constrain their U.S. operations. Recognizing that in some instances the revised procedures would reduce an FBO's net debit cap, the Proposal points to the Streamlined Procedure as a "straightforward process" for obtaining collateralized credit to offset the reduction.

I. SUMMARY

We do not object to the removal of references to SOSA rankings and FHC status from the PSR Policy, and as a general proposition we do not object to incorporating the Equivalent PCA Designation into the PSR Policy. We nevertheless have several significant concerns with the Proposal. As discussed below:

1. The Proposal would only exacerbate the existing PSR Policy's clear inconsistency with the longstanding U.S. policy of national treatment. Imposing a fixed 10 percent U.S. Capital Equivalency measure on all FBOs would significantly reduce many FBOs' net debit caps, thereby expanding the gap in the availability of intraday credit for FBOs compared to U.S. banks. Everything else being equal, there is no reason why any FBO should be placed in a worse position as a result of the Proposal.

2. The Proposal underestimates the adverse effects the reduction in U.S. Capital Equivalency to 10 percent would have for FBOs' U.S.-dollar clearing activities, which in turn would increase transactional costs for customers, and reduce liquidity and increase operational risk in the payment system.

3. Application of the risk-based ratios for purposes of the Equivalent PCA Designation is a straightforward process, but there are critical ambiguities regarding application of the leverage ratio. Given the impact the Equivalent PCA Designation can have on an FBO's net debit cap and its eligibility for the Streamlined Procedure, it is essential to clarify these ambiguities in a manner consistent with the underlying intention to rely on home country standards, minimize burden and facilitate the determination of the net debit cap.

To address the concerns regarding fixing the U.S. Capital Equivalency measure for all FBOs at 10 percent, we recommend that the Board retain the existing categories, so that, all else being equal, any reduction in an FBO's net debit cap would be attributable only to a deterioration in its creditworthiness, as measured by its Equivalent PCA Designation. This approach would maintain the status quo from a national treatment perspective and significantly mitigate any adverse impact on liquidity and risks to the payment system.

Maintaining the existing U.S. Capital Equivalency measures should be coupled with the Board's periodic assessment of the impact the reduction in the Federal Reserve's balance sheet will have on excess reserves and the implications for FBOs' intraday credit requirements, market liquidity and operational risk to the payment system. Such a phased-in approach would enable a more informed and deliberate assessment of the PSR Policy implications of changes in the market and their impact on intraday credit needs.

Regarding the Equivalent PCA Designation, we urge the Board to clarify that its determination is based solely on an FBO's home country leverage ratio, which corresponds to the U.S. supplementary leverage ratio – that is, the U.S. leverage ratio has no relevance to the determination, and the appropriate PCA leverage measure is the FBO's home country leverage ratio. Accordingly, for FBOs that otherwise would qualify as well-capitalized or adequately capitalized on the basis of their home country risk-based capital ratios, the applicable leverage ratio would be 3 percent or greater.

At a minimum, it is essential to provide FBOs a transition period to adjust to the proposed changes. In particular, there is a very real need for FBOs to assess the potential impact of the Designated PCA Equivalency categories, and what for many would be a significant reduction in their net debit cap, on their payment activities. We recommend a delay in the effective date of at least 12 months from publication of the Federal Register notice of the Board's final action. However structured, the implementation of the revisions to the PSR Policy should ensure that FBOs retain their existing net debit caps and eligibility for the Streamlined Process for at least one year

II. DISCUSSION

A. The Proposed Reduction of the U.S. Capital Equivalency Measure Is Contrary To the Principle of National Treatment. Counterintuitively, It Would Have the Greatest Adverse Impact on FBOs Which Are Considered the More Creditworthy under the Existing PSR Policy

Under the existing PSR Policy, FBOs considered to be more creditworthy, and thus eligible for higher intraday credit limits, have a U.S. Capital Equivalency of either 35 percent or 25 percent of worldwide capital. For those considered relatively less creditworthy the figure is 10 percent of worldwide capital or 5 percent of the U.S. branch's net due to related depository institutions as reported on FFIEC Form 002. By comparison, U.S. banks generally have a capital measure equal to 100 percent of their worldwide risk-based capital.

The Proposal would apply a fixed 10 percent U.S. Capital Equivalency for all FBOs, thereby eliminating a critical, risk-based component from the determination of net debit caps. Counterintuitively, the impact of this reduction would be especially severe for those FBOs viewed under the existing PSR Policy as the more creditworthy. These FBOs would still benefit, relative to others because of their net debit cap multiples (which, we understand, would remain the same), but the Proposal would reduce their net debit cap by either approximately 70 percent (for those whose existing U.S. Capital Equivalency measure is 35 percent) or 60 percent (for those whose existing measure is 25 percent). Such a substantial reduction could significantly constrain their access to intraday credit in the future and force them to obtain a Max Cap to make up the difference. Yet even for these FBOs, only those designated well-capitalized would be eligible for the Streamlined Procedure.

By comparison, under the existing PSR Policy, a U.S. bank meeting reasonable safety and soundness standards may, under the de minimis provision and without performing a self-assessment, benefit from a net debit cap equal to 40 percent of its total risk-based capital, provided that a resolution of the board of directors is provided to the Federal Reserve. Under a best-case scenario, a self-assessed U.S. bank's net debit cap could be 225 percent of its risk-based capital (the product of its 100 percent capital measure and 2.25 cap multiple).

However, the best-case scenario for an FBO under the existing PSR Policy results in a net debit cap of only 78.75 percent of its worldwide capital (the product of its 35 percent capital measure and 2.25 cap multiple). Under the Proposal, the maximum net debit cap for such an FBO would be 22.5 percent of its worldwide capital (the product of the (reduced) 10 percent capital measure and 2.25 cap multiple), which is less than the net debit cap of a U.S. bank that qualifies only for a de minimis cap.

By thus substantially expanding the already-significant gap in access to intraday credit on comparable terms between FBOs and U.S. banks, the Proposal would only exacerbate FBOs' competitively disadvantageous position vis-à-vis U.S. banks. The rationale supporting this clear departure from the principle of national treatment should be reconsidered. Structurally, a U.S. branch is an office of an FBO, and as such the U.S. branch can call on the global resources of the FBO to support its liabilities, including its intraday exposure to the Federal Reserve.[2] The Proposal highlights the special legal risks to the Federal Reserve presented by the extension of intraday credit to U.S. branches because of the differences in insolvency laws in various FBOs' home countries and recites the explanation of the Board's concerns arising from these differences as articulated in 2001. However, no consideration is given to the extensive and

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[2] Reflecting this structure, the volume and value of payments flowing through a U.S. branch in many instances are more akin to those of U.S. banks whose asset size is significantly greater than that of the type of U.S. banks referenced in the Proposal (see 82 Fed. Reg. at 58767).

multi-faceted regulatory and supervisory measures that have been implemented in countries outside the United States during the intervening period, and in especially in the aftermath of the financial crisis, to strengthen internationally active banks' resiliency and resolvability, nor is account taken of the robust oversight of U.S. branches by their U.S. licensing authorities.

Further, this perspective does not take into account the protections afforded to third-party creditors of U.S. branches, including the Federal Reserve, under applicable federal and state "ringfence" provisions, pursuant to which third-party creditors acquire by operation of law a priority claim to the distribution of the FBO's assets in the state in which the branch is located (if the branch is state-licensed (in New York, for example)) or in the U.S. (if the branch is licensed by the OCC) upon the relevant authority taking possession of the branch. In addition, it does not consider the enhancements to the liquidity, liquidity risk management, and overall safety and soundness of U.S. branches resulting from the actions by the Board pursuant to the Dodd-Frank Act, as codified in Regulation YY. The required liquidity buffers, supported by enhanced risk management practices, should provide additional comfort regarding the creditworthiness of U.S. branches.

Given these considerations, we do not believe the proposed reduction in the U.S. Capital Equivalency of FBOs is merited, especially for those which under the existing PSR Policy are sufficiently creditworthy to qualify for a self-assessed net debit cap and those that would be well-capitalized or adequately capitalized under the Proposal. The special legal risks presented by FBOs cited in the Proposal are not greater than at the time when the existing U.S. Capital Equivalency categories were established and, indeed, as discussed above, they have since been mitigated further by the extensive regulatory and supervisory measures implemented by home country and U.S. authorities during the intervening period. Even assuming there would be no overall adverse impact (and we believe in fact there would be), the question remains why, everything else being equal, any FBO should be placed in a worse position as a result of the removal of references to its SOSA ranking and FHC status and the addition of the Equivalent PCA Designation to the methodology.

The Proposal presents no compelling policy rationale for the reduction in the U.S. Capital Equivalency measure. Accordingly, we believe the existing measures should be retained. At a minimum, there should be no change in the U.S. Capital Equivalency measure of FBOs whose Equivalent PCA Designation would be well-capitalized or adequately capitalized.

B. The Proposal Underestimates the Impact of the Reduction in FBOs' U.S. Capital Equivalency on Their U.S.-Dollar Clearing Activities; Further Consideration Should Be Given to the Potential Adverse Consequences To the Payment System and Market Liquidity Resulting from Reduction in the U.S. Capital Equivalency Measure

Reducing its U.S. Capital Equivalency would increase pressures on an FBO's net debit cap and complicate the management of its intraday exposures to stay within its limits. The impact would be especially pronounced in the case of U.S. branches that clear significant volumes of cross-border U.S.-dollar payments, including those generated by the head office and non-U.S. branches, foreign affiliates, and their respective customers. For example, many FBOs experience substantial discontinuities in their intraday payment flows, with requests received from overseas to make payments concentrated earlier in the day and their receipt of payments to cover these amounts occurring later in the day.

To manage the resulting intraday overdraft position within the constraints of its net debit cap, a U.S. branch may "throttle" its payment activity throughout the day to stay within its cap, thereby reducing the fluidity of intraday flows, increasing the risk of late-day operational disruptions, and diminishing liquidity. Relying on collateral to cover intraday exposures is costly to the U.S. branch, and it may result in increased transactional costs to customers. Moreover, depending on the circumstances, there may be constraints on the availability of sufficiently high-quality liquid assets, which could increase systemic operational risk.

Looking forward, we anticipate that these pressures will intensify as excess reserve levels decrease in connection with the reduction of the Federal Reserve's balance sheet. The Proposal concludes that a reduction in excess reserves would not constrain most FBOs' U.S. operations. As explained in the Proposal:

> The Board has reached this conclusion by comparing FBOs' projected net debit caps under the proposed fixed-rate capital measure calculation to FBOs' actual daylight overdrafts between 2003 and 2007, when FBOs generally maintained lower reserves. The Board's comparison indicates that, between 2003 and 2007, only four of the 29 FBOs that currently maintain a cap category higher than exempt-from-filing regularly incurred daylight overdrafts that exceeded their projected net debit caps, while five of the 29 FBOs incurred daylight overdrafts that exceeded their projected net debit caps in limited instances. Twenty of the 29 FBOs never incurred daylight overdrafts that exceeded their projected net debit caps.[3]

This explanation is problematic for two reasons. First, it appears to accept as a given that it is appropriate to reduce certain FBOs' net debit caps so long as there is no overall adverse impact on payment activities. As discussed above, we question the assumption that there would be no adverse impact, and we believe there is a real risk that the Proposal, perversely, would penalize those FBOs which, under the existing procedures, are considered to present the lesser risk to the Federal Reserve. The Proposal offers no insight into why such a result, which would profoundly depart from national treatment, is necessary or appropriate.

Second, it appears to assume that the payment levels in 2003 – 2007 are predictive of future payment levels and that reserve levels will revert to those in the prior period. In both cases, the proposition is not self-evident, and in either case if events prove contrary to the

[3] 82 Fed. Reg. at 58768 (footnote omitted).

assumption the results could significantly alter the analysis and related policy conclusions. Given the historically high levels of excess reserves in the aftermath of the financial crisis, and the uncertainties inherent to predicting the scope and impact of their reduction, we would urge the Board to give further consideration to this matter and the potential consequences of imposing on FBOs such an immediate and substantial reduction in their net debit caps.

Specifically, we recommend that the Board retain the existing U.S. Capital Equivalency measures and periodically review whether they should be reduced. This review would be undertaken on a forward-looking basis and consider the actual impact the reduction in excess reserves has on FBOs' intraday credit requirements and market liquidity. As discussed above, there is no compelling, immediate need to reduce FBOs' net debit caps and push them toward greater reliance on collateralized intraday credit, especially since those measures would have the greatest adverse impact on FBOs treated as more creditworthy under the existing PSR Policy. The proposed phased-in approach would enable a more informed and deliberate assessment of the PSR Policy implications of changes in the market and their impact on intraday credit needs.

C. In Determining an FBO's Equivalent PCA Designation, Reference Should Be Made Only To the Supplementary Ratio and Not To the U.S. Leverage Ratio, and, Consistent with that Approach, The Leverage Measure under the PCA Regime Should Be Calibrated by Reference To The Home Country Leverage Ratio

The Board believes that it will not be burdensome for FBOs to calculate an Equivalent PCA Designation on the basis of home country capital standards. This belief appears to be based on the proposition that the information necessary to make the calculation is readily available – because all of it is already reported on Form FR Y-7Q by FBOs with total consolidated assets of $50 billion or more, and those with total consolidated assets less than $50 billion report on Form FR Y-7Q all required information except the common tier 1 capital ratio, which the FBO is required to calculate if its home country adheres to the BCA.

We agree that the Equivalent PCA Designation should be based on home country capital standards. We also agree that under the Proposal the identification of home country risk-based capital ratios and their incorporation into the Equivalent PCA Designation should not be burdensome. However, there are critically important ambiguities regarding how the home country leverage ratio should be applied. Specifically, the PCA categories apply various combinations of the U.S. leverage ratio and the U.S. supplementary ratio,[4] whereas the corresponding measure for FBOs whose home countries adhere to the BCA is the supplementary leverage ratio. Application of anything other than the home country leverage ratio for these purposes could significantly increase burden and needlessly complicate FBOs' determination of their net debit caps. Nothing in the Proposal suggests either of these consequences is intended.

[4] For example, the well-capitalized PCA category is based on the U.S. leverage ratio and, for banks that are subsidiaries of a U.S. global systemically important bank holding company, the U.S. supplementary leverage ratio. Similarly, the adequately capitalized category is based on the U.S. leverage ratio and, for advanced approaches U.S. banks, the U.S. supplementary ratio.

We urge the Board, consistent with reliance on capital ratios as determined under home country standards and in order to ensure the least burdensome determination of the Equivalent PCA Designation, to clarify that determination of the Equivalent PCA Designation is based solely on the FBO's home country leverage ratio, which corresponds to the U.S. supplementary leverage ratio – that is, the U.S. leverage ratio has no relevance to the determination, and the appropriate PCA leverage measure is the FBO's home country leverage ratio. Consistent with this approach, for FBOs that otherwise would qualify as well-capitalized or adequately capitalized on the basis of their home country risk-based capital ratios, the applicable leverage ratio would be 3 percent.

D. At A Minimum, It Is Essential To Provide A Transition Period To Enable FBOs To Adjust To the Proposed Changes

The Proposal solicits comment on whether a transition period should be provided. Given the concerns discussed above, and in particular the need for FBOs to assess the potential impact of the Designated PCA Equivalency categories, and what for many would be a significant reduction in the U.S. Capital Equivalency measure, on their payment activities, we recommend, a delay in the effective date of at least 12 months from publication of the Federal Register notice of the Board's final action. However structured, the implementation of the revisions to the PSR Policy should ensure that FBOs retain their existing net debit cap and eligibility for the Streamlined Process for at least one year from adoption of the final action.

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We appreciate your consideration of our comments. Please contact the undersigned if we can be of further assistance.

Sincerely,

Richard Coffman
General Counsel