



April 15, 2013

Mr. Robert deV. Frierson
Secretary, Board of Governors of the Federal Reserve
20th Street and Constitution Avenue N.W.
Washington, D.C. 20551

Re: Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies (Regulation YY, Docket Number 1438, RIN 7100 AD 86)

Dear Mr. deV. Frierson:

Better Markets, Inc. (“Better Markets”)¹ appreciates the opportunity to provide comments to the Board of Governors of the Federal Reserve System (“Federal Reserve”) in response to the request for public comment in connection with the Notice of Proposed Rulemaking (“Proposed Rule”) published on December 28, 2012, in connection with the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”).

INTRODUCTION

Foreign banking organizations play an important role in the U.S. financial system. Their U.S. regulated subsidiaries, and their lightly regulated branch and agency networks, issue large amounts of short-term dollar liabilities, and use the proceeds to lend to U.S. and foreign firms and to buy dollar denominated assets. When these organizations are distressed and there are runs on their financing, as was witnessed in 2008-2009, the effects on U.S. financial markets can be significant.

Moreover, the risks to the U.S. government can be significant as well. When ranked by peak amounts borrowed from the Federal Reserve during the crisis, four of the ten largest borrowers were foreign banking organizations.²

¹ Better Markets is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular in the rulemaking process associated with the implementation of the Dodd-Frank Act.

² See <http://www.bloomberg.com/data-visualization/federal-reserve-emergency-lending/#/overview/?sort=nomPeakValue&group=none&view=peak&position=0&comparelist=&search=>.

Although the reach of U.S. financial regulation is limited, the Proposed Rule³ is intended to reduce these risks and costs by organizing all U.S. subsidiaries into intermediate holding companies, applying U.S. bank holding company capital requirements on these new holding companies, and applying liquidity rules to the holding companies and to the branch and agency networks.

If such modest regulations are not adopted, then foreign banking organizations operating in the U.S. will continue to expose U.S. taxpayers to the risk of having to bail them out, while allowing foreign banking organizations the competitive advantages that flow from evading soundness and stability regulations. For example, in 2011 Deutsche Bank reorganized its U.S. operations, ending the bank holding company status of its Taunus subsidiary. In 2011 Taunus had a Tier 1 risk-based capital ratio of -6.37 percent, and it clearly was looking for a way to continue avoiding capital requirements and other regulations at its U.S. subsidiary.⁴

While the Proposed Rule will help to mitigate some of the risks created by foreign banking organizations in the U.S., it needs to be strengthened. To be effective, leverage limits for all bank holding companies, including those housing foreign bank subsidiaries, must be stricter than those currently proposed. In addition, short-term borrowing ought to be limited in order to more effectively constrain run risk.

The role of foreign banks in the U.S. financial system

As Federal Reserve Governor Jerome Stein has pointed out, foreign banking organizations operating in the U.S. ("FBOs") play an important role in raising dollar funding for their foreign bank parents.⁵ This funding is often raised by issuing liabilities that are volatile:

"...the dollar liabilities of foreign banks have grown rapidly in the past two decades and now stand at about \$8 trillion, roughly on par with those of U.S. banks. A significant proportion of foreign banks' dollar liabilities are raised via U.S. branches, most of which are legally precluded from raising deposits insured by the Federal Deposit Insurance Corporation. The main source of funding for these branches, therefore, comes from uninsured wholesale claims such as large time deposits, making the cost and availability of such dollar funding highly sensitive to changing perceptions of these banks' creditworthiness."⁶

Foreign banks also raise dollar funding via short-term borrowing from other banks, central banks, and nonbank lenders such as money market funds, or by issuing liabilities in

³ Federal Register, Volume 77, Number 249, 76628.

⁴ Taunus FRY 9-C, December 31, 2011.

⁵ FBOs consist of agencies and branches of the parent bank, which are not chartered in the U.S. and cannot issue federally insured deposits, together with U.S. subsidiaries which can include chartered U.S. depositories, broker-dealers, finance companies, and other financial entities that are subject to U.S. regulation.

⁶ J. Stein (2012). Dollar Funding and Global Banks, December 17, *available at* <http://www.federalreserve.gov/newsevents/speech/stein20121217a.htm>.

their home currency and then swapping these funds for dollars via foreign exchange (“FX”) swaps.⁷ Like the uninsured deposits at their U.S. branches, these short-term borrowings are also subject to runs when there are questions about bank solvency or systemic risk.

The dollars raised by foreign banks are used to finance the purchase of U.S. assets and to finance dollar lending inside the U.S. and around the world.⁸ These loans and assets often have longer maturities than the dollar liabilities supporting them.

Demonstrated vulnerabilities of the foreign bank funding model

During the financial crisis the exposure of FBOs and their parent banks to short-term dollar funding became a serious problem. As questions about their solvency (and that of other banks) increased, interbank lending markets froze, money market funds withdrew from lending to foreign banks (including withdrawing time deposits from their U.S. branches), the FX swap markets were disrupted, and there were runs on ABCP issued by bank subsidiaries and off-balance-sheet special purpose vehicles.⁹

The run on short-term dollar funding caused foreign banks to increase lending rates and reduce lending in the U.S. and elsewhere. The banks were also faced with the prospect of selling large quantities of longer-maturity assets, funded with short-term dollar liabilities, at fire sale prices.¹⁰

The Federal Reserve acted to counter the short-term funding run in two ways. FBOs were given access to emergency lending facilities such as the Term Auction Facility, the Primary Dealer Credit Facility, and the Term Securities Lending Facility. In fact many FBOs borrowed heavily. For example, Figure 1 below shows that RBS and UBS borrowed substantial amounts from the Federal Reserve facilities over long periods. In addition, the Federal Reserve initiated large – and ultimately unlimited – foreign currency swap lines with foreign central banks, which allowed those banks to supply the dollar funds no longer available in the private FX swap market.¹¹

⁷ P. McGuire and G. von Peter (2009). The US dollar shortage in global banking, *BIS Quarterly Review*, March, fn. 10.

⁸ B. Bernanke et al. (2011). International Capital Flows and the Returns to Safe Assets in the United States, 2003-2007, Board of Governors of the Federal Reserve System, International Finance Discussion Papers, Number 1014.

⁹ McGuire (2009), op. cit., 58.

¹⁰ *Ibid*, 54, estimates that in mid-2007 short-term dollar funding of longer maturity assets by European banks was at least \$1.1 - \$1.3 trillion, and probably much larger.

¹¹ See the Better Markets comment letter “Notice of Proposed Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act”, June 6, 2011, *available at* <http://www.bettermarkets.com/sites/default/files/Treas-%20Comment%20Letter-%20ForEx%20Swaps%20and%20Forwards%20Under%20CEA%206-6-2011.pdf>, and incorporated here by reference.



Figure 1

RBS and UBS crisis borrowing from the Federal Reserve

Source: Bloomberg.com

The vulnerabilities of foreign banks that depend on short-term dollar funding resurfaced even more recently during the European sovereign debt crisis, which caused U.S. money market funds to reduce their exposure to euro-area banks significantly.¹² FBOs in the U.S. experienced a run on their deposits, mainly from U.S. money market funds, and as a consequence cut their commercial and industrial lending in the U.S.¹³ The Federal Reserve reauthorized dollar swap lines to several foreign central banks in November 2011, although they have not been used.

¹² V. Ivashina, D. Scharfstein, and J. Stein (2012). Dollar Funding and the Lending Behavior of Global Banks, Board of Governors of the Federal Reserve, International Finance Discussion Paper Number 2012-74.

¹³ R. Correa et al. (2012). Liquidity Shocks, Dollar Funding Costs, and the Bank Lending Channel During the European Sovereign Debt Crisis, Board of Governors of the Federal Reserve, International Finance Discussion Paper Number 2012-1059.

The implications of the Proposed Rule for the soundness and stability of the U.S. financial system

The Proposed Rule has three principal elements that relate to the demonstrated vulnerabilities created by FBOs:

- FBOs with sufficient asset size will be generally required to place all their U.S. financial entities – with the exception of branches and agencies of the foreign parent – in an intermediate holding company (“IHC”).
- The IHC will be required to be separately capitalized and meet capital standards that apply to U.S. bank holding companies.
- The IHC and its branch and agency network will each be subject to liquidity requirements. In the short-term, each will be required to calculate a “net stressed cash flow need” for a 30-day stress test horizon, and to hold highly liquid assets that can be sold to meet that need. In a future rulemaking the FBOs will be subject to the U.S. implementation of Basel III quantitative liquidity rules.

These elements of the Proposed Rule are essential steps to reduce the risks posed by FBOs. By requiring the formation of IHCs, the Proposed Rule makes it easier for the Federal Reserve to monitor all of the FBOs’ U.S. operations, and it creates the “single point of entry” necessary for resolving a failing FBO through the Orderly Liquidation Authority

By requiring the IHC to meet U.S. regulatory capital standards, the Proposed Rule ends total reliance on the foreign parent to keep the U.S. entities solvent in times of financial stress, which is entirely discretionary on the part of the foreign parent and may or may not occur. As we witnessed during the last crisis, the foreign parents came under stress at the same time and in the same way, making any such discretionary support at best difficult, if not impossible.

By establishing liquidity standards, the ability of FBOs to withstand small runs will increase, and the likelihood that they will need to draw on Federal Reserve emergency lending during larger shocks will decline.

Moreover, the Proposed Rule will reduce the competitive advantages that flow to FBOs from the current regulatory system. Under existing rules FBOs with equivalent domestic regulation are exempt from U.S. capital requirements and other rules. The events of the crisis showed, however, that many foreign banking organizations were even more thinly capitalized than U.S. banks. By requiring U.S. bank holding company capital rules for the FBO IHC – and assuming that the new requirements are not fully offset at the consolidated entity level – competitive conditions at the IHC will be brought closer to U.S. banks.

Both the leverage and liquidity requirements of the Proposed Rule should be strengthened

Although the Proposed Rule should help reduce shocks to credit supply and FBO dependence on federally provided emergency lending via FX swaps, it is likely to prove inadequate. For reasons we have explained in previous comment letters,¹⁴ the capital standards that have been proposed for U.S. banks are inadequate to assure that banks will remain solvent during periods of high financial stress. The required leverage ratio of 4 percent, for example, is inadequate, since we know from recent experience that losses at failed banks and bank holding companies were far larger. So the IHCs subject to the Proposed Rule, like U.S. bank holding companies with similar requirements, will remain vulnerable to failure.

Moreover, in times of financial stress, a low level of equity finance increases the probability of a run, even when the bank (or IHC) has not failed. Short term liabilities are generally not rolled over when there is doubt about the firm's ability to repay. Given the very heavy reliance of FBOs on short-term borrowing – not only in their branch and agency network, but in their broker dealers and elsewhere – the low equity requirements embedded in proposed capital rules are a serious shortcoming. This is a reason to raise the regulatory equity requirements for U.S. bank holding companies and IHCs together.

The Proposed Rule contemplates imposing Basel III quantitative liquidity standards on both the IHC and the branch and agency network of the FBO in the future. These changes should increase the ability of FBOs to survive a run by short-term creditors. The Basel III liquidity coverage ratio ("LCR") is intended to help an entity survive a run by mandating that it hold enough easily saleable assets to get it through a 30-day run by its creditors. The Basel Net Stable Funding Ratio ("NSFR") is intended to reduce funding of longer-maturity assets with short-term funding. It uses a weighting scheme to determine an amount of assets that need to be backed by longer-term liabilities.

However, both these Basel III measures appear inadequate to the scale of the runs that were experienced by FBOs during the crisis. The 30-day horizon in the LCR appears to be too short. As can be seen from Figure 1, RBS and UBS needed to borrow heavily from the Federal Reserve for more than a year to deal with their funding runs. The NSFR also appears inadequate to negate the effects of low levels of equity finance. A recent paper on bank failures during the crisis shows that the value of a large bank's NSFR, a key element of

¹⁴ See Better Markets comment letters "Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies", April 30, 2012, *available at* <http://www.bettermarkets.com/sites/default/files/FRS-%20CL-%20Enhanced%20Prudential%20Standards%204-30-12.pdf> and "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action; Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements; and Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule", October 22, 2012, *available at* <http://www.bettermarkets.com/sites/default/files/FRS,%20OCC,%20FDIC-%20CL-3nprs-%2010-22-12.pdf>, incorporated here by reference.

the Basel III liquidity rules, does not help explain the likelihood of failure, while leverage does.¹⁵

A simpler approach to the liquidity issue – setting an upper bound on the share of assets that can be financed by short-term borrowing – would reduce run risk more effectively. If it is set low enough, it could mitigate the effects of shortfalls in dollar funding caused by transient shocks to financial markets.

However, it is important to keep in mind that runs occur when uninsured short-term creditors think that declining asset prices and low levels of bank equity mean they may not be repaid. While asset prices and expectations about them cannot be controlled, we do know that for a given level of short-term financing, higher levels of equity finance will make the prospect of short-term creditors appear better. So the effectiveness of liquidity measures depends on strong leverage restrictions.¹⁶

We hope these comments are helpful in your consideration of the Proposed Rule.

Sincerely,



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¹⁵ F. Vazquez and P. Federico (2012). Bank Funding Structures and Risk: Evidence from the Global Financial Crisis, IMF Working Paper 12/29, January.

¹⁶ See M. Gertler and N. Kiyotaki (2012). Banking, Liquidity and Bank Runs in an Infinite Horizon Economy, May, available at <http://www.princeton.edu/~kiyotaki/papers/BankRunModel2012June27%281%29.pdf>.