

# INSTITUTE OF INTERNATIONAL BANKERS

299 PARK AVENUE, 17<sup>TH</sup> FLOOR, NEW YORK, N.Y. 10171  
TELEPHONE: (212) 421-1611 FACSIMILE: (212) 421-1119  
HTTP://WWW.IIB.ORG

LAWRENCE R. UHLICK  
EXECUTIVE DIRECTOR AND GENERAL COUNSEL  
DIRECT E-MAIL: LUHLICK@IIB.ORG

July 19, 2004

Jennifer J. Johnson  
Secretary  
Board of Governors of the Federal  
Reserve System  
20<sup>th</sup> Street and Constitution Avenue, NW  
Washington, DC 20551

Public Reference Room  
Mail Stop 1-5  
Office of the Comptroller of the Currency  
250 E Street, SW  
Washington, DC 20219

Regulation Comments  
Chief Counsel's Office  
Office of Thrift Supervision  
1700 G Street, NW  
Washington, DC 20552  
Attention: No. 2004-27

Robert E. Feldman  
Executive Secretary  
Federal Deposit Insurance Corporation  
550 17<sup>th</sup> Street, NW  
Washington, DC 20429  
Attention: Comments/OES

Jonathan G. Katz  
Secretary  
Securities and Exchange Commission  
450 Fifth Street, NW  
Washington, DC 20549-0609

Re: Proposed Interagency Statement on Sound Practices Regarding Complex Structured Finance Activities (Federal Reserve Board Docket No. OP-1189; Office of the Comptroller of the Currency Docket No. 04-12; Office of Thrift Supervision File No. 2004-27; Securities and Exchange Commission File No. S7-22-04)

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Ladies and Gentlemen:

We are submitting this letter in response to the request of the Federal Reserve Board (the "FRB"), the Office of the Comptroller of the Currency (the "OCC"), the Federal Deposit Insurance Corporation (the "FDIC"), the Securities and Exchange Commission and the Office of Thrift Supervision (collectively, the "Agencies") for comment on the Agencies' proposed interagency statement (the "Proposed Statement") regarding sound internal controls and risk management practices relating to complex structured finance transactions ("CSFTs").<sup>1</sup> The Institute of International Bankers represents internationally headquartered financial institutions from over 40 countries, and our members include international banks that operate branches and agencies, bank subsidiaries and broker-dealer subsidiaries in the United States.

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<sup>1</sup> 69 Fed. Reg. 28980 (May 19, 2004).

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The Institute's mission is to help resolve the many special legislative, regulatory and tax issues confronting **internationally headquartered** financial institutions that engage in banking, securities and/or insurance activities in the United States.

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# INSTITUTE OF INTERNATIONAL BANKERS

## Introduction and Executive Summary

As the Proposed Statement recognizes, CSFTs can play an important and beneficial role in the U.S. and international financial markets and economy. Many of the Institute's largest members are among the most significant providers of complex structured finance products, and many have developed and implemented leading risk management practices specifically designed to identify and address the legal, reputational and other risks which some such activities present. The Institute thus supports the Agencies' effort to develop uniform guidance in this area on an interagency basis and to promulgate meaningful guidance for institutions that are subject to examination and supervision by multiple federal regulators.

At the same time, the Institute has a number of concerns regarding the Proposed Statement. The principal focus of this letter is on the implications for international banks of the Proposed Statement, taking into account the unique manner in which international banks operate in the United States.

- International banks' U.S. operations include branches and agencies, subsidiary banks and subsidiary broker-dealers, all of which are "financial institutions" as defined in the Proposed Statement (and all of which thus would be subject to the proposed interagency guidance to the extent they engage in complex structured finance activities).
- Specifically in relation to U.S. branches and agencies of international banks, risk management guidance like that reflected in the Proposed Statement should reflect the fact that such U.S. operations are not separately incorporated and do not, for example, have a separate board of directors.
- More broadly, the Institute strongly urges the Agencies to recognize that an international bank's U.S. risk management policies and procedures necessarily will need to be adapted to the bank's global policies and procedures, as informed by home country legal, regulatory and supervisory requirements. As a result, international banks may implement guidance regarding CSFTs in ways that differ in certain respects from the ways U.S.-headquartered institutions would implement the same guidance, without any material difference in the effectiveness of that implementation.

In addition, this letter identifies several other concerns regarding the proposal that we share with domestically headquartered institutions and offers a number of suggestions to address these concerns.

- The Institute respectfully recommends that the Proposed Statement be revised to make clear that the listed examples of characteristics of CSFTs, or transactions warranting additional scrutiny by financial institutions, are simply indicators of types of transactions that could, depending on the context of the transaction or other factors, qualify for the relevant procedures. For international banks, this is especially important in view of the fact that cross-border structures are listed as an example of types of transactions that could warrant additional scrutiny.

# INSTITUTE OF INTERNATIONAL BANKERS

- The Agencies should avoid implications in the Proposed Statement that particular procedures or structures for implementing the Agencies' guidance are required, or even presumptively superior, for all financial institutions. More broadly, the wording of the Proposed Statement should be changed to make the guidance less prescriptive and more flexible and adaptable to the range of different types of institutions, different governance structures and oversight mechanisms, and different types and levels of structured finance activity.
- The Proposed Statement should be revised to avoid the creation of new legal duties on the part of financial institutions to review and evaluate their customers' and counterparties' legal, compliance, accounting or disclosure treatment of proposed transactions. The Institute believes it would be inappropriate and fundamentally contrary to the stated objectives of the Proposed Statement to establish new legal duties or standards, even by implication, through Agency guidance in this area.

## Importance of Taking Into Account the Unique Structure of International Bank's U.S. Operations

The Institute believes it is critical that the Agencies take into account the nature of U.S. operations of international banks in applying risk management guidance to such offices. For example, as offices of an international bank headquartered in another country, U.S. branches and agencies are not separate corporate entities and do not have boards of directors. Thus, when the Proposed Statement describes the important role that a financial institution's board of directors plays in establishing the financial institution's risk management framework, the Agencies should recognize that, for U.S. branches and agencies, there necessarily will be a distinction between (1) the global risk management oversight role of an international bank's board of directors (or comparable governing board), which will reside at the international bank's head office, which is supervised by the international bank's home country supervisor, and (2) the local risk management role of a U.S. branch or agency's senior management. The Proposed Statement is drafted largely with U.S.-incorporated and U.S.-headquartered financial institutions in mind, and we would respectfully request that the Agencies more explicitly recognize in the final version of the interagency guidance (and in other related guidance, such as additions to examination manuals) that special considerations should be taken into account when assessing the internal control framework of U.S. branches and agencies of international banks. Thereafter, we would encourage the FRB and the OCC (and, in the case of insured branches, the FDIC) to apply the guidance flexibly to such branches and agencies when evaluating the scope and nature of their internal control framework, taking into account the fact that they are offices of internationally-headquartered institutions.<sup>2</sup>

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<sup>2</sup> For example, the Proposed Statement indicates that financial institutions "should define the complex structured finance transaction reporting requirements appropriate for various levels of management and the Board." 69 Fed. Reg. at 28989 (emphasis added). In the case of a U.S. branch or agency, reporting requirements relating to complex structured finance activities in the United States will in most cases appropriately apply to various levels of management. The extent to which reports are made to the international bank's home country governing board depends on separate considerations relating to the international bank's global framework for risk management and internal controls.

# INSTITUTE OF INTERNATIONAL BANKERS

U.S. branches and agencies typically implement their own internal controls and risk management systems, reflecting the nature of the activities they conduct in the United States and particular U.S. legal, regulatory and supervisory considerations. At the same time, it will be important to recognize that U.S. branches and agencies also operate under the international bank's global internal controls and risk management systems.<sup>3</sup> In supervising international banks' compliance with the Agencies' final guidance, the Agencies should take into consideration the fact that internal controls and risk management systems for cross-border establishments involve resource allocation and coordination between the internal controls and risk management systems applicable to the local U.S. operations and those applicable to the global operations of the institution. In some cases, this will require that the U.S. risk management procedures and internal controls be adapted to the institution's global infrastructure and thus may not mirror the procedures and controls or evidence the same level of resources located in the United States that a U.S.-headquartered institution would implement. These considerations apply not only to U.S. branches and agencies of international banks but also to separately incorporated U.S. financial institutions operated by international banks, such as U.S. bank and broker-dealer subsidiaries.

The Institute appreciates the fact that the scope of the Proposed Statement is expressly limited to the U.S. branches and agencies of internationally headquartered banks and does not purport to apply to their non-U.S. banking offices.<sup>4</sup> This territorial limitation is appropriate in the Institute's view, and any extension to the non-U.S. branches and agencies of international banks would have posed significant problems and potential conflicts with non-U.S. risk management practices, corporate procedures, legal and regulatory requirements and supervisory standards.

## General Concerns Regarding the Proposed Statement

As noted above, the Institute also shares many of the concerns raised by domestically headquartered commenters and their associations regarding the Proposed Statement.

### *The Scope of Transactions Covered by the Proposed Statement*

An issue of particular concern to the Institute's members relates to the scope of the transactions covered by the Proposed Statement. The Institute believes the Agencies should revise the Proposed Statement to avoid any implication that the many types of routine and well-established structured transactions, which may appear complex by some criteria but which do not raise the types of legal and reputational risks to which the guidance is directed, should be subject to enhanced scrutiny by financial institutions. For example, the Proposed Statement helpfully identifies a non-exclusive list of characteristics of CSFTs that could warrant review under the risk management procedures described in the Proposed Statement.<sup>5</sup> Elsewhere, the Proposed

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<sup>3</sup> See 69 Fed. Reg. at 28986 ("In the case of U.S. branches and agencies of foreign banks, these policies should be coordinated with the group-wide policies developed in accordance with rules of the foreign bank's home supervisor.")

<sup>4</sup> See, e.g., id.

<sup>5</sup> See 69 Fed. Reg. at 28985.

## INSTITUTE OF INTERNATIONAL BANKERS

Statement lists examples of characteristics that should be considered in determining whether a transaction warrants additional scrutiny.<sup>6</sup> Given the tendency for such lists of examples to become “checklists” in the examination process, or to be misused as disjunctive criteria for a “definition” of a CSFT, we would recommend that the Proposed Statement be revised to make clear that any one or more examples of characteristics of CSFTs (e.g., the creation or use of SPEs designed to address the economic, legal, tax or accounting objectives of the customer), standing alone, do not necessarily indicate that a structured finance transaction should be considered “complex.”

From the perspective of internationally headquartered institutions, this point is particularly important in view of the fact that one of the identified examples of characteristics of transactions that could warrant additional scrutiny is “transactions that cross multiple geographic or regulatory jurisdictions.” The U.S. operations of international banks routinely structure and engage in cross-border transactions, including many transactions that are entered into on a cross-border basis using multiple branches or affiliates of the international bank. The vast majority of such transactions do not raise issues that would warrant additional scrutiny pursuant to a procedure aimed at managing the legal, reputational and other risks associated with CSFTs. Without discounting the general relevance of that particular characteristic to a framework of structured finance risk management, we would respectfully suggest that its presence in the Agencies’ list of examples underscores the need to clarify that the complexity of any one transaction will necessarily depend on the overall context of the transaction and the parties involved.

### *The Importance of Flexibility and Accommodation of Tailored, Risk-Based Practices*

The Proposed Statement generally suggests a degree of deference to financial institutions’ own judgments regarding the nature and structure of the scrutiny that should apply to CSFTs. In our experience, this deference is critical in areas of risk management that are as sophisticated and as rapidly evolving as structured finance. As new products and structures are introduced into the marketplace, new risk management techniques are adapted, especially in the area of structured finance where many products themselves are (or contain) tools for mitigation of risks. The financial institutions that develop the products and risk management techniques typically are in the best position to tailor their procedures to the risks presented. As a result, overly prescriptive standards in this area could present difficult problems for financial institutions seeking to comply with Agency guidance. Guidance that is too rigid and unable to evolve with new practices, or that adopts a “one size fits all” approach without allowing institutions to tailor their practices to their circumstances or types of structured finance activities, risks undercutting financial institutions’ efforts to develop effective risk management.

While the Proposed Statement appears intended, consistent with risk-management guidance issued by the banking Agencies in other areas, to permit institutions to tailor their policies and procedures to their individual circumstances, types of transactions, etc., in the Institute’s view there are several areas in which the Proposed Statement implies an unduly prescriptive approach. For example, the Proposed Statement implies that some risk management structures, such as a senior-level review committee, are favored means of managing the risks

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<sup>6</sup> See 69 Fed. Reg. at 28988.

# INSTITUTE OF INTERNATIONAL BANKERS

presented by CSFTs.<sup>7</sup> Many financial institutions have implemented such review committees; however, the appropriateness of relying on such a committee necessarily will depend on the scope and nature of the financial institution's activities. We would recommend that the Proposed Statement be revised to clarify that the appropriateness of implementing a senior-level review committee will depend on the nature of the institution's complex structured finance activities and its overall internal controls and risk management framework.

Similarly, the Proposed Statement indicates in places that a financial institution's own legal department should review CSFTs as part of the approval process and should be involved throughout a product's development, implying a need to have significant involvement of in-house legal staff. The Proposed Statement also calls for a delineation of the roles of other in-house internal control groups, such as tax and accounting. At many international banks, however, the U.S.-based internal control groups commonly seek assistance from outside professionals in assessing the legal, tax, accounting and compliance risks presented by CSFTs (either professionals advising the bank in the transaction or the bank's regular outside advisors). This is frequently the case at international banks whose U.S.-based legal, tax and accounting departments are smaller than those of comparable domestically headquartered institutions. The Institute believes that the Proposed Statement should be made sufficiently flexible to allow international banks to develop procedures to ensure adequate review using an appropriate combination of (1) in-house resources in their U.S. and non-U.S. operations and (2) assistance from outside advisors.<sup>8</sup>

## *The Importance of Not Creating New Legal Duties for Financial Institutions*

The Institute also believes it is important that the Proposed Statement not create new duties on the part of financial institutions to monitor the compliance by their customers and other counterparties with applicable laws, regulations and accounting standards. The Institute recognizes that financial institutions, in order to manage their own legal and reputational risks, should be attentive to types of transactions that could be subject to abuse by counterparties. Agency guidance can usefully underscore the importance of having procedures to make informed, risk-based judgments regarding the circumstances under which an inquiry regarding a customer's legal compliance, disclosure or accounting treatment may be appropriate. That guidance should not, in the Institute's view, go so far as to create new duties on the part of financial institutions to undertake such a review in particular circumstances.

The Institute believes it would be inappropriate for the Proposed Statement to create such legal duties beyond the existing standards embodied in relevant statutes and common law relating to secondary and vicarious liability. The Institute would respectfully submit that the development of such legal duties is not within the competency of the Agencies. Furthermore,

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<sup>7</sup> See 69 Fed. Reg. at 28986 ("The [A]gencies believe that such a senior-level committee can serve as an important part of an effective control infrastructure for complex structured finance activities.").

<sup>8</sup> For example, the flexibility reflected in the statement to the effect that "[f]inancial institutions should ensure that any legal reviews are conducted by qualified in-house or outside counsel and that these professionals are provided the documentation and other information needed to properly evaluate the transaction," see 69 Fed. Reg. at 28987 (emphasis added), should be expanded and applied throughout the discussion of internal review procedures to avoid any implication (which arises at other places in the discussion) that the professional resources devoted to the review need to be located in-house.

## INSTITUTE OF INTERNATIONAL BANKERS

even the inadvertent creation of new legal standards in this area would be contrary to the objectives of the Proposed Statement to assist financial institutions in the management of legal risks presented by CSFTs. The Agencies' guidance should not become an instrument for litigants seeking to obtain from financial institutions damages that could not be obtained from the financial institution's customer or counterparty. It would be unfortunate indeed if the Agencies' guidance had the unintended effect of increasing the liability of financial institutions in disputes concerning CSFTs and deterring financial institutions from engaging in transactions whose value to the liquidity and stability of U.S. financial markets the Agencies recognize in the Proposed Statement.

Even beyond these considerations, however, the Institute would respectfully submit that the Proposed Statement overstates the role that financial institutions reasonably can be expected to perform in policing the marketplace for CSFTs. At the most practical level, it is fundamentally unrealistic to expect financial institutions to "obtain and document complete and accurate information regarding a customer's accounting treatment of the transaction [and] financial disclosures," "assess[] the customer's business objectives for entering into a transaction," or "ensure that the customer understands the risk and return profile of the transaction." Even if as a policy matter it were considered appropriate for financial institutions to undertake these measures (and in our view it is not), a financial institution generally will not have access to complete information necessary to make the types of judgments they imply. Rather, only the customer/counterparty will be able to make these judgments, with the advice of the advisors it retains for this purpose.

To avoid any doubt regarding the intended effect of the Proposed Statement, the Agencies should add an explicit statement to the Proposed Statement when it is finalized to the effect that the guidance is intended to assist financial institutions in the development of appropriate risk management procedures and not to imply what legal standards or duties apply to a financial institution's transactions with its customers and other counterparties.

In addition, we would encourage the Agencies to revisit their approach to describing appropriate measures a financial institution should take vis-à-vis its customers. In view of the fact that there may be different sources for, and degrees of, elevated risk, and consistent with the overall risk-focused approach of the Proposed Statement, we would recommend that prescriptive statements such as "should ensure," "should assess," and "should obtain and document" be revised to suggest that financial institutions' procedures identify when such review and documentation will be required, as opposed to suggesting that it should be required in all instances of elevated risk.<sup>9</sup>

At a minimum, we believe that the Proposed Statement should be revised to make clear that the types of review and other risk management procedures that a financial institution should use for CSFTs will necessarily depend not only on the type of transaction involved but also on the nature and circumstances of the financial institution's role in the transaction. For example, appropriate risk management procedures may vary depending on whether the financial institution is the agent or arranger in a syndicated transaction or is instead a participating institution. A

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<sup>9</sup> Compare, e.g., 69 Fed. Reg. at 28988 ("The financial institution's policies also should address when third party accounting professionals should be engaged to review transactions." (emphasis added)).

## INSTITUTE OF INTERNATIONAL BANKERS

participating institution often serves as a “Liquidity Provider” or “Credit Enhancer,” which contractually obligates it to replace the market investors in certain specified situations. In such situations, these participants are more akin to the investing public for whom the draft guidance is offering protection. Also, participants rarely, if ever, are afforded the in-depth and continuing access to the structuring customer that the arranging institution enjoys. Similarly, appropriate risk management procedures may vary depending on whether the particular structured finance product is one developed by the financial institution itself or presented to the financial institution by a customer of the financial institution or by one of the financial institution’s outside advisors. While the relevance of these types of considerations is implicit in the Proposed Statement, we believe they should be explicitly identified in the final version of the Proposed Statement.

Lastly, we would encourage the Agencies to take into account the fact that many customers and other counterparties of financial institutions covered by the proposal (both domestically headquartered financial institutions and U.S. operations of international banks) are non-U.S. entities. These non-U.S. counterparties operate under a variety of home country laws and regulations that could impact the ability of U.S. financial institutions to obtain information regarding their legal and regulatory compliance, accounting treatment, disclosure practices, etc. Concomitantly, the types of risk management procedures called for by the Proposed Statement could impose unique burdens on non-U.S. counterparties. We respectfully submit that such extraterritorial effects should be minimized where possible, consistent with the Agencies’ objective of guiding the industry’s development of sound risk management practices for CSFTs.

Please do not hesitate to contact the Institute if we can be of further assistance.

Sincerely,

A handwritten signature in black ink that reads "Lawrence R. Uhlick". The signature is written in a cursive style with a large initial 'L' and 'U'.

Lawrence R. Uhlick  
Executive Director and  
General Counsel