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Finance & Regulatory Alert

Federal Reserve Board Enhances Prudential Supervision of US and Non-US Banks

The Federal Reserve Board recently adopted substantial portions of Regulation YY, "Enhanced Prudential Standards," subjecting US bank holding companies, US savings and loan holding companies and foreign banking organizations to a graduated series of requirements. These new standards—which impose a range of stress testing, risk management, and capital and liquidity requirements that were previously left to the home country regulators in the case of foreign banking organizations—suggests a continuation of the shift (applicable to both US and non-US institutions) toward regulation from the perspective of systemic risk, potential insolvency and tighter compliance standards and, to some extent, away from regulation from the perspective of permissible activities.

In partial fulfillment of its responsibility under section 165[1] of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the Federal Reserve Board recently adopted substantial portions of Regulation YY, "Enhanced Prudential Standards."[2] Regulation YY subjects US bank holding companies, US savings and loan holding companies and foreign banking organizations to a graduated series of requirements. The severity of the requirements depends on the size of the consolidated institution, (in some instances) whether

[1] Section 165(a) and (b) generally require the Federal Reserve Board to impose enhanced prudential standards on institutions with $50 billion or more in consolidated assets. Other subsections of section 165 authorize the Federal Reserve Board to take other steps, such as requiring the issuance of conditional capital.
[2] Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, available at http://www.federalreserve.gov/newsevents/press/bcreg/20140218a.htm (the "Release").

their shares are publicly traded and, in the case of foreign banking organizations, on the size of their US operations. For the US organizations affected, the new standards would appear to be largely procedural and compliance oriented at this stage, although single-counterparty credit limits will be adopted later. The imposition of the new standards reflects Congress' determination that larger banking institutions may potentially pose a greater risk to the financial system than smaller ones. Nonbank financial companies that are determined to be systemically significant are, with one exception (relating to stress testing), not yet affected.

Similar prudential concerns also appear to have led to the adoption of new standards for foreign banking organizations. In addition, however, the exercise by the Federal Reserve Board of its authority over areas such as the adequacy of capital and liquidity in the US operations of foreign banking organizations, previously left to the home country regulators of those organizations, suggests a continuation of the shift (applicable to US institutions as well) toward regulation from the perspective of potential insolvency and tighter compliance standards and, to some extent, away from regulation from the perspective of permissible activities.[3] Powers-oriented regulation of non-US banking organizations has been in effect in the US and has been a focus since the adoption of the International Banking Act of 1978, which itself ended an era of great freedom for the non-branch or agency activities of foreign banks. Increasing the emphasis on potential insolvency is consistent with the Dodd-Frank Act and with a general concern for systemic risk. Earlier versions of concern for safety and soundness looked more to the health of individual institutions, which made it easier to allow home country regulators to be solely responsible for matters such as capital and liquidity. Concern for systemic risk, however, almost by definition requires (at this stage of the globalization process) that more attention be paid to nationally defined financial systems (without excluding the necessity of working toward international solutions), since only national or regionally empowered regulators have authority over the financial system facing the relevant impending risk. At the moment, the regulatory system established by the Dodd-Frank Act conceives of responses to systemic risk in terms of methods thought to reduce the risk of catastrophic insolvency and to speed the resolution of insolvent institutions as those methods relate to the US financial system and the US economy.

[3] Note, however, that section 165(b)(2) requires the Federal Reserve Board to take certain matters into account when applying section 165 to foreign banking organizations: "STANDARDS FOR FOREIGN FINANCIAL COMPANIES.—In applying the standards set forth in paragraph (1) to any foreign nonbank financial company supervised by the Board of Governors or foreign-based bank holding company, the Board of Governors shall—(A) give due regard to the principle of national treatment and equality of competitive opportunity; and (B) take into account the extent to which the foreign financial company is subject on a consolidated basis to home country standards that are comparable to those applied to financial companies in the United States." As will be seen from the discussion below, the regard given to national treatment by the Federal Reserve Board consists largely, but not entirely, in its requiring certification rather than the implementation of new compliance procedures for non-US organizations with less than $50 billion in US assets. In addition the Release points out that "[t]o the extent that there are differences in the application of the standards for U.S. bank holding companies and foreign banks, the differences generally reflect the structural differences between foreign banking organizations' operations in the United States and U.S. bank holding companies. For instance, because the final rule permits U.S. branches and agencies of foreign banks to continue to operate on the basis of the foreign bank's capital, the final rule does not impose capital or stress testing requirements on U.S. branches and agencies of foreign banks." Release, p. 108.

Application of Regulation YY to US Institutions

The new standards imposed on US depository institutions and their holding companies vary depending on whether they are publicly traded, have between $10 billion and $50 billion in assets or have $50 billion or more in assets.

- **Non-publicly traded depository institutions and their holding companies that have $10 billion or less in consolidated assets** are not covered by Regulation YY.

- **US savings and loan holding companies with $50 billion or more in consolidated assets and state member banks with more than $10 billion in consolidated assets that are subsidiaries of bank holding companies with $50 billion or more in consolidated assets** are required to conduct stress tests on themselves by January 5 of each calendar year based on data from September 30 of the prior year. The Preamble to Regulation YY explains that the Federal Reserve Board may adopt further prudential standards for savings and loan holding companies, especially for those that are substantially engaged in banking.[4]

- **Savings and loan holding companies and bank holding companies with more than $10 billion but less than $50 billion in consolidated assets and state member banks with more than $10 billion in consolidated assets that are not subsidiaries of bank holding companies with $50 billion or more in consolidated assets** must conduct such a stress test by March 31 of each calendar year based on data from September 30 of the prior year. The stress tests must satisfy particular standards and be reported to the Federal Reserve Board. A summary of the results must be reported to the public. A rule subjecting US bank holding companies with more than $10 billion but less than $50 billion and savings and loan holding companies with assets greater than $10 billion to company-run stress testing requirements was already adopted in 2012.

- **Publicly traded bank holding companies with consolidated assets of $10 billion or more but less than $50 billion** are required to establish a risk committee with a number of specified responsibilities and with specified governance and membership requirements. This requirement applies beginning on July 1, 2015 to institutions that satisfy the asset requirements as of June 30, 2014.

[4] Release, p. 24.

- **Bank holding companies with $50 billion or more in consolidated assets** must, regardless of whether they are publicly traded, satisfy whatever requirements the Federal Reserve Board adopts with respect to their risk-weighted and leverage capital and to their stress testing. They must also:

  – Establish a risk committee with the same specified responsibilities and membership requirements as those applicable to the smaller bank holding companies described above, but with some additional governance requirements. In addition, the risk committee must also be responsible for compliance with the liquidity risk management standards imposed by Regulation YY.

  – Appoint a chief risk officer who has specified credentials, responsibilities and reporting lines and whose compensation and other incentives "are consistent with providing an objective assessment of the risks taken by the bank holding company."[5]

  – Ensure that their boards of directors implement liquidity risk management systems that define liquidity risk tolerance and periodically review liquidity risk-management policies and procedures and that the risk committee and senior management have correlative duties.

  Senior management must develop liquidity risk measurement and reporting systems, review the effect new products will have on liquidity risk, evaluate cash flow projections, establish liquidity risk limits and conduct liquidity stress tests.

  Moreover, such bank holding companies must (i) establish a liquidity review function that is independent of the portion of management that conducts the company's funding operations, (ii) produce comprehensive cash-flow projections that meet specified standards, (iii) establish a contingency funding plan that fulfills certain requirements, (iv) monitor collateral, legal entity and intraday liquidity risk; (v) conduct liquidity stress tests at least monthly with overnight, 30-day, 90-day and one-year planning horizons and maintain the systems and procedures necessary to collect the requisite data and carry out such procedures; and (v) maintain a liquidity buffer sufficient to accommodate the cash flow needs of the institutions during a stressed 30-day planning horizon. These liquidity requirements are similar, but not identical to, the liquidity coverage ratio that will eventually apply.

  Such bank holding companies must also carry out stress tests supervised and using standards chosen by the Federal Reserve Board. These tests are in addition to the two tests such companies must themselves conduct annually using scenarios provided by the Federal

[5] Regulation YY, § 252.33(b)(3).

Reserve Board and satisfying various criteria set out in Regulation YY. Both these stress-testing requirements also apply to non-banking financial companies that have been designated as systemically significant and are intended to determine capital adequacy, rather than the satisfaction of any liquidity standards.

The risk-management, risk-committee, liquidity risk-management and liquidity stress test requirements begin to apply on January 1, 2015 for institutions that satisfy the asset requirements as of June 30, 2014. The supervisory and company stress test requirements already apply.

Independently of the effective dates and asset classes described above, the Financial Stability Oversight Council is entitled to determine that a US bank holding company "poses a grave threat to the financial stability of the United States and that the imposition of a debt-to-equity requirement is necessary to mitigate such risk." Within 180 days after receiving notice of such a determination, a US bank holding company must maintain a ratio of total liabilities to total equity capital of no more than 15-to-1.[6]

Application of Regulation YY to Non-US Institutions

The application of Regulation YY to foreign banking organizations also depends on asset thresholds and on whether the organization is publicly traded; however, the asset thresholds not only apply at the consolidated level but also, in effect, at the US border, distinguishing between assets held inside and outside the US. This differentiation between US and non-US assets provides the framework for the imposition of standards on foreign banking organizations that Regulation YY itself does not impose on US institutions (because these are already subject to such requirements under other regulations), in addition to those that Regulation YY applies more or less equally to both to US and non-US institutions.

- **Non-publicly traded foreign banking organizations with consolidated assets of more than $10 billion and less than $50 billion and foreign savings and loan holding companies with consolidated assets of more than $10 billion** must be subject to capital stress testing in their home countries. One such test must be conducted by their home country supervisor. Unless the Federal Reserve Board determines otherwise, an institution that fails to satisfy these requirements must maintain in its US branches and agencies "eligible assets . . . that, on a daily basis, are not less than 105 percent of the average value over each day of the previous calendar quarter of the total liabilities of all branches and agencies operated by the foreign banking organization in the United States," conduct annual capital stress tests on its US subsidiaries and report the results of those stress tests to the Federal Reserve Board.[7]

[6] Regulation YY, § 252.220(b).
[7] Regulation YY, § 252.122(b)(1). Eligible assets are essentially good quality, performing non-equity investments but do not include amounts due from other offices, prepaid expenses, unamortized costs, furniture, fixtures, or leasehold improvements.

Stress testing already applies to savings and loan holding companies. It begins to apply on July 1, 2016 to foreign banking organizations with the appropriate amount of assets as of June 30, 2015.

- **Publicly traded foreign banking organizations with consolidated assets of $10 billion or more but less than $50 billion** must establish a risk committee, but are essentially required only to certify annually, concurrently with their filing of Federal Reserve Form Y-7, that they have a board committee, a separate committee or a part of an enterprise-wide risk committee that is responsible for overseeing the risk management policies of their US operations and that at least one member of that committee satisfies certain professional standards. Such foreign banking organizations must also ensure that their US operations implement the institutions' risk management policies. The Federal Reserve Board will respond to noncompliance with these requirements case by case and in consultation with other federal and state regulators.

  Foreign banking organizations that were publicly traded and had the requisite assets as of June 30, 2015 must be in compliance by July 1, 2016.

- **Foreign banking organizations with consolidated assets of $50 billion or more but combined US assets[8] of less than $50 billion** must certify to the Federal Reserve Board concurrently with their filings on Federal Reserve Form FR Y-7Q that their home country regulator imposes capital standards consistent with the standards established from time to time by the Basel Committee on Banking Supervision ("BCBS") and that they meet those standards. In addition, such foreign banking organizations must provide certifications as to their risk committees, which must meet the same standards as those applicable to foreign banking organizations with $10 billion or more but less than $50 billion in consolidated assets. The Federal Reserve Board will respond to noncompliance with either of these requirements case by case and in consultation with other federal and state regulators.

  Such foreign banking organizations must also report annually to the Federal Reserve Board that they have conducted liquidity stress tests in accordance with the standards adopted by the BCBS in 2008 on either their consolidated operations or their combined US operations. Noncompliance will require any such organization to "limit the net aggregate amount owed by the foreign banking organization's non-U.S. offices and its non-U.S. affiliates to the combined U.S. operations to 25 percent or less of the third-party liabilities of its combined

[8] Combined US assets include the assets of branches and agencies of the foreign bank but do not include interests in (roughly speaking) nonfinancial companies that certain foreign banking organizations, unlike US bank holding companies, are entitled to retain.

U.S. operations, on a daily basis."[9] They are also subject to capital stress testing requirements identical to those applicable to foreign banking organizations with assets between $10 and $50 billion, noncompliance with which has the same consequence with respect to the maintenance of eligible assets.

Foreign banking organizations that satisfy the asset requirements as of June 30, 2015 must be in compliance by July 1, 2016.

- **Foreign banking organizations with consolidated assets of $50 billion or more and combined US assets of $50 billion or more** are treated, with respect to their US assets and activities, more like US bank holding companies than are other foreign banking organizations.

  In addition, if its US non-branch assets should exceed $50 billion, a foreign banking organization must establish an intermediate holding company in the US that holds all of those non-branch assets. The intermediate holding company must "[b]e governed by a board of directors or managers that is elected or appointed by the owners and that operates in an equivalent manner, and has equivalent rights, powers, privileges, duties, and responsibilities, to a board of directors of a company chartered as a corporation under the laws of the United States, any one of the fifty states of the United States, or the District of Columbia."[10] It must hold all US subsidiaries of the foreign banking organization (other than those referred to in footnote 8 above and shares received in foreclosing debt previously contracted) and file reports on forms developed, and be subject to examination, by the Federal Reserve Board. An implementation plan must be filed that sets out the steps that will lead to the formation, capitalization and operation of the intermediate holding company, including descriptions of risk-management and liquidity stress testing practices and how they will be brought into conformity with the applicable requirements. There are, however, procedures for requesting waivers from these holding company requirements, including the requirement that there be only one intermediate holding company.

  Intermediate holding companies will be subject to ordinary US capital (including leverage) requirements, other than the provisions relating to internal ratings-based and advanced measurement approaches, all restrictions relating to capital buffers and all capital planning requirements. They will, however, be permitted to choose to apply the internal ratings-based and advanced measurement approaches.[11] Noncompliance with capital planning standards

[9] Regulation YY, §252.145(b).
[10] Regulation YY, § 252.153(a)(2)(ii).
[11] In addition, under § 252.153(e)(2)(i)(C) of Regulation YY, "if a bank holding company is a subsidiary of a foreign banking organization that is subject to this section and the bank holding company is subject to [the internal ratings-based and advanced measurement approaches], the bank holding company, with the Board's prior written approval, may elect not to comply with [them]."

could presumably result in the intermediate holding company's inability to pay dividends to the home office of the foreign banking organization.

Additionally, the board of directors of the intermediate holding company must establish a risk committee that reviews risk management policies and oversees risk management in general. This committee may serve as the risk committee that is required to be maintained for the combined US operations (that is, the operations of any branches and agencies, as well as the operations of the intermediate holding company). The requirements to be satisfied by the risk management framework and the membership requirements for the risk committee are comparable to those for large US bank holding companies, but the governance requirements are slightly less strict.

Compliance is required by July 1, 2016 if the asset standards are met as of June 30, 2015; however, while any required intermediate holding company must be established by that date and must hold at least 90 percent of the institution's non-branch assets (measured as of June 30, 2015), the requirement that such company hold all non-branch assets (with some exceptions) need not be satisfied until July 1, 2017.

- **Foreign banking organization with combined US assets of $50 billion or more**, regardless of the amount of their non-branch assets, are subject to several enhanced prudential standards. The risk-based capital to which they are subject match those applicable to foreign banking organizations with consolidated assets of $50 billion or more but combined US assets of less than $50 billion, discussed above.

  The risk management and risk committee requirements applicable to such organizations are essentially those that also apply to large US bank holding companies, with some variation in governance possibilities to accommodate relationships with any required intermediate holding company. Such organizations (or their intermediate holding companies) must have a US chief risk officer, whose duties and qualifications are essentially those described above for US bank holding companies with consolidated assets of $50 billion or more. The risk committee and the chief risk officer have, among other things, responsibilities relating to liquidity risk management that parallel those for large US bank holding companies.

  The liquidity stress testing and liquidity buffer standards are also parallel, and apply to the organization's combined US operations. Because branch operations differ from holding company operations and because there are also interactions between the two, however, the calculation of the required liquidity buffers for the two types of operation differ. Among other things, the liquidity requirements for the intermediate holding company relate to the entire 30-day planning horizon, whereas only the first two weeks of the liquidity needs of any branches or agencies during a given 30-day period need to be covered.

> Capital stress testing for the combined US operations of such foreign organizations requires a certification about the standards applied by the home country supervisor, together with the provision of specified financial information, including additional information if the US operations provide funding to offices outside the US. Failure to satisfy the capital stress testing requirements can result in the application to the branches and agencies of a requirement that they maintain eligible assets equal to 108 percent of their average daily total liabilities.
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> Compliance is required by July 1, 2016 if the asset standards are met as of June 30, 2015.

Independently of the effective dates and asset classes described above, the Financial Stability Oversight Council is entitled to determine that a foreign banking organization "poses a grave threat to the financial stability of the United States and that the imposition of a debt-to-equity requirement is necessary to mitigate such risk." Within 180 days after receiving notice of such a determination, any intermediate holding company (and, in the absence of any such intermediate holding company, most US subsidiaries) must maintain a ratio of total liabilities to total equity capital of no more than 15-to-1.

Indirect Effects of Intermediate Holding Company Requirement for Non-US Banks

Among the indirect effects that the establishment of an intermediate holding company may have on the US activities of foreign banking organizations is the imposition of US capital and liquidity requirements on conduits and special purpose vehicles. Although, as noted above, applications for waivers are permitted, the Release is clear that such vehicles would normally be held by the intermediate holding company:

> Commenters also provided examples of subsidiaries that they asserted should not be required to be held within the U.S. intermediate holding company, including: (1) subsidiaries that do not pose a material risk to U.S. financial stability, or subsidiaries below a *de minimis* asset or liability threshold, such as subsidiaries with no more than $1 billion or $10 billion in total consolidated assets; (2) subsidiaries that are fully and unconditionally guaranteed by the parent, conduits for funding, or U.S. subsidiaries of foreign financial subsidiaries; (3) property casualty insurers; (4) investment funds, including registered and unregistered funds under the Investment Company Act of 1940; (5) branch subsidiaries, particularly those that are significantly related to the U.S. branch's operations; (6) investments held in satisfaction of debts previously contracted in good faith (DPC assets); (7) non-U.S. subsidiaries of the foreign banking organization, even if they were held by a U.S. subsidiary; and (8) joint ventures with another foreign banking organization. Commenters asserted that requiring funding subsidiaries, in particular, to be transferred to the U.S. intermediate holding company would increase funding costs for foreign banking

> organizations. Some commenters also asked the Board to exclude non-U.S. subsidiaries that are consolidated under the U.S. intermediate holding company from U.S. regulations.
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> As discussed above, the Board is adopting a transparent, objective threshold standard for determining whether a U.S. intermediate holding company is required and which entities must be held by that company. Excluding the subsidiaries described above would be at odds with the transparency and objectivity of the standard, and, furthermore, would limit the extent to which these subsidiaries would be subject to enhanced prudential standards in a manner consistent with U.S. bank holding companies. The Board believes it is necessary for virtually all legal entities incorporated in the United States, including those mentioned above, to be organized under the U.S. intermediate holding company. This will facilitate application of the capital, liquidity, and other enhanced prudential standards to the operations of these subsidiaries, promoting the financial stability goals discussed earlier. Also, as discussed above, one of the aims of the proposal, and of the final rule, is to provide a platform for consistent supervision and regulation of the U.S. operations of a foreign banking organization. The alternatives suggested by commenters would undermine these goals.[12]

Although it has always been the position of the Federal Reserve Board that US subsidiaries should be treated as subsidiaries of the foreign banking organization, as opposed to any US branch or agency of that organization, for subsidiaries that were not themselves directly subject to US regulation the allocation of capital to their activities was a matter for the home country regulator and, perhaps, any rating agency whose views had been solicited. Unless a waiver is granted, the amount of capital that an intermediate holding company must maintain because of any conduit or special purpose vehicle that it holds will be determined using US standards, which may affect costs and structuring.

Other Indirect Effects

The Release also makes clear that any liquidity stress testing that may be required must cover the activities of asset-backed commercial paper conduits:

> The proposed rule would have required a bank holding company's liquidity stress testing comprehensively to address its activities, exposures and risks, including off-balance sheet exposures. The preamble to the proposal indicated that stress testing should address non-contractual sources of risk, such as reputational risk, and risk arising from the covered company's use of sponsored vehicles that issue debt instruments periodically to the markets, such as asset-backed commercial paper and similar conduits.

[12] Release, pp. 130-1.

> Many commenters supported these proposed liquidity stress testing requirements because they were flexible and permitted bank holding companies to develop their own liability run-off factors and other assumptions. One commenter objected to the Board's statement in the proposal that a bank holding company should incorporate liquidity risks arising from sponsored vehicles in its liquidity stress tests, asserting that sponsored vehicles have a broad diversity of risk. The Board has adopted the substance of the proposed liquidity stress testing requirements as proposed, and has adjusted certain aspects of the regulatory language to clarify the minimum requirements set forth in the rule. With respect to sponsored vehicles, the Board reiterates that bank holding companies should include sponsored vehicles and similar conduits in their stress tests, as these vehicles received unanticipated support from some banking institutions in the recent financial crisis, and similar liquidity risks may arise in the future.[13]

Since the liquidity stress testing requirements contained in Regulation YY are largely procedural in nature and are not identical to the liquidity coverage ratio standards that will be adopted later, their application will presumably be evaluated on the basis of economic substance rather than formal compliance with any particular regulatory standard. This may create conflicts with the ultimate application of the liquidity coverage ratio.

Potential Consequences

The stress testing, risk management and capital requirements that Regulation YY imposes, and the manner in which it imposes them, will be tested from at least three perspectives: their effectiveness in reducing systemic risk, their effect on foreign banking activity in the US and their influence on the regulatory efforts of other jurisdictions. As to the interaction between Regulation YY and other regulatory efforts, on February 26, 2014 the Bank of England Prudential Regulation Authority (the "PRA") released its Consultation Paper CP4/14 entitled "Supervising international banks: the Prudential Regulation Authority's approach to branch supervision."[14] Although CP4/14, as its title suggests, largely deals with the supervision of branches, it also touches upon the PRA's general views on supervision and its views on subsidiaries. For example, the PRA states that "[t]he process of assessing whether a Home State Supervisor (HSS) meets the PRA's standards for equivalence will not be provided for in rules. Similarly, the division of responsibilities between the PRA and home regulators will be a matter of bilateral agreement."[15] The latter sentence would appear to be of special interest in connection

[13] Release, pp. 72-3.
[14] Available at http://www.bankofengland.co.uk/pra/Documents/publications/policy/2014/branchsupcp4-14.pdf.
[15] CP4/14, p. 5.

with Regulation YY. On the other hand, the various references of the PRA in CP4/14 and elsewhere to resolvability suggest that joining collegial regulation to national economic responsibilities will play a significant role in all jurisdictions.

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