New York Law Journal

SERVING THE BENCH AND BAR SINCE 1888

WWW.NYLJ.COM

An ALM Publication

VOLUME 243—NO. 8

WEDNESDAY, JANUARY 13, 2010

INTERNATIONAL BANKING

Expert Analysis

The House Regulatory Reform Bill and Non-U.S. Banks

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On Dec. 11, 2009, the U.S. House of Representatives passed, by a vote of 223-202, H.R. 4173, the "Wall Street Reform and Consumer Protection Act." H.R. 4173, at approximately 1,300 pages, cuts a broad swath through many of the financial issues attracting attention in the past year, including systemic risk, consumer financial protection, derivatives and executive compensation. It is based on many of the ideas proposed by the Obama administration earlier in 2009.[1]

Many of the provisions in the House bill will directly affect non-U.S. banks with U.S. operations such as branches and agencies and/or separately incorporated U.S. banking and nonbanking subsidiaries. This month's column summarizes some of the systemic risk provisions of H.R. 4173 that could affect the U.S. operations of non-U.S. banks. A future column will discuss the provisions dealing with consumer financial protection, derivatives and other amendments to the securities laws.

Systemic Regulator

In my July 2009 column, I discussed proposals by the U.S. Treasury Department and the European Union (EU) to address systemic risk.[2] One of the concerns I raised was that the proposed systemic risk regulators in the United States and the EU appeared to be little more than advisory monitors with no authority to force change. Fortunately, H.R. 4173 does give the systemic regulator some real authority.

The House bill establishes the Financial Services Oversight Council, which has the power to determine that a particular "financial company" should be subject to stricter standards to be imposed by the Board of Governors of the Federal Reserve System (FRB) in such areas as capital, leverage, liquidity, and risk management. A financial company subject to stricter standards generally would be required to wall off most, if not all, of its financial activities in an intermediate holding company (called a "Section 6 Holding Company") that would be subject to regulation by the FRB.

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The definition of "financial company" includes a non-U.S. company, such as a non-U.S. chartered bank, that has "significant operations" in the United States through a direct branch or agency or a U.S.-incorporated subsidiary, that engages in the United States in whole or in part in financial activities as defined in section 4(k) of the Bank Holding Company Act—these activities include not only traditional banking, insurance and securities activities, but also other nonbank financial activities.[3] Non-U.S. banks may have U.S. subsidiaries or direct branches and agencies that engage in banking activities, and/or may have subsidiaries that engage solely in other financial activities such as issuance of commercial paper or money transmission.

> The Financial Services Oversight Council has the power to determine that a particular 'financial company' should be subject to stricter standards.

While the term "significant operations" has yet to be defined, any non-U.S. bank that engages in any financial activities in the United States through either direct branches and agencies, and/or subsidiaries, should assume that it will be seen as a "financial company" and thus potentially subject to the stricter standards designation. However, a non-U.S. bank determined to be subject to stricter standards will not have to wall off its financial activities from its non-financial activities in a Section 6 Holding Company. Under the International Banking Act, non-U.S. banks with branches or agencies in the United States (as well as with bank subsidiaries) already are supervised by the FRB, and their non-banking activities are subject to the same restrictions on bank holding companies under the Bank Holding Company Act.

Systemic Risk Designation

The council can designate a non-U.S. bank as subject to the stricter standards but in making such a determination, it is supposed to take into account the extent to which the non-U.S. bank is "subject to prudential standards on a consolidated basis in [its] home country…that are administered and enforced by a comparable foreign supervisory authority."[4] In the imposing of the stricter prudential standards on a particular financial company, there is no one set of standards applicable to any financial company that becomes subject to such stricter standards; the council is required to tailor them to the individual financial company, taking into account factors such as the particular company's capital structure, activities and risk.

With respect to a non-U.S. financial company such as a non-U.S. bank, the FRB is to prescribe regulations regarding the application of the standards to the non-U.S. bank as well as to its U.S. operations, "giving due regard to principles of national treatment and equality of competitive opportunity and taking into account the extent to which the [non-U.S. bank] is subject on a consolidated basis to home country standards comparable to those applied to financial holding companies in the United States."[5]

While some non-U.S. companies that engage in financial activities in the United States may not have a consolidated home country regulator, the majority of non-U.S. banks do have some level of consolidated supervision in their home countries. Thus, in the implementation of these stricter standards, those non-U.S. banks with significant operations in the United States may well fare better if they already are supervised by both the home country regulator and the FRB.

Specifying Financial Activities

In addition to designations of financial companies as being subject to stricter standards, the council also may designate that specific financial activities should be subject to stricter standards. If so, the FRB is to promulgate recommendations that specify such stricter standards, but with respect to non-U.S. financial companies, such stricter standards will not apply to any activity conducted solely outside the United States if such activities are conducted only by an entity located outside the United States.[6]

Termination of Activities

Despite imposition of stricter standards on a non-U.S. financial company, if the FRB believes that a condition, practice, or activity of a non-U.S. bank subject to stricter standards does not comply with the law or orders issued by the FRB or "otherwise poses a threat to financial stability," the FRB may "take such actions as necessary to mitigate such risk," including ordering a termination of the activities of the particular branch, agency, or subsidiary.

While such an order is supposed to come after notice and an opportunity for a hearing, the FRB can issue an order without notice or opportunity for a hearing if the FRB determines that immediate action is necessary "in order to protect the public interest."[7]

Other Amendments

Even if a non-U.S. bank is not tapped by the council for stricter standards, H.R. 4173 contains other provisions applicable to financial companies that would be applicable to non-U.S. banks.

Stress Tests. Financial companies not subject to stricter standards but that have more than $10 billion in assets will be required to conduct semi-annual "stress tests" (a term to be defined by regulation) and submit the results to the FRB. Financial companies subject to stricter standards must perform these stress tests on a quarterly basis.[8]

Increased Lending Limit Restrictions. U.S. branches and agencies of non-U.S. banks (whether licensed by a state or by the Office of the Comptroller of the Currency (OCC)) are subject to the same lending limits as for national banks that are regulated by the OCC. H.R. 4173 revises the lending limits for national banks to broaden the definition of "loan" to include credit exposure to a person arising from a derivative transaction, repurchase (or reverse repurchase) agreement, or securities lending or borrowing transaction between the bank and the borrower.[9] U.S. branches and agencies of non-U.S. banks often are engaged in derivatives activities with their clients so non-U.S. banks should take special note of this provision.

Retention of Credit Risk. Non-U.S. banks that engage in asset securitization activities in the United States now will be required to retain a portion of the risk in the loans they sell. Under H.R. 4173, federal banking, securities and housing regulators must jointly prescribe regulations to require (i) any creditor that makes a loan to retain an economic interest in a material portion of the credit risk (initially set at 5 percent but under certain circumstances, can be reduced below 5 percent, increased to more than 5 percent or exempted entirely) of any such loan that the creditor transfers, sells or conveys to a third party, "including for the purpose of including such loan in a pool of loans backing an issuance of asset-backed securities" and (ii) any securitizer of asset-backed securities, not otherwise covered as a "creditor" described in (i), to retain an economic interest in a material portion of any such asset used to back an issuance of securities.

Regulators have the option of applying the risk retention requirements to securitizers of loans or particular types of loans in addition to or in substitution for any or all of the requirements placed on the creditors that actually make the loans, as well as to grant exemptions from any regulations that are issued. The regulations also must: (i) specify that the retained credit risk must be no less at risk than the average of the credit risk not retained, (ii) establish a minimum time period for the risk to be retained and (iii) prohibit a creditor or securitizer from directly or indirectly transferring or hedging the credit risk it is required to retain.[10]

Dissolution Authority

One of the linchpins of the House bill is the systemic dissolution provision, under which the Secretary of the Treasury may determine that a particular financial company is in default or in danger of default, the failure of the financial company would have serious adverse effects on financial stability or economic conditions in the United States, and the appointment of a receiver would avoid or mitigate such adverse effects.[11] For purposes of this section, the term "financial company" is limited to a U.S. company; however, while a non-U.S. bank would not be subject to the systemic dissolution provisions, any U.S. subsidiary bank or financial company of the non-U.S. bank would be so subject.[12]

In order to fund the dissolutions if the assets of the financial company do not cover the costs, the House bill establishes a Systemic Dissolution Fund that would be capitalized through assessments by the FDIC on financial companies with total assets of $50 billion or more (except for hedge funds, where the threshold is $10 billion or more) (adjusted for inflation annually) pursuant to regulations issued by the FDIC in consultation with the council, with the maximum amount of the fund at any time generally being $150 billion.

> Financial companies not subject to stricter standards but that have more than $10 billion in assets will be required to conduct semi-annual stress tests' (a term to be defined by regulation) and submit the results to the Federal Reserve System.

Examining Progress

H.R. 4173 adds an additional factor to the FRB's consideration of an application by a non-U.S. bank to establish a U.S. branch or agency, or to acquire or control a U.S. commercial lending company: whether the home country of a non-U.S. bank that has been determined to be a systemic risk to the United States has adopted or made "demonstrable progress" toward adopting an appropriate system of financial regulation to mitigate such systemic risk.

The House bill also authorizes the FRB to terminate the authority of a non-U.S. bank to operate a U.S. branch, agency or commercial lending company subsidiary if the non-U.S. bank presents a systemic risk to the United States and the home country of the non-U.S. bank has not adopted or made demonstrable progress toward adopting an appropriate system of financial regulation to mitigate the systemic risk.[13]

Conclusion

The debate over regulatory reform is far from over; the next stop is the Senate. This past November, Senator Christopher Dodd (D-Conn.), chair of the Senate Banking, Housing and Urban Affairs Committee, issued a discussion draft of a regulatory reform bill, which also was based on the Obama administration plan. However, that draft received strong criticism, and he now is working with the members of his committee from both parties to issue a new draft of a regulatory reform bill, which is expected to be issued sometime this month.

Final enactment of financial regulatory reform legislation likely will not occur until the spring. No matter how the final legislation turns out, non-U.S. banks should pay close attention because the final bill will have an impact, and perhaps a significant impact, on their U.S. operations.

1. See Financial Regulatory Reform, a New Foundation: Rebuilding Financial Supervision and Regulation, June 17, 2009, available at http://www.treas.gov/initiatives/regulatoryreform.
2. "International Banking: U.S. and EU Proposed Regulatory Reforms: Chance for Real Change?," New York Law Journal, July 15, 2009.
3. H.R. 4173, §1000.
4. H.R. 4173, §1103(b).
5. H.R. 4173, §1104(a).
6. H.R. 4173, §1107(a).
7. H.R. 4173, §1104(e).
8. H.R. 4173, §1114.
9. H.R. 4173, §1308.
10. H.R. 4173, §1502. Exempted from this requirement are loans insured, guaranteed or administered by the Departments of Education, Agriculture and Veterans Affairs, and the Small Business Administration; and made, insured, guaranteed or purchased by any person that is subject to the supervision of the Farm Credit Administration.
11. H.R. 4173, §1603.
12. H.R. 4173, §1602.
13. H.R. 4173, §1951.