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INTERNATIONAL BANKING

Expert Analysis

Dodd-Frank's Effect on Non-U.S. Banks Doing Business in the United States

By
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In my January 2010 column, I wrote about the financial services regulatory reform bill that had been passed by the U.S. House of Representatives on Dec. 11, 2009.[1] The Senate passed its own version of the bill in May 2010, and after House-Senate conference committee sessions in June, the resulting agreed-upon bill was passed by the House June 30 and by the Senate on July 15, 2010. The President signed the bill, now called the Dodd-Frank Wall Street Reform and Consumer Protection Act, on July 21, 2010.[2]

This month's column will discuss some of the provisions in Dodd-Frank that could be of interest to non-U.S. banks engaging in business in the United States.

Systemic Risk Oversight

Dodd-Frank establishes the Financial Stability Oversight Council (FSOC), chaired by the Secretary of the Treasury with 10 voting members (primarily members of the various agencies that regulate financial services). Among other responsibilities, the FSOC will designate "nonbank financial companies" that are considered to be of "systemic risk" to be supervised and regulated by the Board of Governors of the Federal Reserve System (FRB), which, along with large bank holding companies (bank holding companies with total consolidated assets of more than $50 billion as of Jan. 1, 2010), can be subject to prudential requirements such as more stringent capital and liquidity requirements, leverage and concentration limits, increased risk management requirements, and restrictions on, or termination of, particular conditions, practices or activity at the company.[3]

Under the International Banking Act, generally any non-U.S. bank that maintains a U.S. branch, agency or commercial lending company, and any company controlling that non-U.S. bank, is treated as if it is a bank holding company and is subject to the restrictions of the Bank Holding Company Act of 1956, as amended (BHC Act) on its nonbanking activities in the United States. If the non-U.S. bank has total consolidated assets of more than $50 billion as of Jan. 1, 2010, its U.S. activities and subsidiaries could become subject to all or some of the same prudential requirements as large U.S.-based bank holding companies and nonbank financial companies designated by the FSOC to be supervised by the FRB.

To be a "nonbank financial company," the company must derive 85 percent or more of its annual gross revenues from, or its consolidated assets relating to, "financial activities" (as that term is defined in §4(k) of the BHC Act). A "foreign nonbank financial company" is a non-U.S. company that is not otherwise treated in the United States as a bank holding company, that is incorporated or organized in a country other than the United States, and that meets the 85 percent revenue/assets test noted above. Thus, a non-U.S. bank without a U.S. branch, agency or commercial lending company could be designated by the FSOC as a foreign nonbank financial company and its U.S. activities or subsidiaries could become subject to supervision by the FRB.

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Various standards, processes and exemptions remain to be clarified through regulations and other regulatory issuances. In subjecting non-U.S.-based bank holding companies and foreign nonbank financial companies subject to supervision by the FRB to the increased prudential requirements, the FSOC and the FRB are to "give due regard to the principle of national treatment and equality of competitive opportunity," consider the extent to which the non-U.S. financial company in its home country is subject to consolidated supervision on a basis comparable to that applied to U.S. financial companies, and consult with appropriate home country regulatory authorities as appropriate.

Revised Lending Limits

U.S. branches and agencies of non-U.S. banks, whether federally or state-licensed, are subject to the same lending limits as national banks. Thus, by revising the lending limits for national banks, Dodd-Frank also revised the lending limits for U.S. branches and agencies of non-U.S. banks.[4] These revised limits, among other things, 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. U.S. branches and agencies of non-U.S. banks should keep these changes in mind when structuring loan transactions.

Retention of Credit Risk

Under Dodd-Frank, the federal banking agencies and the Securities and Exchange Commission (and, with respect to residential mortgages, the federal housing regulators), must jointly issue regulations requiring securitizers (and in some circumstances, originators who are not otherwise securitizers), in accordance with specified standards, to retain an economic interest in a portion of any asset (set generally at 5 percent of the credit risk amount but adjustable up or down depending upon the circumstances) that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party.[5] Some of the specified standards include a requirement that the securitizer not be permitted to hedge or otherwise transfer the portion of the credit risk it is required to hold. There are specific exemptions (and more may be granted by the regulators), including for certain residential mortgages, and for certain government-backed loans or assets, but Fannie Mae and Freddie Mac are ineligible for this exemption. Regulations are required no later than 270 days after the date of enactment (April 17, 2011), but the effective date would be delayed by one to two years, depending upon the asset being securitized.

Dissolution Authority

One of the key provisions of the various versions of regulatory reform has been aimed at eliminating the notion of a financial company being "too big to fail." Under Dodd-Frank, the Secretary of the Treasury may, under certain circumstances, put a failing nonbank financial company into receivership.[6] This authority is limited to a U.S. company, so while a non-U.S. bank would not be subject to the dissolution authority, a U.S. subsidiary potentially would be subject. While the House bill provided for pre-funding of a fund to be used to pay the costs of a receivership of a

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nonbank financial company, Dodd-Frank provides for after-the-fact funding of the fund.

U.S. Offices of Non-U.S. Banks

Dodd-Frank amended the International Banking Act to add to the list of issues that may be considered by the FRB when a non-U.S. bank applies to establish a U.S. branch or agency, or to acquire or control a U.S. commercial lending company. With respect to an applicant non-U.S. bank "that represents a risk to the stability of the U.S. financial system," the FRB may consider whether the non-U.S. bank's home country has adopted, or "is making demonstrable progress toward adopting, an appropriate system of financial regulation for the financial system of such home country to mitigate such risk."[7] The FRB also will be able to terminate the authority of such a bank to operate a branch, agency or commercial lending company in the United States if it finds that the bank's home country has not adopted, or made any demonstrable progress toward adopting, an appropriate system of financial regulation to mitigate such risk.

Capital Requirements

Under the so-called "Collins Amendment" (for Senator Susan Collins of Maine, a primary proponent of the amendment), the federal banking agencies are required to establish, on a consolidated basis, minimum leverage capital requirements and risk-based capital requirements. These rules are applicable to depository institutions (banks and thrift institutions) and their holding companies, and nonbank financial companies deemed to be of systemic risk and supervised by the FRB.[8] While bank holding companies have been subject to risk-based capital rules for many years, savings and loan holding companies (which control thrift institutions such as savings banks and savings and loan associations) have not.

These new capital requirements will be applicable only to U.S. entities. Non-U.S. banks that are depository institution holding companies because they own insured depository institutions will not themselves be subject to the capital requirements but the requirements will be applicable to any U.S.-based depository institution or depository institution holding company. Over the years, some non-U.S. banks that have maintained an intermediate U.S. holding company to hold a U.S. banking organization have relied on the provisions of FRB Supervisory Letter 01-1, which provides that U.S. bank holding company capital standards are not applicable to U.S. bank holding companies that are owned by non-U.S. banks that qualify as financial holding companies.[9] That authority will be phased out over five years.

Volcker Rule

Under the so-called Volcker Rule in Dodd-Frank, subject to certain exceptions, "banking entities" are prohibited from engaging in proprietary trading in most securities and financial instruments or sponsoring or investing in hedge funds or private equity funds.[10] The federal financial regulators must issue regulations to implement the section. "Banking entities" include insured depository institutions, any company that controls an insured depository institution, any company that is treated as a bank holding company for purposes of the International Banking Act, and any affiliate of the above. As such, this would capture non-U.S. banks that maintain branches and agencies in the United States and non-U.S. systemically significant financial companies regulated by the FRB.

Permitted proprietary trading activities include activities conducted solely outside the United States under §§4(c)(9) and 4(c)(13) of the BHC Act.[11] Under these sections, a non-U.S. bank's activities in the United States do not need to take place completely outside the United States; however, the Volcker Rule exception requires that the transaction be conducted solely outside the United States. Regulations will have to clarify the precise parameters of this exception. Moreover, a non-U.S. bank that is not subject to §§4(c)(9) and 4(c)(13) of the BHC Act, (because it does not maintain a branch, agency or commercial lending company and does not otherwise own an insured bank) does not appear to be able to take advantage of this exclusion.

Swaps Push-Out

Under Dodd-Frank, no "federal assistance" may be provided to any "swaps entity," a prohibition which would include access to the Federal Reserve Bank discount window for purposes of obtaining a loan from the Federal Reserve Bank.[12] Insured depository institutions are permitted to engage in hedging and other similar risk-mitigating activities directly related to the insured depository institution's activities or engage in swaps related to assets that are permissible investments for a national bank. However, U.S. branches and agencies of non-U.S. banks, most of which are uninsured, will not be able to take advantage of that exclusion when it becomes effective in July of 2012. This oversight appears to be an inadvertent drafting error, acknowledged as such in a colloquy between Senators Christopher Dodd, D-Conn., and Blanche L. Lincoln, D-Ark., and thus likely will be remedied in any bill to make technical corrections to Dodd-Frank.[13]

U.S. regulators are required to consult and coordinate with foreign regulatory authorities on the establishment of "consistent international standards" regarding the regulation (including fees) of swaps, entities engaging in swaps activities, and futures and options contracts.[14]

Regulatory Consolidation

Non-U.S. banks have established a variety of U.S. subsidiary banking institutions. Dodd-Frank reshuffles the deck of regulators. The Office of Thrift Supervision, which charters federal savings associations and supervises and regulates savings and loan holding companies, is being abolished in 2011, and its powers transferred to the FRB (for savings and loan holding company supervision and regulation, but using the provisions of the Home Owners Loan Act), the Office of the Comptroller of the Currency for federal savings association chartering and supervision and the Federal Deposit Insurance Corporation for supervision of state savings institutions.

Retail Deposit Threshold

By making the temporary increase in the federal standard maximum deposit insurance amount to $250,000 permanent, Dodd-Frank also has made permanent the temporary increase from $100,000 to $250,000 in the dollar threshold for purposes of the prohibition on state-licensed U.S. branches of non-U.S. banks accepting "retail deposits" that I wrote about in my May 12, 2010 column.[15]

FHC Merchant Banking

Many non-U.S. banks qualified to be treated as if they were financial holding companies (FHC) in order to engage in merchant banking activities. Under an amendment to the BHC Act in Dodd-Frank, FHCs no longer will be able just to give notice of merchant banking acquisitions exceeding $10 billion; affirmative approval from the FRB will be required.[16]

Conclusion

The true effect of Dodd-Frank on all financial institutions, not just non-U.S. banks, will unfold over the coming months and years as effective dates are reached, required studies are completed and mandatory and permissive regulations are promulgated. Non-U.S. banks will continue to need to weigh the potential added costs of doing business in the United States as a result of Dodd-Frank against the benefit of being able to access the U.S. markets. Moreover, some of what Dodd-Frank has wrought in the United States may be adopted in other countries as well.

1. Jan. 13, 2010, New York Law Journal, "International Banking: The House Regulatory Reform Bill and Non-U.S. Banks."
2. Public Law 111-203, July 21, 2010, 124 Stat. 1376.
3. Pub. Law 111-203, §113.
4. Pub. Law 111-203, §610.
5. Pub. Law 111-203, §941.
6. Pub. Law 111-203, Title II.
7. Pub. Law 111-203, §173.
8. Pub. Law 111-203, §171.
9. FRB Supervisory Letter SR 01-1 (SUP), "Application of the Board's Capital Adequacy Guidelines to Bank Holding Companies owned by Foreign Banking Organizations," Jan. 5, 2001, accessible at http://www.federalreserve.gov/boarddocs/srletters/2001/sr0101.htm.
10. Pub. Law 111-203, §619.
11. Permitted fund-related activity also includes acquiring or retaining ownership interests in or sponsoring a hedge fund or private equity fund outside the United States under those two sections (there is a prohibition on offering interests to U.S. residents).
12. Pub. Law 111-203, §716.
13. Congressional Record, July 15, 2010, S5903-S5904.
14. Pub. Law 111-203, §752.
15. "High Price of 'Retail': Deposits in U.S. Branches of Non-U.S. Banks," NYLJ, May 12, 2010; Pub. Law 111-203, §335.
16. Pub. Law 111-203, §604(e).