New York Law Journal
WWW.NYLJ.COM
An ALM Publication
VOLUME 249—NO. 006
WEDNESDAY, JANUARY 9, 2013

INTERNATIONAL BANKING

Expert Analysis

Proposed Enhanced Prudential Standards for Non-U.S. Banks

By
Kathleen A. Scott

Among its many new requirements for banks and their regulators, the Dodd-Frank Wall Street Reform and Consumer Protection Act[1] required the Board of Governors of the Federal Reserve System (FRB) to promulgate enhanced prudential standards for large banking organizations and nonbank financial companies that have been deemed to be a systemic risk to the U.S. financial system. "Large" financial institutions have been defined as those with $50 billion or more in consolidated assets. On Dec. 28, 2012, a Notice of Proposed Rulemaking was published in the *Federal Register* by the FRB regarding the imposition of enhanced prudential standards on non-U.S. banking organizations with banking operations in the United States.[2] Comments are requested by March 31, 2013.

The proposed regulations include limits on loans to one counterparty, required stress tests and probably most importantly, the requirement for some non-U.S. banks to establish an intermediate holding company (IHC) for its U.S. subsidiaries. This month's column provides a broad overview of the Notice and some of its 103 questions on which the FRB has requested comment.

KATHLEEN A. SCOTT *is counsel in the financial services practice group at Arnold & Porter LLP.*

Background

FRB staff believe that the proposed regulations contained in the Dec. 28 Notice are "broadly consistent" with the proposed regulations published in the *Federal Register* on Jan. 5, 2012, regarding enhanced prudential standards for domestic U.S. bank holding companies, and for U.S. nonbank financial companies designated as posing a systemic risk to the U.S. financial system.[3]

FRB staff also assert in the Notice that any differences are due to how non-U.S. banks operate in the United States, and should not be construed as evidencing any changes in position on the FRB's proposed enhanced prudential standards on U.S. bank holding companies and U.S. nonbank financial companies.[4] In addition, FRB staff note that the FRB believes that these proposed requirements are supplementary to, and not departing from, existing supervisory practices.[5]

The Notice

Most of the proposed regulations generally are applicable only to non-U.S. banks with total global consolidated assets of $50 billion or more that have a banking presence in the United States through operating a U.S. branch, agency or commercial lending company, or controlling a U.S. bank, or any company of which the non-U.S. bank is a subsidiary. If the non-U.S. bank has total global consolidated assets of $50 billion or more at least $10 billion of which is represented by a U.S. subsidiary, the enhanced prudential standards are more stringent.

The Notice is very detailed and deserves close review by non-U.S. banks, but below is a broad overview of the proposed requirements that escalate as the level of the non-U.S. bank's U.S.-based assets increases.

(1) Non-U.S. banks with at least $10 billion or more of total global consolidated assets will be required to:

• Certify, if they are publicly traded, that they maintain a U.S. risk committee that has at least one member with risk

> The proposed regulations include the requirement for some non-U.S. banks to establish an intermediate holding company for its U.S. subsidiaries.

management expertise commensurate with, among other criteria, the risk profile and complexity of the combined U.S. operations of the non-U.S. bank;

• Be subject to a home country stress testing regime that is broadly consistent with the FRB's own stress testing requirements for U.S. bank holding companies, or otherwise be subject to additional requirements to help ensure the capital adequacy of their U.S. operations.

(2) Non-U.S. banks with at least $50 billion or more of total global consolidated assets but less than $50 billion of those consolidated assets located in the United States will be required to:

• Comply with the requirements listed above for non-U.S. banks with at least $10 billion of total global consolidated assets;

• Certify to the FRB that it meets the capital adequacy standards established by its home country supervisor on a consolidated basis and that those standards are consistent with the Basel Capital Accords;

• Annually report to the FRB the results of an internal liquidity stress test (either on a consolidated basis or for its combined U.S. operations) pursuant to a home country stress testing regime that is broadly consistent with U.S. stress testing standards;

• Limit its aggregate net credit exposure to a single unaffiliated counterparty to 25 percent of regulatory capital of the non-U.S. bank or its U.S. intermediate holding company subsidiary, with that limit becoming stricter the higher the amount of the non-U.S. bank's total global or U.S. consolidated assets[6]; limits would be applicable to non-U.S. sovereign governments except the non-U.S. bank's own home country sovereign, and applicable to U.S. state and local governments, but not the U.S. federal government;

• Be subject to early remediation requirements to address financial distress in the non-U.S. bank's U.S. operations if deemed necessary by the FRB.

(3) Non-U.S. banks with (i) at least $50 billion or more of total global consolidated assets and (ii) U.S. assets of at least $10 billion but less than $50 billion (excluding assets of the non-U.S. bank's U.S. branch/agency network and of so-called "2(h)(2) companies")[7] will be required to:

• Form a U.S. intermediate holding company (IHC) for its U.S. subsidiaries (except for 2(h)(2)companies), including those that hold merchant banking investments; the FRB is proposing to apply the U.S. bank holding company risk-based capital and leverage requirements to such IHC, regardless of whether the IHC holds a depository institution subsidiary, and other enhanced prudential requirements proposed for large U.S. bank holding companies;

• Subject its U.S. IHC to the annual internal company-run stress requirements of Dodd-Frank for U.S. bank holding companies with assets of at least $10 billion.[8]

(4) Non-U.S. banks with at least $50 billion or more of total global consolidated assets and U.S. combined assets of at least $50 billion (including those of its U.S. branches and agencies) will be required to:

• Comply with all of the foregoing requirements applicable to non-U.S. banks with less than $50 billion in U.S. assets;

• Have its IHC with assets of more than $50 billion subject to the requirements to have a capital plan and to stress tests run by the FRB (in addition to internal stress tests run semi-annually imposed per Dodd-Frank on U.S. bank holding companies with more than $50 billion in assets)[9];

• Have both its IHC and its direct U.S. branches/agencies subject to the monthly liquidity stress tests and 30-day liquidity buffer requirements applicable to U.S. bank holding companies; while IHCs would need to maintain the highly liquid unencumbered assets satisfying this requirement in U.S. accounts for the entire 30 days, U.S. branches and agencies of the non-U.S. banking organization could, under certain conditions, maintain such assets at its head office after the 14th day;

• Whether or not publicly traded, have a U.S. Chief Risk Officer in addition to a U.S. risk committee with at least one member of such risk committee being independent;

• Be subject to the nondiscretionary Dodd-Frank early remediation requirements if the FRB determines that the non-U.S. bank's U.S. operations are in financial distress.

Remediation measures start with a targeted supervisory review of the non-U.S. bank's U.S. operations, then progress to limits on the non-U.S. bank's growth or operations in the United States, and finally culminate with consideration by the FRB whether to terminate the non-U.S. bank's ability to operate in the United States.

Remediation

Early remediation depends on the regulatory capital ratios, stress test results, market-based indicators and risk management weaknesses of the non-U.S. bank. While imposition of any remedial measures on non-U.S. banks with less than $50 billion in total U.S. assets is at the discretion of the FRB, once that $50 billion in U.S. assets threshold is reached, mandatory remediation requirements are imposed.

Remediation measures start with a targeted supervisory review of the non-U.S. bank's U.S. operations, then progress to limits on the non-U.S. bank's growth or operations in the United States, and finally culminate with consideration by the FRB whether to terminate the non-U.S. bank's ability to operate in the United States.

Effective Date

No doubt understanding the material changes in operations that non-U.S. banks may need to make to comply with any final regulations, the FRB has proposed a long implementation period, an issue on which the FRB has

specifically requested comment. The proposed effective date of the rule generally is July 1, 2015, for those non-U.S. banks that meet one or more of the regulation's various asset thresholds as of July 1, 2014, including the requirement to have formed an IHC. Non-U.S. banks reaching required thresholds after July 1, 2014, generally (subject to certain exceptions) have a year thereafter to conform to the requirements.

Comments Requested

FRB staff have raised 103 specific questions in the Notice on which it would like comment, in addition to comments generally on any aspect of the proposal. The questions cover such areas as costs of compliance, effective dates, calculation of asset thresholds, proposed exemptions, implementation challenges and triggers for remedial action.

Just to highlight two of the areas where specific questions were asked, first, the Notice poses several questions with respect to the proposed requirement regarding the formation and operation of an IHC.[10] One of the reasons for the proposed IHC requirement is to enable the FRB to impose the enhanced prudential requirements on a non-U.S. banking organization's U.S. subsidiaries on a "consistent, comprehensive and consolidated basis," which should avoid difficulties the FRB could encounter in monitoring compliance at the consolidated non-U.S. bank level due to limited access to information on the non-U.S. bank's global operations as a whole.[11]

In determining whether a particular company is a "subsidiary" that would be required to be placed under the IHC, the FRB is recommending using the terms "subsidiary" and "control" as defined in the FRB's regulations on bank holding companies, 12 CFR Part 225 (Regulation Y), which would mean that ownership of as little as 25 percent of any class of voting shares of a particular company could require the non-U.S. bank to treat that company as a subsidiary.[12]

The questions on which comment has been requested include issues such as (i) calculation of the asset threshold triggering the IHC requirement, (ii) possible additional exemptions to the IHC requirement, (iii) the definition of "subsidiary," and (iv) costs and tax consequences of implementing this provision. Questions already have been raised as to whether this IHC requirement needs to be more closely tailored to those non-U.S banking organizations with subsidiaries that potentially pose a realistic risk to the U.S. financial system.[13]

Second, the Notice discusses in great detail the proposed regulatory regime that provides for early remediation if financial weaknesses occur at U.S. bank holding companies and non-U.S. banks with total consolidated assets of $50 billion or more and nonbank financial companies deemed to be a systemic risk to the U.S. financial system.[14] As noted above, the remediation measures range from targeted supervisory reviews to consideration by the FRB as to whether to terminate the non-U.S. bank's ability to maintain a banking presence in the United States or to resolve a U.S. subsidiary of the non-U.S. bank.

The Notice points out that the triggers for remediation are "broadly consistent" with those proposed for U.S. bank holding companies, with modifications to reflect the structure of non-U.S. banks. Some of the questions posed in this section of the Notice are similar to those posed in the notice on enhanced prudential standards for U.S.-based bank holding companies with consolidated assets of $50 billion or more[15] (e.g., triggers and other factors regarding imposition of remedial actions), while others focus more on to what extent, if at all, the proposed triggers must be adjusted further to account for the manner in which non-U.S. banks operate in the United States.

Conclusion

Large non-U.S. banks with U.S. banking operations should undertake a careful and thorough review of the Notice, and the specific questions on which the FRB has requested feedback, and consider submitting a comment that specifically sets out for the FRB the practical effect of the regulation on the non-U.S. bank's operations in the United States, and the associated costs. A non-U.S. bank cannot submit a comment simply stating "We don't like it, don't do it." Such a comment will be of no use to the FRB staff reviewing the comments and developing the final rule. Dodd-Frank requires regulations to be issued regarding sections 165 and 166.

This Notice is the chance for non-U.S. banks to weigh in on regulations that could impact their U.S. operations for many years to come. The more substantive the commenter can be about the effect of the proposed regulations as currently written, such as with respect to costs of compliance and material changes that would be needed to the non-U.S. bank's U.S. operations in order to comply, then the more use that comment will be to the FRB staff.

1. Pub. Law 111-203, July 21, 2010.
2. 77 Fed. Reg. 76628, Dec. 28, 2012.
3. 77 Fed. Reg. 594, Jan. 5, 2012.
4. See 77 Fed. Reg. at 76632.
5. See 77 Fed. Reg. at 76636.
6. Non-U.S. banks with total global consolidated assets of at least $500 billion and IHCs with assets of at least $500 billion would be subject to loan to one borrower limits of between 10 and 25 percent.
7. Section 2(h)(2) of the Bank Holding Company Act of 1956 allows qualifying foreign banking organizations to retain their interests in non-U.S. commercial firms conducting business in the United States.
8. See 12 C.F.R. §§252.151 to 252.157.
9. See 12 C.F.R. §§252.141 to 252.148.
10. See 77 Fed. Reg. at 76637-76639.
11. 77 Fed. Reg. at 76637.
12. See proposed 12 C.F.R. §252.3 and 12 C.F.R. §225.2 (e) and (o): Control of a bank or other company means (i) direct or indirect ownership, control, or power to vote 25 percent or more of the outstanding shares of any class of voting securities of the bank or other company; (ii) control in any manner over the election of a majority of the directors, trustees, or general partners of the bank or other company; (iii) power to exercise, directly or indirectly, a controlling influence over the management or policies of the bank or other company; or (iv) conditioning in any manner the transfer of 25 percent or more of the outstanding shares of any class of voting securities of a bank or other company upon the transfer of 25 percent or more of the outstanding shares of any class of voting securities of another bank or other company.
13. See "Press Statement by IIB [Institute of International Bankers] CEO Sally Miller on the Federal Reserve's Proposed Rules Applying Enhanced Prudential Standards to Large Foreign Banking Organizations," Dec. 14, 2012, available on the IIB website at www.iib.org.
14. See 77 Fed. Reg. at 76664 -76674.
15. See 77 Fed. Reg. at 634 - 642.

Reprinted with permission from the January 9, 2013 edition of the NEW YORK LAW JOURNAL © 2013 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited. For information, contact 877-257-3382 or reprints@alm.com. # 070-01-13-12.