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Federal Reserve Proposes Enhanced Prudential Standards and Early Remediation Requirements for U.S. Operations of Foreign Banks

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This article focuses on the potential impact to affected foreign banking organizations of the proposed rule to implement provisions of Sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

Recently, the Board of Governors of the Federal Reserve System ("Board") approved for issuance a proposed rule and request for public comment[1] ("Notice") to implement provisions of Sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act" or "Act")[2] related to foreign banking organizations. Sections 165 and 166 generally require the Board to impose enhanced prudential standards on bank holding companies, including foreign banking organizations with a banking presence in the United States, with total consolidated assets of US$50 billion or more and on nonbank financial companies designated for Board oversight by the Financial Stability Oversight Council (Council).[3] This article will deal solely with the proposed regulations' impact

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on affected foreign banking organizations.

The regulations are broadly consistent with the standards that have been proposed for U.S. bank holding companies, and U.S. nonbank financial companies.[4] The Board has asked for feedback on all aspects of the proposed regulations, including in response to 103 specific questions posed in the Notice. The proposed effective date is July 1, 2015.

BACKGROUND

The proposed regulations are applicable to foreign banking organizations that are treated as U.S. bank holding companies for purposes of the Bank Holding Company Act of 1956, pursuant to Section 8(a) of the International Banking Act of 1978: (1) any foreign bank that maintains a branch or agency in a State, (2) any foreign bank or foreign company controlling a foreign bank that controls a commercial lending company organized under state law, and (3) any company of which any foreign bank or company referred to in (1) and (2) is a subsidiary.[5] If the foreign banking organization has such a presence in the United States, and has total global consolidated assets of US$50 billion or more, at least US$10 billion of which is represented by a U.S. subsidiary, the enhanced prudential standards are even more stringent. The proposal also would bolster the capital and liquidity positions of the U.S. operations of foreign banking organizations.

SCOPE

The proposed regulations address seven major areas: establishment of intermediate holding companies, risk-based capital and leverage, liquidity, overall risk management and risk committees, single-counterparty credit limits, stress tests, debt-to-equity limits, and early remediation requirements. Each of these areas is discussed below. The proposed rules generally would apply to foreign banking organizations with total global consolidated assets of US$50 billion or more, and more stringent standards are proposed for such foreign banking organizations that also have combined U.S. assets of US$50 billion or more.[6]

SPECIFIC REQUIREMENTS

U.S. Intermediate Holding Company Requirement

In order to enhance U.S. regulation and supervision of its combined U.S. operations, a foreign banking organization with both US$50 billion or more in global consolidated assets and U.S. consolidated assets of at least US$10 billion that are booked in U.S. subsidiaries would be required to form a U.S. intermediate holding company ("IHC") to hold those assets. This IHC requirement would allow the Board to implement a consistent supervisory program across U.S. subsidiaries of foreign banking organizations. The proposed regulations do *not* require that branches become separately incorporated banking subsidiaries and placed under the IHC.

In calculating the US$10 billion threshold, the foreign banking organization should exclude the assets of its U.S. branches and agencies. In addition, U.S. subsidiaries held under Section 2(h)(2) of the Bank Holding Company Act are not required to be held under the IHC and are not counted towards the US$10 billion threshold for forming an IHC. Section 2(h)(2) of the Bank Holding Company Act allows qualifying foreign banking organizations to retain their interest in foreign commercial firms that conduct business in the United States.[7]

In the event that the U.S. subsidiary operations of a foreign banking organization must be resolved or restructured, a U.S. IHC could help facilitate that resolution or restructuring by providing one top-tier U.S. legal entity to be resolved or restructured. The IHC requirement also would reduce the ability of foreign banking organizations to minimize or avoid enhanced prudential requirements by restructuring their U.S. operations in ways that would not reduce their U.S. risk profile.

Risk-Based Capital and Leverage Requirements

The proposal would require IHCs to meet the same capital standards applicable to U.S. bank holding companies. These requirements would help bolster the consolidated capital positions of the IHCs as well as promote a level playing field among all banking firms operating in the United States.

A foreign banking organization with total global consolidated assets of

US$50 billion or more would be required to certify that it meets capital adequacy standards established by its home country supervisor on a consolidated basis, and that those standards are consistent with the Basel Capital framework. The capital plan rule would require IHCs to submit annual capital plans to the Board in which they demonstrate an ability to maintain capital above the Board's minimum risk-based capital and leverage ratios under both baseline and stressed conditions. An IHC that is unable to satisfy the capital plan rule's requirements generally may not make any capital distributions until it provides a capital plan that is satisfactory to the Board.

Liquidity Requirements

During the financial crisis, many global financial companies experienced significant financial stress, due in part to inadequate liquidity risk management. The U.S. operations of foreign banking organizations also experienced liquidity stresses during the financial crisis and more recently in response to financial strains in Europe. The liquidity requirements in the Board's proposal would establish a regulatory framework for the management of liquidity risk for U.S. operations of foreign banking organizations with at least US$50 billion in total global consolidated assets and combined U.S. assets of US$50 billion or more.

The U.S. operations of these companies would be required to meet enhanced liquidity risk-management standards, conduct liquidity stress tests, and hold a 30-day buffer of highly liquid assets. The U.S. branch and agency network would be required to maintain the first 14 days of its 30-day buffer in the United States and would be permitted to meet the remainder of the requirement at the parent consolidated level. The IHC would be required to maintain the full 30-day buffer in the United States.

A foreign banking organization with total global consolidated assets of US$50 billion or more but combined U.S. assets of less than US$50 billion would be required to report the results of an internal liquidity stress test (either on a global consolidated basis or for its combined U.S. operations) to the Board on an annual basis.

Single-Counterparty Credit Limits

During the financial crisis, counterparties of a failing firm were placed under severe strain when the failing firm could not meet its financial obligations, in some cases resulting in the counterparties' inability to meet their own obligations. Section 165(e) of the Dodd-Frank Act addresses single-counterparty concentration risk among large financial companies. It directs the Board to establish single-counterparty credit exposure limits, for bank holding companies and foreign banking organizations with total global consolidated assets of US$50 billion or more and U.S. and foreign nonbank financial companies supervised by the Board, in order to limit the risks that the failure of any individual firm could pose to the company.[8]

The Board's proposal would impose a two-tier, single-counterparty credit limit on foreign banking organizations. First, the proposal would impose a 25-percent net credit exposure limit between an IHC or the combined U.S. operations of a foreign banking organization and a single unaffiliated counterparty. It would prohibit an IHC from having aggregate net credit exposure to any single unaffiliated counterparty in excess of 25 percent of the IHC's capital stock and surplus. Similarly, it would prohibit the combined U.S. operations of a foreign banking organization from having aggregate net credit exposure to any single unaffiliated counterparty in excess of 25 percent of the consolidated capital stock and surplus of the foreign banking organization.

The proposal also would apply a more stringent limit to the combined U.S. operations of a foreign banking organization that has total global consolidated assets of US$500 billion or more and financial counterparties of similar size,[9] with respect to exposures to certain large financial counterparties.

Risk Management and Risk Committee Requirements

The risk management weaknesses revealed during the financial crisis among many large U.S. bank holding companies also were present in the U.S. operations of large foreign banking organizations. Section 165(b)(1)(A) of the Dodd-Frank Act requires the Board to establish overall risk management requirements as part of the enhanced prudential standards.[10] Implementing Section 165(h) of the Dodd-Frank Act, the Board's proposed regulation requires any publicly traded bank holding company with US$10 billion or more in total consolidated assets to establish a risk committee. A foreign banking organization with total global consolidated assets of US$10 billion or more would be required to certify that it maintains a U.S. risk committee.[11] In general, the company's enterprise-wide risk committee may serve as the U.S. risk committee.

Any foreign banking organization, regardless of whether its stock is publicly traded, with combined U.S. assets of US$50 billion or more would be subject to additional U.S. risk committee requirements and a requirement to appoint a U.S. chief risk officer in charge of implementing and maintaining a risk management framework for the company's combined U.S. operations.

Stress Test Requirements

The Board has previously highlighted the use of stress testing as a means to better understand the range of a banking organization's potential risk exposures.[12] The Board's proposed regulations would help to ensure that IHCs have sufficient capital in the United States to withstand a severely adverse stress scenario.

The proposal would apply stress testing requirements to the U.S. branches and agencies of a foreign banking organization by first evaluating whether the home country supervisor for the foreign banking organization conducts a stress test and, if so, whether the stress testing standards that are applicable to the consolidated foreign banking organization in its home country are broadly consistent with U.S. stress testing standards. If a foreign banking organization with combined U.S. assets of US$50 billion or more is subject to a home country stress testing regime that is broadly consistent with U.S. standards, the company could generally meet the stress test requirement of the proposed regulations by submitting a high-level summary of annual stress test results for the consolidated company.

However, if the U.S. branch and agency network of a foreign banking organization with combined U.S. assets of US$50 billion or more generally provides, on a net basis, funding to its parent, the foreign banking organization would be required to provide additional, more detailed, information regarding the results of its annual consolidated capital stress test. Foreign banking organizations with combined U.S. assets of less than US$50 billion that are subject to and comply with a consistent consolidated capital stress test regime in their home country would not be required to submit results of their home country stress tests on an annual basis.

Early Remediation Framework

The Board's proposal would implement early remediation requirements for foreign banking organizations with total global consolidated assets of US$50 billion or more. The combined U.S. operations of a foreign banking organization would be subject to early remediation triggers based on capital ratios, stress test results, market indicators and liquidity, and risk management weaknesses. The framework would minimize the probability that such companies will become insolvent and mitigate the potential harm of such insolvencies to the financial stability of the United States.[13]

A foreign banking organization with total global consolidated assets of at least US$50 billion and combined U.S. assets of at least US$50 billion that exceeds an early remediation trigger would be subject to a set of non-discretionary remediation actions imposed on its U.S. operations. Foreign banking organizations with a smaller U.S. presence would not be automatically subject to remediation actions.

There are four levels of remediation:

- Heightened supervisory review (Level 1), in which supervisors conduct a targeted review of the foreign banking organization's U.S. operations to determine if it should be moved to the next level of remediation;
- Initial remediation (Level 2), in which a foreign banking organization's U.S. operations are subject to an initial set of remediation measures, including restrictions on growth and capital distributions;
- Recovery (Level 3), in which a foreign banking organization's U.S. operations are subject to a prohibition on growth and capital distributions, restrictions on executive compensation, requirements to raise additional capital, and additional requirements on a case-by-case basis; and
- Recommended resolution (Level 4), in which the Board would consider whether the U.S. operations of the foreign banking organization

warrant termination or resolution based on the financial decline of the combined U.S. operations and other relevant factors.

Debt-to-Equity Limitation

Section 165(j) of the Dodd-Frank Act provides that the Board must require a foreign banking organization with US$50 billion or more in total global consolidated assets to maintain a debt-to-equity ratio of no more than 15-to-1, upon a determination by the Council that such company poses a grave threat to the financial stability of the United States, and that the imposition of such requirement is necessary to mitigate the risk that such company poses to the financial stability of the United States. The proposal would implement the debt-to-equity ratio limitation with respect to a foreign banking organization by applying a 15-to-1 debt-equity limitation to its IHC (or, if the foreign banking organization does not have an IHC, on each U.S. subsidiary) and a 108-percent asset maintenance requirement on its U.S. branch and agency network, if applicable.

TIMING OF IMPLEMENTATION

The Board has proposed an extended phase-in period to allow foreign banking organizations time to implement the proposed requirements. For foreign banking organizations that meet the total global consolidated assets threshold of US$50 billion and, as applicable, the combined U.S. asset threshold of US$50 billion as of July 1, 2014, the enhanced prudential standards required under this proposal would apply beginning on July 1, 2015.

Unless accelerated or extended by the Board in writing, a foreign banking organization that becomes subject to the requirements of the proposal after July 1, 2014, would be required to form a U.S. IHC beginning one year after it reaches the total global consolidated asset threshold of US$50 billion and the US$10 billion minimum in combined U.S. assets, excluding assets of the foreign banking organization's branches and agencies and the foreign banking organization's (2)(h)(2) investments. Such foreign banking organization would be required to comply with the enhanced prudential standards (other than stress test requirements and the capital plan rule) beginning on the same date as it is required to establish the IHC, unless accelerated or extended by the Board. The stress test requirements and the capital plan rule would be applied in October of the year after that in which the foreign banking organization is required to establish the IHC.

NOTES

[1] "Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies," Board of Governors of the Federal Reserve System, RIN 7100 AD 86, December 14, 2012 (*available at* http://www.federalreserve.gov/newsevents/press/bcreg/20121214a.htm).

[2] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[3] Section 113 of the Dodd-Frank Act authorizes the Council to designate a U.S. nonbank financial company for supervision by the Board if the FSOC determines, pursuant to factors set forth in the Act, that the U.S. nonbank financial company could pose a threat to the financial stability of the United States. To date, no such designation has been made.

[4] 77 Fed. Reg. 594, January 5, 2012.

[5] *See* Dodd-Frank §102(a)(1), 12 U.S.C. § 5311; 12 U.S.C. § 3106 (a) (International Banking Act).

[6] Pub L No 111-203, 124 stat. 1376, 1426-1427; *see* 12 USC 5365, 5366.

[7] The IHC requirement excludes a foreign banking organization's U.S. branch and agency assets and investments in 2(h)(2) companies when determining the combined U.S. assets of the foreign banking organization. In determining the applicability of other requirements in the proposed regulations that are triggered by combined U.S. assets of the foreign banking organization, the foreign banking organization would include its U.S. branch and agency requirements and any investments in 2(h)(2) companies.

[8] *See* 12 U.S.C. § 5365(e)(1).

[9] Major counterparty would be defined to include a bank holding company or foreign banking organization with total consolidated assets of US$500 billion or more, and their respective subsidiaries, and any nonbank financial company supervised by the Board.

[10] 12 U.S.C. § 5365(b)(1)(A).

[11] 12 U.S.C. § 5365(h).

[12] *See e.g.*, Supervisory Guidance on Stress Testing for Banking Organizations

With More Than $10 billion in Total Consolidated Assets, 77 FR 29458 (May 17, 2012); SR 10-6 Interagency Policy Statement on Funding and Liquidity Risk Management (March 17, 2010), *available at* http://www.federalreserve.gov/boarddocs/srletters/2010/sr1006.htm.

[13] *See* 12 U.S.C. 5366(b).