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INTERNATIONAL BANKING

Expert Analysis

Dodd-Frank Three Years On: International Bank Consequences

It has been almost three years since President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act on July 21, 2010.[1] This month's column will discuss some of the effects Dodd-Frank has had thus far on non-U.S. banks with U.S. banking operations.[2]

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Prudential Standards

Under Dodd-Frank, large U.S. bank holding companies with total consolidated assets of more than $50 billion as of Jan. 1, 2010, and non-U.S. banks that had total global consolidated assets of more than $50 billion as of Jan. 1, 2010, will be subject to heightened supervision by the Board of Governors of the Federal Reserve System (FRB) with additional prudential requirements over and above their normal supervision and examination by the FRB, including 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]

The FRB has proposed prudential requirements for both U.S.-based bank holding companies,[4] and for non-U.S.-based banks with banking operations in the United States.[5]

On the non-U.S. based bank side, 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.

However, some requirements begin to be applicable when the total global consolidated assets of a non-U.S. bank with a U.S. banking presence reached at least $10 billion, with additional requirements added as the total global consolidated assets, and the U.S. assets, of the non-U.S. bank increase.

These additional requirements include maintenance of a U.S. risk committee, certified compliance with home country capital standards, required stress test requirements in the home country and the United States, imposition of limits on aggregate credit exposure to a single counterparty, development of capital plans and enhanced liquidity requirements.

Comments were received from a variety of trade groups representing both U.S. and non-U.S. banks, financial institutions, individuals, and international governmental agencies. One issue focused on by many of the commenters was the proposal by the FRB to require a non-U.S. bank with at least $50 billion or more of total global consolidated assets and U.S. assets of at least $10 billion (excluding assets of the non-U.S. bank's U.S. branch/agency network and of so-called "2(h)(2) companies")[6] 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 IHC would be subject to the same risk-based capital and leverage requirements to IHCs as U.S. bank holding companies, and other enhanced prudential requirements proposed for large U.S. bank holding companies, regardless of whether the IHC holds a depository institution subsidiary.

Resolution Plans

Section 165(d) of Dodd-Frank requires each bank holding company with consolidated assets of $50 billion or more, and each non-U.S. bank with total global consolidated assets of $50 billion or more that maintains U.S. banking operations, to submit an annual plan to the regulators that would describe how it would resolve the "material financial distress or failure" of the company.

On Nov. 1, 2011, the FRB and the Federal Deposit Insurance Corporation (FDIC) issued a joint final rule implementing this requirement.[7] Each company covered by the rule, in addition to providing details of how it would plan to "rapid[ly] and orderly" resolve the company if it were to fail or suffer "material financial distress," also must provide detailed information on the covered company, its organizational structure and systems, and, for a non-U.S. covered company, information on its U.S. operations and how they are interconnected with the home country's operations and integrated into company-wide contingency planning. The regulators will review and require changes as needed.

The regulators divided the submission dates for the initial set of resolution plans into three parts: July 1, 2012, for companies with $250 billion or more in non-bank assets or that amount in total U.S.

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nonbank assets for a non-U.S. bank; July 1, 2013, for companies with $100 billion to $250 billion in non-bank assets or for a non-U.S. bank, that amount in total U.S. nonbank assets; and Dec. 31, 2013, for all other covered companies with less than $100 billion in total non-bank assets, including all other non-U.S. banks with at least $50 billion in total global consolidated assets, regardless of the amount of U.S. nonbank assets.

However, a covered company with less than $100 billion in total nonbank assets (for a non-U.S. bank, that amount in total U.S. nonbank assets), the banking operations (insured depository institutions or U.S. branches and agencies of non-U.S. banks) of which constitute at least 85 percent of the covered company's total assets (or for non-U.S. banks, total U.S. assets), may request approval to file a "tailored," less complex, resolution plan.

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. Section 610 of Dodd-Frank revised the lending limits for national banks to, 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. On June 25, 2013, the Office of the Comptroller of the Currency, which charters and supervises national banks, published a rule finalizing its June 2012 interim final rule on lending limits that includes provisions implementing section 610.[8]

Retention of Credit Risk

Section 941 of Dodd-Frank required the federal banking agencies, the Securities and Exchange Commission (SEC), and, with respect to residential mortgages, the federal housing regulators, to 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. There are specific exemptions (and more may be granted by the regulators), including for certain residential mortgages.

A proposed rule was issued for comment in April 2011 that generally provided for securitization sponsors to retain at least 5 percent of the credit risk of the assets in the securitization pool.[9] Several hundred comments were received and have been reviewed, but the rule has not been finalized yet. One reason for that is that the residential mortgage exemption is linked to definitions in another rule under the Truth in Lending Act to be issued by the Consumer Financial Protection Bureau (CFPB) regarding a borrower's ability to repay a mortgage. The CFPB only recently issued its final regulations on that subject.

> Some of the biggest issues are the cross-border implications of proposed regulations such as those connected with the Volcker Rule and swaps activities.

Capital Requirements

Under Section 171 of Dodd-Frank (the Collins Amendment), the federal banking agencies are required to establish, on a consolidated basis, minimum leverage capital requirements and risk-based capital requirements. 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 that they own.

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.[10] That authority is being phased out over five years. Thus, if, under the prudential requirements, a non-U.S. bank must establish a U.S. IHC, that entity, even if a shell, will be treated as any other bank holding company for capital purposes.

Volcker Rule

Under Section 619 of Dodd-Frank, the so-called "Volcker Rule," 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. "Banking entities" include a non-U.S. bank that is treated as a bank holding company for purposes of the International Banking Act, and any affiliate. As such, this would capture non-U.S. banks that maintain branches and agencies in the United States in addition to insured bank subsidiaries. The federal financial regulators must issue regulations to implement the section.

Permitted proprietary trading activities include activities conducted solely outside the United States under Sections 4(c)(9) and 4(c)(13) of the Bank Holding Company (BHC) Act.[11] The Volcker Rule exception requires that the "trading occurs solely outside the United States and that the banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States."

On Nov. 7, 2011, a proposed rule issued by all the federal financial regulators named in the Volcker Rule (except for the Commodity Futures Trading Commission (CFTC) which published its own proposed rule in February of 2012) proved just as controversial as its statutory predicate.[12]

In the proposed "outside the United States" exception, the regulators went beyond the plain language of the statute, and proposed that this exception would be available only if the following four conditions were met:

> (i) The covered banking entity conducting the purchase or sale is not organized under the laws of the United States or of one or more States;
>
> (ii) No party to the purchase or sale is a resident of the United States;
>
> (iii) No personnel of the covered banking entity who is directly involved in the purchase or sale is physically located in the United States; *and*
>
> (iv) the purchase or sale is executed wholly outside of the United States. (Emphasis added.)[13]

Comments criticized the proposal for going beyond the plain language of the statute, for its taking insufficient note of the purpose of the Volcker Rule, for the unintended consequences that would result if the rule were adopted as proposed, and for not being in keeping with the principles of international comity.

As of July 1, the rule has yet to be finalized, one reason likely being that several regulatory agencies have to agree with each other, and in the past banking and securities regulators have had trouble reaching consensus on regulations.[14]

Swaps Push-Out

Under Section 716 of Dodd-Frank, the "swaps push-out" provision, 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 a Federal Reserve Bank.[15] 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 engaging in swaps related to assets that are permissible investments for a national bank, and may request up to 24 months to conform their activities to Section 716. However, U.S. branches and agencies of non-U.S. banks, most of which are uninsured, were not included in that exemption. This oversight appears to be an inadvertent drafting error, but proposed legislation to correct that and other technical errors in Dodd-Frank has yet to pass.[16]

Section 716 becomes effective July 16, 2013. On June 5, 2013, the FRB announced the adoption of an interim final rule, effective immediately, to do by regulation what the Congress failed to do by statute.[17] Finding that the legislative history of section 716 supported the view that the exemption for insured depository institutions should extend to uninsured branches and agencies of non-U.S. banks, the FRB issued an interim final rule doing just that. In addition, the FRB also allowed non-U.S. banks that are or could be swaps entities to request up to 24 months to conform their activities to the restrictions of section 716. The last day to submit comments is Aug. 4, 2013.

Cross Border Swaps Activity

Title VII of Dodd-Frank introduced detailed regulation of swaps activities, including registration of swap dealers and security-based swap dealers. Section 722(i) of Dodd-Frank specifically makes these new swaps provisions applicable to activities outside the United States only if the activities have a "direct and significant connection with activities in, or effect on, U.S. commerce" or contravene CFTC regulations meant to prevent evasion of the new swaps provisions. However, proposed CFTC guidance and proposed SEC regulations are not identical and have yet to be finalized.[18]

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A CFTC order exempting the applicability of its swaps provisions to certain cross-border transactions expires on July 12, 2013, and there has been a push by both U.S. and non-U.S. banks to extend the exemption until year-end. As of July 1, 2013, there had been no word from the CFTC as to whether it would do so. In the meantime, many non-U.S. banks are uncertain whether their swaps activities outside the United States will subject them to U.S. registration. Moreover, U.S. regulators are required to consult and coordinate with foreign regulatory authorities on the establishment of international standards regarding swaps regulation. Regulators from other countries also have requested an extension of the CFTC exemption.[19] The G-20 group of international finance ministers and central bank officials continues to work toward international standards, and plans to issue proposals later this year.

Assessments

Finally, all of this enhanced supervision must be paid for somehow. Dodd-Frank directs the FRB to recoup its costs of enhanced regulation of bank holding companies with total consolidated assets in excess of $50 billion.[20] The FRB has issued a proposed rule on how it proposes to assess for the costs of this increased supervision.[21] The proposed rule would be applicable to a U.S. bank holding company and a non-U.S. bank or company that is a bank holding company. The proposed rule sets out how the FRB will determine which companies are subject to an assessment, the method for determining the assessment and the time periods for billing and collecting the assessment. The last day for comments was June 15.

Conclusion

Many questions still remain about the ultimate effect of various aspects of Dodd-Frank on non-U.S. banks and their U.S. operations. Some of the biggest issues as noted above are the cross-border implications of proposed regulations such as those connected with the Volcker Rule and swaps activities as well as the proposed prudential requirement that would require that certain non-U.S. banks establish U.S. IHCs. The question still remains whether the cumulative effect of Dodd-Frank implementation may cause some non-U.S. banks to consider curtailing or even terminating some of their U.S. operations.

1. Pub. Law 111-203, July 21, 2010, 124 Stat. 1376.
2. Previous columns since the enactment of Dodd-Frank have discussed different aspects of Dodd-Frank and their possible effect on the U.S. operations of non-U.S. banks: "Dodd-Frank's Effect on Non-U.S. Banks Doing Business in the United States," New York Law Journal, Sept. 8, 2010; "Non-U.S. Banks, 'Volcker' And 'Solely Outside the United States,' " New York Law Journal May 9, 2012; "Proposed Enhanced Prudential Standards for Non-U.S. Banks," New York Law Journal Jan. 9, 2013; "Comments on Proposed Enhanced Standards for Non-U.S. Banks," New York Law Journal, May 10, 2013.
3. Pub. Law 111-203, Section 113.
4. 77 Fed. Reg. 594, Jan. 5, 2012.
5. 77 Fed. Reg. 76628, Dec. 28, 2012.
6. 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.
7. 76 Fed. Reg. 67323, Nov. 1, 2011.
8. 78 Fed. Reg. 37930, June 25, 2013.
9. 76 Fed. Reg. 24090, April 29, 2011.
10. 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.
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. 76 Fed. Reg. 68846, Nov. 7, 2011.
13. The proposed regulation also sets out the qualifications for when a purchase or sale shall be deemed to be conducted pursuant to section 4(c)(9) or (13) of the BHC Act by an entity that is a non-U.S. banking organization.
14. See, for example, Statement by Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System, before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Feb. 14, 2013; Remarks at "The SEC Speaks in 2013," Daniel M. Gallagher, Commissioner, U.S. Securities and Exchange Commission, Feb. 22, 2013.
15. Pub. Law 111-203, Section 716.
16. See, for example, Congressional Record, July 15, 2010, S5903-S5904.
17. 78 Fed. Reg. 34545, June 10, 2013.
18. See 77 Fed,. Reg. 41214 (July 12, 2012), 78 Fed. Reg. 858 (Jan. 7, 2013), 78 Fed. Reg. 909 (Jan. 7, 2013), 78 Fed. Reg. 30968 (May 23, 2013).
19. Pub. Law 111-203, Section 752.
20. Pub. Law 111-203, Section 318.
21. 78 Fed. Reg. 23162, April 18, 2013.