Tailored enhanced prudential standards for non-US banks

Since the 2008 financial crisis, a non-US bank seeking to establish or maintain a US presence has been required to comply with a set of stringent regulatory requirements, but a recently adopted rule (Final Rule) limits their application. Recently approved by the Federal Reserve Board, limit the application of those requirements, as **Duane Wall**, **Glen Cuccinello**, **Max Bonici**, **John Wagner** and **Roseann Cook** explain.

The Final Rule, released by the Federal Reserve Board in October 2019, tailors the enhanced prudential standards—a series of stringent capital, liquidity, risk management, stress testing and other requirements—to a non-US bank with a traditional US banking presence, such as a US branch, in a number of important ways:

- The enhanced prudential standards are focused on non-US banking organizations with a significant US risk profile. Non-US banks that maintain a US branch but no US bank subsidiary, material US non-bank subsidiaries or US intermediate holding company (IHC), in general, may rely on home- country requirements to fulfill applicable enhanced prudential standards.
- New risk-based indicators place foreign banking organizations (FBOs) into categories based on US-focused indicators, rather than looking simply to an FBO's global asset size
- The threshold for an FBO to establish an IHC remains the same, but the enhanced prudential standards that apply focus on IHCs with a significant risk profile
- An FBO's US branch is not subject to any standalone capital or liquidity requirements

Four categories for enhanced prudential standards requirements

The Final Rule, which becomes effective on December 31, 2019, divides FBOs with US$100 billion or more in total consolidated assets into four categories based on a sliding scale of size and risk profile.

FBOs are classified into categories based on asset size and specific risk-based indicators: US non-bank assets; US off-balance sheet exposure; US weighted short-term wholesale funding; and US cross-jurisdictional activity. A non-US bank with less than US$100 billion in combined US assets, is subject to a more limited set of enhanced prudential standards.

- **Category I** requires compliance with the most stringent enhanced prudential standards and applies only to US global systemically important banks (US GSIBs)
- **Category II** standards apply to FBOs that have US$700 billion or more in combined US assets or US$75 billion or more in US cross-jurisdictional activity
- **Category III** covers FBOs that have US$250 billion or more in combined US assets or at least US$75 billion in US nonbank assets, US weighted short-term funding or US off-balance -sheet exposures
- **Category IV** applies to FBOs with US$100 billion to US$250 billion in combined US assets that do not meet any of the additional thresholds specified for Categories II or III
- **Other** An FBO with at least US$100 billion in total global assets but less than US$100 billion in combined US assets is not classified into a category and is subject only to limited enhanced prudential standards

The date the Final Rule become effective

Applying the risk-based indicators to FBOs

Under the Original Rule, an FBO with US$50 billion or more in total consolidated global assets was covered and the specific EPS that applied were determined based on the FBO's combined US assets, as well as its level of US non-branch assets. The Final Rule changes that approach by classifying FBOs into categories based on asset size and five specified risk-based indicators: combined US assets; non-bank assets; off-balance sheet exposure; weighted short-term wholesale funding (wSTWF) and cross-jurisdictional activity.

FBOs must calculate and report their level of risk-based indicators on Form FR Y-15, which is currently used by US banking organizations to report systemic risks. As a result, an FBO will need to establish new monitoring and reporting procedures for the new filing requirement. Each indicator must be calculated and reported based on the average of the trailing four quarters for a non-US bank with an existing US banking presence and based on the most recent quarter for a non-US bank establishing a US presence.

> **The enhanced prudential standards are focused on non-US banks with a significant US risk profile**

Categories of FBOs and level of compliance required with enhanced prudential standards

	No Category		Category IV	Category III	Category II
Total global assets	US$100 billion – US$250 billion	US$250 billion+	US$100 billion+	US$100 billion+	US$100 billion+
US combined assets	less than US$100 billion	less than US$100 billion	US$100 billion+ and less than US$75 billion nonbank assets, off-balance-sheet exposures, wSTWF or cross-jurisdictional activity	US$250 billion to US$700 billion or US$100 billion+ and US$75 billion+ nonbank assets, off-balance-sheet exposures or wSTWF	US$700 billion+ or US$100 billion+ and US$75 billion+ cross-jurisdictional activity
Home-country requirements					
Regulatory capital	Yes, if US$100 billion+ combined US assets	Yes	Yes	Yes	Yes
Liquidity stress testing	No	Yes	Yes	Yes	Yes
Capital stress testing	Yes, every two years	Yes, annually	Yes, every two years	Yes, annually	Yes, annually
Single counterparty credit limits				Yes	Yes
US requirements					
US IHC	Yes, if US$50 billion+ US non-branch assets	Yes, if US$50 billion+ US non-branch assets	Yes, if US$50 billion+ US non-branch assets	Yes, if US$50 billion+ US non-branch assets	Yes, if US$50 billion + US non-branch assets
US liquidity cash flow projections	No	No	Yes	Yes	Yes
US contingency funding plan	No	No	Yes	Yes	Yes
US liquidity risk limits	No	No	No	Yes	Yes
US asset/collateral monitoring	No	No	Yes, monthly	Yes, weekly	Yes, weekly
US liquidity stress testing	No	No	Yes, quarterly	Yes, monthly	Yes, monthly
US branch liquidity buffer	No	No	Yes	Yes	Yes
US risk committee	Yes	Yes	Yes	Yes	Yes
US chief risk officer	Yes, if US$50 billion+ in combined US assets	Yes, if US$50 billion+ in combined US assets	Yes	Yes	Yes
US risk management framework	Yes, if US$50 billion+ in combined US assets	Yes, if US$50 billion+ in combined US assets	Yes	Yes	Yes
US debt-to-equity limits	Yes, if a grave threat	Yes, if a grave threat	Yes, if a grave threat	Yes, if a grave threat	Yes, if a grave threat

Source: White & Case

IHC Requirement

An FBO with at least US$100 billion in total global consolidated assets is required to form an IHC if the FBO has US non-branch (i.e., subsidiary) assets of US$50 billion or more.

The enhanced prudential standards that apply to an IHC are the same as the asset thresholds and the US$75 billion risk-based indicator thresholds that apply to an FBO, but are based on the IHC's global assets and activities, rather than its US-only assets and activities.

In general, any IHC formed by an FBO is subject to the same type of US-specific enhanced prudential standards that apply to a BHC of a similar size, including regulatory capital, liquidity, capital stress testing, capital planning and long-term debt requirements.

Regulatory capital requirements

The US branches and other US operations of an FBO that sit outside the IHC are not subject to US regulatory capital and leverage requirements.

However, an FBO with either US$250 billion or more in global consolidated assets or US$100 billion or more in combined US assets (irrespective of its total global consolidated assets) must show that it complies with home-country regulatory capital and leverage requirements comparable to US capital standards.

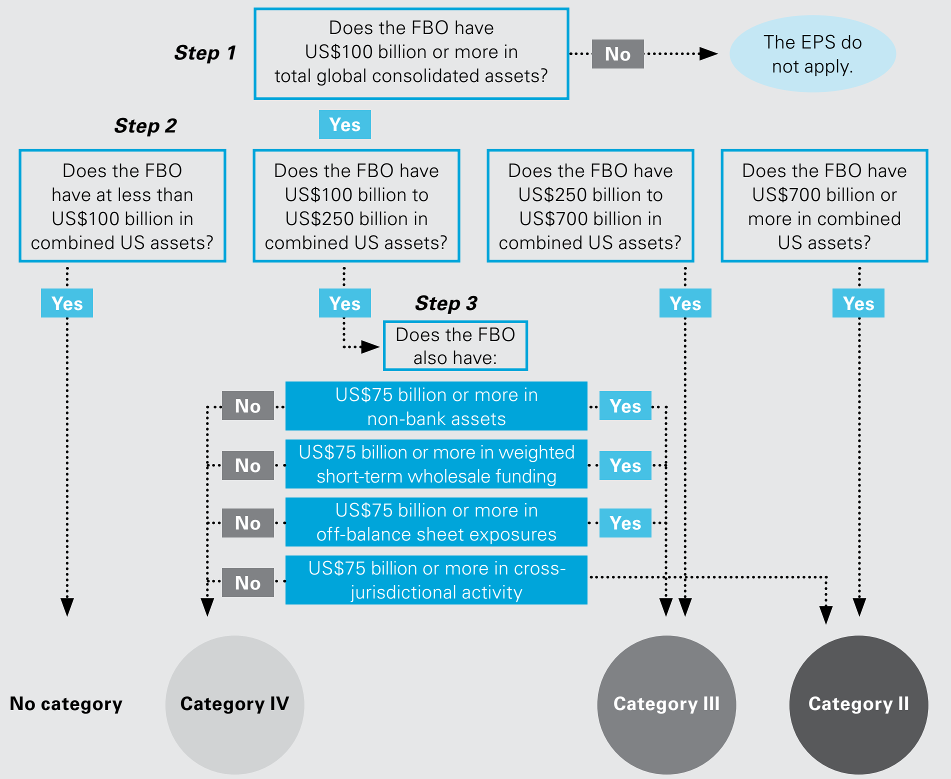
Liquidity stress testing

An FBO with US$250 billion or more in total global consolidated assets must conduct annual liquidity stress testing of its combined US operations, irrespective of the size of its US operations. The goal of the liquidity stress testing is to assess the potential impact of stress events on cash flows, liquidity, profitability and solvency.

An FBO can fulfil the liquidity stress-testing obligation using home country testing provided that tests covers its global activities, comply with Basel Committee requirements and incorporate 30-day, 90-day and one-year horizons.

An FBO that does not comply with the home-country liquidity stress testing requirement must limit the daily net aggregate amount due to its combined US operations from its non-US branches, subsidiaries and affiliates to no more than 25 percent of the third-party liabilities of its combined US operations.

Applying risk-based indicators to FBOs



Source: White & Case

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An FBO with less than US$100 billion in combined US assets is not subject to US specific capital, liquidity and stress testing requirements

Capital stress tests

An FBO with total global consolidated assets of at least US$100 billion must show that it is subject to a home-country capital stress-testing regime, regardless of the size of its combined US operations.

An FBO that does not meet the home- country capital stress-testing standard must conduct stress tests of its US subsidiaries (or its global activities) to determine if it has sufficient capital to meet adverse economic conditions. It must also maintain, on a daily basis, eligible assets in its US branches equal to at least 105 percent of the average total liabilities of the branch, if the FBO has less than US$250 billion in total global consolidated assets, or at least 108 percent of average total branch liabilities if the FBO has US$100 billion or more in combined US assets.

Single counterparty credit limits

An FBO that falls into Category II or III must comply with single counterparty credit limits that prevent it from having aggregate credit exposure that exceeds 25 percent of its Tier 1 capital to a single counterparty—or 15 percent if the FBO is defined as a global systemically important bank.

US-specific requirements

While FBOs with a smaller US footprint may rely on home-country regulatory capital, liquidity and stress-testing requirements, FBOs with at least US$50 billion in combined US assets are subject to certain US-specific risk management requirements, and are required to form an IHC to ring-fence US subsidiaries if US non-branch assets total at least US$50 billion.

FBOs with US$100 billion or more in combined US assets or US$75 billion or more in nonbank assets, off-balance sheet exposure, weighted short-term wholesale funding or cross-jurisdictional activity, are also subject to US-specific enhanced prudential standards akin to those applicable to large US bank holding companies (BHCs).

FBOs that fall into this category must provide US liquidity cash flow projections, a US contingency funding plan, adhere to US liquidity risk limits, monitor US assets and collateral, conduct liquidity stress tests and maintain a US branch liquidity buffer.

They must also maintain a US risk committee, a chief risk officer and a risk management framework that includes risk governance and control policies, procedures and systems.

An FBO that is designated as posing a grave threat to US financial stability must limit the debt-to-equity ratio of any non-US subsidiary, including any IHC, to no more than 15-to-1.

The final enhanced prudential standards apply to those non-US banks with a significant US presence. While most non-US banks that have a US presence may have at least US$100 billion in total global consolidated assets, the majority of those banks will fall outside Categories II to IV and therefore will not need to comply with the more onerous standards.

Such banks, which fall into the "no category" will be subject only to compliance with home-country standards and the US-specific enhanced prudential requirements to maintain a risk committee, a risk management framework and a US chief risk officer. Similarly, while an FBO with US$50 billion or more in US non-branch assets is required to form an IHC to hold its US bank and nonbank subsidiaries, an IHC with less than US$100 billion in total consolidated assets is subject only to the same risk management requirements applicable to the combined US operations of an FBO and to compliance with US regulatory capital requirements.

A non-US bank that currently does not have a US presence but is considering entry to the US banking market typically would do so incrementally. A common approach used by non-US banks to establish initial entry into the US is to establish a representative office, which would not be subject to any enhanced prudential standards requirements, regardless of a non-US bank's US or global asset size.

Establishing a US branch would not cause a non-US bank to be required to comply with any EPS requirements, other than home-country requirements and US-specific risk committee and risk management requirements, until the assets of the branch (and any US bank or nonbank subsidiaries) reach at least US$100 billion.

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