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Client Alert

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A Proposal for Rebalancing US Supervision of Foreign Banking Organizations

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The Board of Governors of the Federal Reserve System ("Board") appears ready to propose rules to implement enhanced prudential capital and other standards for foreign banking organizations with banking operations in the United States ("FBOs"). Board Governor Daniel K. Tarullo, in a recent speech given to the Yale School of Management Leaders Forum, presaged a proposal designed to achieve a **rebalanced approach** to FBO supervision.[1] That is, one that would recognize both the benefits that FBOs bring to the US economy and the risks that their increased presence may pose to the financial stability of the United States.

The result appears to be an approach that would extend the principle of national treatment to include not only the US branches and agencies of an FBO, but its US subsidiary banks and US nonbank subsidiaries as well. That would be achieved by a "more territorial" ring-fencing of all US subsidiary banks and nonbank subsidiaries and the required regulatory capital to maintain those subsidiaries. The Board has made clear that the process of extending to FBOs the enhanced capital, liquidity and other prudential standards required by the Dodd-Frank Act for systemically important banking organizations has been *difficult*. If adopted, this rebalancing proposal would mark the end of that difficult process and the now year-long gap since proposing such standards for US banking organizations. FBOs should expect a proposed rulemaking shortly with implementation of final rules not far behind.

In anticipation of a proposed rulemaking, we offer this Client Alert to provide you with insight on Governor Tarullo's proposal and the thinking behind it. We are available to address any questions you may have on the proposal.

The Rebalancing Proposal

Governor Tarullo calls the rebalancing proposal "targeted adjustments" to the existing FBO supervisory regime. The adjustments are meant to create a regulatory system that "maintain[s] the principle of national treatment and allow[s] foreign banks to continue to operate here on an equal competitive footing, to the benefit of the US banking system and the US economy generally," but also "recognize(s) that while internationally active banks live globally, they may well die locally." In other words, FBOs with subsidiary bank and nonbank subsidiaries in the United States should, in his view, be subject to the same capital and other prudential standards as US banking organizations and are to maintain *in the United States* sufficient capital to cover those operations. Presumably the Board would rely on its existing statutory authority to implement the proposal.

1 The full text of Governor Tarullo's speech is available on the Board website at http://www.federalreserve.gov/newsevents/speech/tarullo20121128a.htm.

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Governor Tarullo's speech does not offer fulsome details on the scope of application of the rebalancing proposal. It would seem that the ring-fencing of required capital in the United States is aimed at FBOs with the "largest" or "large" US operations, and the enhanced capital and other prudential standards dictated by the Dodd-Frank Act would apply to "large foreign banks" irrespective of the size of their US operations.[2]

The rebalancing proposal includes the following three components:

Required US Intermediate Holding Companies

The rebalancing proposal has at its center a requirement that an FBO with "the largest US operations" be required to consolidate all of its US bank and nonbank subsidiaries under a single, top-tier intermediate holding company ("IHC"). The IHC would be required to house all of the FBO's US subsidiaries, including its US bank subsidiaries, as well as any subsidiaries engaged in nonbank activities, whether permissible as "closely related to banking" or as a result of the FBO's status as a financial holding company. The IHC would be subject to compliance with US enhanced capital requirements, as well as to other prudential standards dictated by the Dodd-Frank Act for systemically important bank and nonbank organizations.

The IHC structure is viewed as working to resolve two shortcomings in existing FBO supervision. The first is to "reduce the ability of foreign banks to avoid US consolidated capital regulations." Governor Tarullo takes exception to the "organizational flexibility" that FBOs have in structuring their US operations to minimize the impact and application of US capital rules (though he does recognize that much of that flexibility derives from policies maintained by the Board).[3] A required US holding company, the IHC, would simplify application of US capital requirements to all US operations of an FBO. Second, and perhaps most importantly, an IHC structure would ensure that required capital remains in the United States. Governor Tarullo recognizes that such ring-fencing is a "more territorial" approach than the United States has taken in the past. It is seen by him as reasonable "middle course" to address the potential risk to US financial stability that the sizeable US activities of FBOs could pose, while recognizing that FBOs are desired participants in the US financial system that provide benefits to the US economy. If adopted by the Board, FBOs will need to consider preparing a strategic capital allocation plans to decide on the business they want to undertake through an operation in the United States. Will other nations pick up on this proposed approach? If so, what will be the implications for an FBO's capital needs?

This required marshaling of all US bank and nonbank subsidiaries into a US IHC would apply only to those FBOs with the largest US operations. It may well be that "largest" will mean those with US assets of at least US$50 billion. The speech does not define "largest." The IHC structure would not encompass US branches or agencies. These offices, which are not separate legal entities, would continue to operate as direct offices of the FBO outside the IHC. Branches and agencies already operate under a ring-fence structure. While there has been some talk in the past about branches being converted into subsidiary banks, that would require legislation that would likely be opposed by virtually all banking organizations in the United States.

The IHC structure addresses the Board's difficulty in determining how to apply those standards to an FBO. The IHC structure clearly defines which FBO activities will be subject to US enhanced prudential standards and, importantly, the amount of capital that an FBO will be required to retain in the United States to conduct those activities. Governor Tarullo seems satisfied to limit its capital and other enhanced requirements to the US bank and US broker-dealer and other nonbank subsidiaries of the FBO. A severely troubled IHC would be resolved under the new Dodd-Frank Act resolution procedures. The activities of non-US subsidiaries engaged in cross-border business in the United States would not be covered. US branches and agencies would continue to rely on parent FBO capital and the Basel Committee capital adequacy and leverage requirements as implemented by their home country regulatory authorities.

Capital and Other Enhanced Prudential Standards

IHCs would be subject to the same capital rules that apply to US bank holding companies. That would require FBOs to capitalize their IHCs, through the IHC's subsidiaries or directly, with sufficient risk-based capital to meet US requirements and would preclude a look-through to parent FBO consolidated capital to meet those requirements. That could require the injection of substantial amounts of capital into the IHC. Governor Tarullo makes a point of noting that the Board's ability to rely on an FBO to act as a source of strength to its US operations "has come into question in the wake of the crisis." Based on the enhanced capital rules proposed for US bank holding companies, an IHC's required capital would at a minimum be the required risk-based capital to meet the Basel Accord then in place in the United States, as well as common equity capital sufficient to maintain at least 5.0 percent common risk-based capital in supervisory stress testing of adverse scenarios.

2 The Dodd-Frank Act defines a "large" bank holding company as one with US$50 billion or more in total consolidated assets, including for the purposes of the Board's application of enhanced prudential supervision, a foreign bank treated as a bank holding company pursuant to the International Banking Act of 1978. While the speech does not make clear if the distinction between "large foreign banks" and "large US operations" is intentional, the latter appears to refer to a subset of systemically important FBOs to be subject to the ring-fencing requirement.

3 The Board has in place a longstanding exemption from US capital requirements for the top-tier US holding company of an FBO. Board Supervision and Regulation Letter SR 01-01 (January 5, 2001), available at http://www.federalreserve.gov/boarddocs/srletters/2001/sr0101.htm. Section 171 of the Dodd-Frank Act, the so-called Collins Amendment, eliminates the Board exemption as of July 21, 2015.

Governor Tarullo proposes also that the "US operations of large foreign banks" be subject to the other enhanced prudential standards established by the Dodd-Frank Act. Those include single-counterparty credit limits, risk management requirements, and internal and Board stress testing.[4] Similarly, the Dodd-Frank Act's early remediation requirements, limiting dividends, and distributions and growth activities and ultimately, requiring resolution, would apply. It is unclear if by the "US operations of large foreign banks," as opposed to FBOs with the "largest US operations," it is intended that enhanced prudential standards, other than capital, would apply both to IHCs and to FBOs not required to establish an IHC but whose total global asset size would meet the US$50 billion threshold for enhanced prudential supervision.

Liquidity Standards

Liquidity standards for the large US operations of FBOs, as well as for US branches and agencies, that are comparable to those applicable to US bank holding companies are proposed as the third prong of the rebalancing proposal. For IHCs, the liquidity requirement would be "broadly" consistent with those the Board has proposed for systemically important US bank holding companies. Those include maintenance of a liquidity buffer sufficient to sustain net cash outflows over a 30-day stressed period, periodic stress testing to determine that adequate liquidity buffers are in place and a contingency funding plan.

It is unclear to what degree "broadly" is meant to differentiate from the "same," the adjective used in referring to the capital requirements that should be imposed on IHCs. It may be that the distinction is that home-country liquidity standards if consistent with Basel III requirements will be allowed to substitute for the US requirement. That would allow, for instance, that home-country sovereign debt, not just US Treasury securities, could be used to satisfy a liquidity buffer. Governor Tarullo proposes that "less stringent" US liquidity standards would be sufficient for the US branches and agencies of an FBO to take into account that those offices are part of the global FBO which itself is subject to liquidity standards. In either case, the liquid assets would be maintained on the books of the relevant US operation.

The Thinking Behind the Rebalancing Proposal

The speech highlights the growth of the US activities of FBOs and the shift in the risk profile of those activities in the years leading up to the recent global financial crisis. Governor Tarullo cites a number of examples. One is the shift in US branches from lending funds borrowed from their parent FBO to borrowing large amount of US dollars to upstream to the parent FBO. Another is while branch commercial and industrial lending has been decreasing, the number of systemically important FBOs now is the same as that of US systemically important firms. Notably it is cited that five of the top ten broker-dealers in the United States are owned by FBOs.

Governor Tarullo also provides insight into the considerations that informed the determination of how best to supervise the US operations of FBOs. Those include:

1. **Need for Ring-Fencing Approach.** The challenges to development of a cross-border resolution scheme and the risks associated with large intra-group funding flows are cited as two main reasons to support a ring-fencing approach. Governor Tarullo uses the examples of the failure of the Icelandic Banks and Lehman Brothers to illustrate the risk of capital and liquidity being "trapped" in the home country at the time of crisis. That could leave the FBO unable to serve as a source of strength to its US operations. That leads to the conclusion that ring-fencing US assets in a separately capitalized US IHC is a needed practical alternative.

   Reading between the lines, it would seem that a US IHC is not simply the practical alternative, but his preferred approach. It may be that, if there existed an effective cross-border insolvency scheme that required the cooperation of home-country supervisors in working to resolve a large FBO that was failing, ring-fencing of an FBO's US assets and capital would not be seen as necessary. There has been little movement on this sort of effort by the Financial Stability Board, and the speech seems to discount this likelihood of such a development in the near term. The speech finds too that the lack of access to capital by the host country outweighs any benefit to the FBO of being able to concentrate capital and liquidity in the home-country. The speech goes out of its way to point out that allowing an FBO to consolidate capital in the home country is a "worst of both worlds" approach. It would require the Board to intrude on home-country supervisors to assess that the home-country regulatory and resolution regimes were up to Dodd-Frank Act standards, but not leave the Board with any authority to require the FBO to take action to mitigate any identified risks to US financial stability.

2. **Need for a US-Tailored Supervisory Regime.** The speech indicates Governor Tarullo's preference for tailoring a US-specific response to the supervision of FBO activities in the United States. Extensive international harmonization of national regulatory practices is seen as less appealing. Governor Tarullo notes that the United States would not be the first country to respond to the limitations of coordinated international reform with its own policies to "fortify the resources of internationally active banks within their geographic boundaries." He cites UK liquidity requirements covering the local operations of domestic and foreign banking organizations, as well as other prudential

4 The Board has proposed rules to implement the Dodd-Frank Act enhanced standards for US BHCs and nonbanks designated by the US financial supervisors as systemically important. The Board's proposed rules and issuing release may be found at http://www.gpo.gov/fdsys/pkg/FR-2012-01-05/pdf/2011-33364.pdf.

standards that the UK and Switzerland are considering or have imposed on their large domestic banking organizations. While this reference to home-country supervision of domestic banking organizations seems misplaced, the point is clear. A *global* one-size-fits-all approach to supervision of FBOs would not be considered the best solution to mitigating the risks to US financial stability. The speech offers numerous examples of the uniqueness of the US financial system and the role of FBO participants to support that conclusion. Among them, the importance of the US dollar as a currency for international transactions, the resulting use by FBOs of their US operations as a dollar funding source for offshore operations, the level of FBO ownership of the largest US broker-dealers, and the increased leverage and concentration of FBO US assets in those nonbank subsidiaries.

This preference for a made-in-the-USA supervisory regime indicates that the Board might be concluding that there needs to be limits to the Basel Committee process. That is not to say that the US banking supervisors will not move forward with adoption of Basel II and III. But, where the US financial markets and its participants are seen as presenting unique supervisory challenges, as in the case of supervision of the US activities of FBOs, it would not be surprising for US banking supervisors to continue to opt for uniquely US rulemaking.

In sum, Governor Tarullo has sent up a new balloon for others to take shots at. That may well be the better way to commence the debate on the structure of FBO supervision in the United States. Whether or not you favor the proposal, Governor Tarullo has clearly laid the issues on the table. The ensuing dialogue on this topic over the next few weeks will be fulsome and interesting. Foreign banking organizations and home country supervisors should not wait for the issuance of a Board proposal to express their views to the Board.

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