Final Federal Reserve Rules for Foreign Banking Organizations

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This Alert describes the final regulations issued by the Federal Reserve Board (the "FRB") on February 18, 2014, that radically modify the former requirements applicable to foreign banking organizations ("FBOs") pursuant to the FRB's Regulation K. The final rules (the "Final Rules") impose various requirements on large FBOs that previously have been applied to large U.S. domestic bank holding companies and banks under the Dodd-Frank Act. In addition, however, the Final Rules also alter many of the former approaches to the regulation of FBOs in general, including the necessity for many FBOs to form "U.S. intermediate holding companies" for their U.S. operations.

Regardless of the category an FBO falls into, the Final Rules present significant additional compliance burdens.

Introduction

In December of 2012 the Federal Reserve Board issued for public comment a proposed comprehensive modification to the rules governing the operations of foreign banking organizations ("FBOs") in the United States. Premised upon very broad interpretations of Sections 165 and 166 of the Dodd-Frank Act, the FRB proposed to create an enhanced prudential standards scheme to apply to FBOs—with a layering of increased structural and operational procedures and substantive compliance requirements based upon the amount of an FBO's global and U.S.-based assets. Among other things, these proposed requirements addressed the following:

- Risk-based capital and leverage,
- Liquidity,
- Stress testing,

- Risk management and risk committee obligations,
- Single-counterparty credit limits, and
- Resolution planning requirements.

In a somewhat Orwellian rationale that argued that its actions adhered to decades of compliance with principles of national treatment, equality of cross-border competition, and deference to home country regulatory standards (when compatible with U.S. and international paradigms), the FRB proposed to require that even modest-sized FBOs be required to organize a U.S. intermediate holding company (an "IHC"), and place most U.S. assets (other than assets held in a branch, agency office or Section 2(h)(2) subsidiary) under the newly formed IHC as its top-tier U.S. subsidiary. Further, the IHC and its subsidiary operations would become subject to U.S. capital rules applicable to domestic bank holding companies. (Stated another way, even though the IHC might technically not qualify as a bank holding company, the FRB proposal would have required that the IHC comply with most bank holding company rules as if it were, in fact, a bank holding company.)

On February 18, 2014, the FRB adopted the Final Rules, which are summarized in this Alert—with particular emphasis on the changes made by the FRB. In addition, this Alert provides initial suggestions for analyzing the impact the Final Rules will have on a particular FBO's U.S. operations, as well as the time frames within which compliance must be completed.[1]

Discussion and Analysis

The Final Rules provide some small degree of relief for FBOs with smaller operations in the U.S. (based upon the amount of U.S. assets), while increasing the degree of regulatory oversight and complexity for an FBO with a substantial U.S. presence. This was accomplished by imposing increased compliance requirements on covered FBOs with U.S. assets of $50 billion or more, while permitting FBOs with smaller U.S. operations to comply in many respects with regulatory oversight as required by their respective home country supervisors—or to incorporate new U.S. requirements into existing management structures.[2]

The most significant point of this new this regulatory scheme is that most of the new—and onerous—FBO regulatory requirements will apply to larger FBOs with U.S. assets of $50 billion or more *regardless of whether those assets are held on the books and records of the FBO's U.S. branch or agency*. This is because the Final Rules create what is effectively a "mirror image" of requirements that will subject larger FBOs to U.S. compliance requirements regardless of the structural scheme by which the FBO conducts its U.S. operations.[3]

For purposes of understanding the applicability of the Final Rules to a particular FBO, it is useful to divide the discussion into two general categories:

[1] In the same rule-making, the FRB adopted other amendments to Regulation YY (12 C.F.R. Part 252) to implement certain of the enhanced prudential standards required to be established under Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") for domestic U.S. bank holding companies with total consolidated assets of $50 billion or more. For large U.S. bank holding companies, many of these enhanced prudential standards under the Dodd-Frank Act have previously been adopted or are the process of being adopted under other rule-makings by the Federal Reserve. This release focuses only upon the portions of rule-making that relate to FBOs.

[2] For purposes of this discussion, a covered FBO must have global consolidated assets of $10 billion in order to be subject to any of the new requirements created by the Final Rules. In addition, in the category of larger FBOs, discussed below, the global asset size of an FBO must be $50 billion or more. (In that regard, the Final Rules contain comprehensive requirements for computing both an FBO's consolidated global assets, as well as U.S.-based assets.)

[3] As pointed out by many commenters, one of the practical results of the Final Rules for larger FBOs will be to subject securities brokerage subsidiaries to FRB regulation by requiring that larger FBOs place those operations under an IHC.

- Smaller FBOs with U.S. assets less than $50 billion, and
- Larger FBOs with U.S. assets of $50 billion or more.

Each of these categories is discussed separately below, including the major compliance requirements imposed on that category (or subcategory) by the Final Rules.

Smaller FBOs

Smaller FBOs with Total Consolidated Assets of $10 Billion or More and Less than $50 Billion

The Final Rules require that, on an annual basis, an FBO with consolidated global assets of $10 billion or more but less than $50 billion comply with the stress testing regimen of its home country supervisor, provided that this stress testing complies with the following requirements:

- The supervisory capital stress test must be conducted by the home-country supervisor, or the home-country supervisor must review an internal capital adequacy stress test conducted by the FBO, and
- The FBO must have in place acceptable corporate governance and controls of stress testing practices by the FBO's board of directors (or equivalent governing body).

If the FBO's home country stress program fails these standards, the FRB may impose an assets-to-liabilities ratio on the U.S. agencies and branches of the FBO of 105%.[4]

Smaller FBOs with Total Consolidated Global Assets of $50 Billion or More but U.S. Assets of Less than $50 Billion

FBOs in this category must comply with certain capital requirements, risk-management and risk committee requirements, liquidity risk-management requirements, and capital stress testing requirements. Although these compliance obligations are less onerous than similar requirements for larger FBOs, they impose enhanced compliance requirements on these FBOs. These new obligations include:

- **Capital**—the FBO must certify to the FRB that it complies with home country capital adequacy standards that conform to Basel III, including leverage capital levels.
- **Risk-Management and Risk Committee**— the FBO must certify to the FRB that it has established a risk management committee and framework to oversee its U.S. operations, including at least one individual with financial services risk management experience. However, compliance may be implemented through an existing enterprise-wide risk management structure of the FBO, rather than requiring that a stand-alone risk structure be established for the FBO's U.S. operations.
- **Liquidity Risk-Management**—the FBO must report to the FRB its home country liquidity stress results that are in compliance with the Basel Committee's guidance.[5]
- **Capital Stress Testing Requirements**—the FBO must be subject to a capital stress test that is established by its home country supervisor (and which must be reviewed by the FBOs' board of directors).[6]

[4] It should be noted that publically traded FBOs falling into this subcategory must also comply with the risk committee requirements that are discussed in the next section of this Alert.

[5] The penalty for failing to comply with this requirement is to substantially limit its "due-to" obligations of its total U.S. operations.

Larger FBOs

FBOs with Total Consolidated Assets of $50 Billion or More and Non-Branch U.S. Assets of $50 Billion or More

It is in this category that significant additional U.S. regulatory oversight will be imposed. In light of the impact of forming an IHC, we will address that requirement first, followed by the requirements imposed on larger FBOs not required to form an IHC.

Intermediate Holding Company ("IHC") Requirement

A large FBO must form an IHC if its U.S. assets equal $50 billion or more, *excluding* assets held on the books and records of agencies and branch offices, and subsidiaries organized pursuant to Section 2(h)(2) of the federal Bank Holding Company Act.[7] Importantly, U.S. insured depository institutions as well as other U.S. based subsidiaries must be held under the IHC, with some limited flexibility provided by the FRB to hold U.S. assets under a multiple holding company structure.[8]

If an IHC is required, it must be a U.S. corporation (or other entity, such as a limited liability company) formed under the laws of the United States, one of the 50 States, or the District of Columbia. From a corporate governance perspective, the board of directors of the IHC must be subject to fiduciary responsibilities equivalent to those of corporate directors pursuant to the laws of the U.S., one of the 50 states, or the District of Columbia.

Importantly, while the effective date for establishing the IHC is not until July 1, 2016, a covered FBO must create an implementation plan and submit it to the FRB by January 1, 2015—which means a relatively short time period to design the new corporate governance system for the FBO's U.S. operations.

In regard to additional compliance, the newly formed (or designated) IHC must comply with the following enhanced prudential standards:

- **Capital**—the IHC must comply with the capital rules set forth at 12 C.F.R. Part 217, with some flexibility provided not to comply with Subpart E of 12 C.F.R Part 217.[9] The IHC must also comply with the capital planning requirements set forth in Section 225.8 of the FRB's Regulation Y.

- **Risk Management**—the IHC must establish a risk management committee of the IHC's board of directors, and create a risk management framework commensurate with the complexity of the IHC's operations.[10] The risk committee must have qualified individuals, including at least one member who is independent of the FBO. The risk committee for the largest FBO category must also have one member

[6] In a similar manner, the failure to comply with this requirement permits the FRB to impose a maximum ratio of assets-to-liabilities for the FBOs' U.S. branches and agencies of 105%.

[7] A Section 2(h)(2) company refers to a company principally engaged in business outside the United States if such shares are held or acquired by a bank holding company organized under the laws of a foreign country.

[8] An FBO desiring to form multiple IHCs or seeking permission not to transfer ownership of certain subsidiaries to an IHC must apply to the FRB within 180 days prior to the date that an IHC must be organized.

[9] 12 C.F.R. Part 217 establishes minimum capital requirements and overall capital adequacy standards for entities regulated by the FRB.

[10] The framework must include: (a) policies and procedures establishing risk-management governance, risk-management procedures, and risk-control infrastructure for the IHC; (b) processes and systems for implementing and monitoring compliance with policies and procedures, including processes and systems: (i) for identifying and reporting risks and risk-management deficiencies; (ii) for establishing managerial and employee responsibility for risk management; (iii) for ensuring the independence of the risk-management function of the IHC; and (iv) to integrate risk management and associated controls with management goals and the compensation structure of the IHC.

with experience in identifying, assessing and managing risk exposures of large, complex financial firms. (It would appear that this "financial expert" member could be a non-independent director.)

- **Liquidity**—the IHC must comply with the liquidity risk management requirements applicable to FBOs with U.S. assets in excess of $50 billion.

- **Stress Testing**—the IHC must comply with the supervisory and company-run stress testing requirements applicable to larger bank holding companies under the Final Rules.

FBOs With Combined U.S. Assets of $50 Billion or More

If a large FBO is not required to form an IHC—yet holds U.S. assets of at least $50 billion—numerous additional requirements apply that are summarized below. As a practical matter, unless a topic is not specifically addressed in the portion of the Final Rules addressing FBOs that must form an IHC, the requirements addressed below would also be applicable to both subcategories of large FBOs.

- **Risk-risk Capital and Leverage**—the FBO must certify that it complies with the capital adequacy requirements of its home country supervisor and that its home country regulatory capital framework is consistent with the Basel Capital Framework. If an FBO cannot make this certification to the FRB, the FRB may impose requirements, conditions or restrictions relating to the FBO's activities or business operations in the U.S.

- **Risk Management**—in a manner similar to the risk management requirement of an IHC, an FBO must establish a risk management framework that contains the components that are summarized above, except that the risk management committee of an FBO without an IHC may incorporate the U.S. risk management committee into its global risk management structure.[11]

- **Liquidity Risk Management**—the provisions regarding liquidity risk management and monitoring are extensive. Larger FBOs are required to create and to manage a liquidity risk system, which reports to the risk management committee. Among other things, the liquidity risk system must establish risk tolerances and limits, create effective monitoring, contingency funding, and an event management process. Further, liquidity funding considerations must be a component of any product development and implementation process for an FBO's U.S. operations.

Importantly, all large FBOs, including IHCs, must appoint a U.S. chief risk officer, who is assigned substantial corporate governance, oversight and repotting responsibility.[12]

In addition to the foregoing, as part of liquidity risk management, a large FBO must periodically perform liquidity stress testing to assess the cash flows, liquidity position, profitability and solvency of the FBO's: (a) total U.S. operations; (b) U.S. branches and agencies; and (c) IHC (if applicable). Among other things, appropriate liquidity buffers must be established and maintained.[13]

11 In the instance in which an FBO operates partially through an IHC and partially through U.S. branches and agencies (i.e., outside of the IHC structure), the FBO may use its IHC risk management committee for its entire U.S. operations, operate through its global risk management structure or form a risk management structure for its U.S. branches and agencies that operates on a stand-alone basis or jointly with the IHC risk management committee.

12 The U.S. chief risk officer is specifically assigned responsibility for management of the FBO's liquidity risk management functions.

13 As an indication of the importance the FRB Rule assigns to the adequacy of available liquidity, the qualifying liquidity funds must be located in the U.S. and available liquidity funds must be divided between funds related to an IHC and funds relating to the branches and agencies of the FBO.

Stress Testing—for larger FBOs not required to form an IHC, comprehensive liquidity and capital stress testing is required with respect to their U.S. assets.

Implementation Considerations

Several observations and considerations are offered when considering the implementation requirements for a particular FBO:

First, in regard to the requirements for stress testing, liquidity and risk management compliance, an FBO should note that those requirements are extremely complex and detailed. Because similar obligations apply to larger covered FBOs regardless of whether an IHC must be organized, advance planning is highly recommended. For example, we note that when the Final Rules become operative, the required structural changes will need to be reflected in the living wills (i.e., the resolution plans) required to be filed by many FBOs—which means that coordination between these two related reporting functions is well advised.

Second, an FBO should promptly commence calculating its global and U.S. assets for purposes of the Final Rules in order to identify the provisions of the Final Rules that apply. (Depending upon the results of those calculations, the Final Rules contain time periods within which compliance with applicable requirements begin to apply.) As noted above, there are numerous instances in which overlapping provisions will apply based upon the asset composition of an FBO, and a thorough understanding of its compliance obligations is suggested.

Third, should an FBO be required to restructure its U.S. operations, tax and corporate governance considerations will come into play. In the case in which ownership of subsidiaries must be transferred to a newly formed IHC, an FBO should confirm that it will not incur adverse tax liability under U.S. federal or state tax regimes.

Fourth, in regard to corporate governance, FBOs should be aware that there are differences on a state-by-state basis with respect to the fiduciary duties of directors and officers. For example, in some states the case law may be construed to suggest that corporate directors can have liability for acts involving simple negligence (as opposed to gross negligence). Also, cases in some states raise questions about whether corporate officers are protected by the business judgment rule to the same degree as corporate directors.

Fifth, if employees of an insured depository institution subsidiary of an FBO are also to perform duties as employees of an IHC or the FBO itself (i.e., under a "dual hat" arrangement), attention should be given to the guidance of the various federal bank regulators regarding dual employee situations.

Finally, if an insured depository institution is to provide services to an IHC for an FBO under a service agreement, consideration should be given to compliance with the "arm's length" requirements of Section 23B of the Federal Reserve Act and the FRB's implementing Regulation W.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors. Pillsbury's Financial Services Regulation practice lawyers are actively discussing the numerous issues raised by this Alert with staff at the FRB.

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