OnPoint Dechert LLP

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U.S. Federal Reserve Board Proposes Major Changes in How the U.S. Operations of Foreign Banks and Their Subsidiaries Are Supervised

While several foreign banking organizations ("FBOs") were restructuring their U.S. presence to reduce the impact of U.S. regulation, the Board of Governors of the Federal Reserve System ("Board") recently countered with proposed rules pursuant to the Dodd-Frank Act ("DFA") to heighten supervision of FBOs.

The proposal generally follows the substance of the proposed rules that the Board issued under the DFA in December 2011 for the heightened supervision of large domestic bank holding companies ("Large BHCs") and nonbank financial companies that may be designated as systemically important financial institutions ("SIFIs"). See *DechertOnPoint*, Potential SIFIs Take Note – Your Future is Being Decided Now: FRB Prepares to Act on Enhanced Prudential Standards (PDF). However, the proposed rules would mark a significant change in how the U.S. operations of FBOs are regulated. In many cases, an FBO would be required to house all of its non-branch U.S. operations (including U.S. investment advisory and broker-dealer subsidiaries) in a U.S-based intermediate holding company ("IHC") that would independently be subject to substantial capital, liquidity and other prudential requirements.

The Board is also proposing to generally apply the same requirements to a foreign nonbank financial company that is designated as a SIFI as it would apply to FBOs. The Board has indicated that it plans to tailor the requirements to each foreign SIFI as appropriate and has set forth criteria that it would apply in determining whether to require a foreign SIFI to establish an IHC.

Practical Implications

The proposed rules would re-orient the Board's supervision of FBOs to a more U.S.-centric approach. The preamble to the proposed rules recounts several lessons learned by the Board during and after the financial crisis that have led to this change, among them that FBOs may be unable or unwilling to provide financial support to their U.S. operations during times of financial distress. In response, the Board in the proposed rules would require many FBOs to maintain substantial capital and liquidity in the U.S. to support their U.S. operations, which could dramatically increase an FBO's cost of doing business in the U.S. The proposal would also substantially increase the level of supervision and oversight of an FBO's U.S. operations.

To comply with the proposal, FBOs with more than $10 billion in U.S. assets outside of their U.S. branch and agency network may be required to undergo an extensive internal reorganization of their U.S. activities, which may have tax and other implications. The proposed rules would require, in general, that all U.S.-based banking and nonbanking subsidiaries of an FBO, which would include direct and indirect subsidiaries of various entities within the international group, and may include joint ventures with unaffiliated parties, be placed under a single U.S.-based IHC. This would cause all functionally regulated U.S. nonbanking subsidiaries of an FBO (*e.g.*, investment advisers, broker-dealers and insurance companies), to come under the IHC umbrella and the direct supervision of the Board. The reshuffling of these companies may not only be difficult to accomplish, but may result in conflicts between the requirements of their functional regulator and those of the Board.

One particular challenge of the IHC concept relates to the broad scope of the term "subsidiary" for purposes of the rule (which would include, for example, any company in which an FBO, directly or indirectly, controlled 25% or more of the voting securities). While that company may be a "subsidiary" for bank regulatory purposes, if the FBO did not have actual control over that company, it may be difficult, if not impossible, to cause that company to become part of the IHC. Also noteworthy is the fact that an IHC would become subject to the same capital requirements as a U.S.-based BHC, even though it may have no U.S. bank or thrift subsidiaries. This is a novel expansion of U.S. bank capital requirements and is a topic worthy of substantial comment and debate.

The application of single counterparty credit limits could also raise substantial issues for the U.S. operations of FBOs, as evidenced by the blizzard of comment letters submitted on this topic in response to the Board's comparable proposal for Large BHCs and U.S. non-bank SIFIs. Under the proposal, the rules for identifying companies that must be aggregated either as creditors or debtors and for netting credit exposure are complex and will entail a substantial compliance burden. For asset managers, it will be particularly important that sponsored or advised funds be excluded from the calculation of an IHC's credit exposure (and the credit exposure of the combined U.S. operations of the FBO). As a result, FBOs with U.S. asset management subsidiaries may wish to weigh in on this topic in response to the Board's request for comment.

Comments on the proposal must be received by the Board by March 31, 2013.

General Overview

The proposed rules call for enhanced regulation of an FBO's U.S. operations. The proposal would impose a series of escalating prudential requirements, including capital, liquidity, single counterparty credit limits, risk management, stress tests, debt-to-equity limits and early remediation requirements, based on the size of an FBO's U.S. and global operations. Some requirements would apply primarily to an FBO's U.S.-based banking and nonbanking subsidiaries, whereas others would apply to an FBO's U.S. operations generally, including its branches and agencies.

An FBO with global total consolidated assets of $50 billion or more ("Large FBO") and total consolidated assets of $10 billion or more in its U.S.-based subsidiaries (*i.e.*, excluding U.S. branch and agency assets) would be required to establish a U.S.-based IHC for those U.S. operations in order to provide a platform for more intensive supervision by the Board. An IHC would be subject, among other things, to the same risk-based and leverage capital requirements that apply to U.S. bank holding companies, regardless of whether the IHC controlled a bank. If adopted in its current form, this rule may have an impact on banking laws around the world as foreign governments may seek to impose reciprocal requirements on foreign banks operating in their countries.

The proposed rules generally would become effective on July 1, 2015. These changes would go some distance toward "ring-fencing" the U.S. operations of an FBO by requiring that it maintain substantial additional capital and liquidity in the U.S. This is a departure from the Board's current supervisory practice with respect to FBOs, which relies on the consolidated capital of the FBO to support its U.S. operations. If adopted in its current form, the proposal would tend to increase the capital cost and compliance burden for many FBOs doing business in the U.S and may cause some institutions to consider whether to restructure or curtail their U.S. activities.

Scope of Coverage of the Proposed Rule

Pursuant to sections 165 and 166 of the DFA, the proposed rules would apply to all Large FBOs. The proposed rules also would impose certain requirements on smaller FBOs, *i.e.*, those with global total consolidated assets of $10 billion or more. In general, the larger the FBO and the larger its U.S. operations, the more extensive the prudential requirements would be upon the FBO and its IHC, if one must be established.

The proposed requirements are generally consistent with the enhanced prudential standards and early remediation requirements proposed by the Board in December 2011 for Large BHCs and SIFIs. The application of the proposed prudential requirements to FBOs of varying sizes both globally and within the U.S. is discussed further below.

Intermediate Holding Companies

Perhaps the most significant aspect of the proposal is the requirement that all Large FBOs with $10 billion or more of assets in U.S.-based banking and nonbanking subsidiaries place all their interests in those subsidiaries under a single, independently capitalized, U.S.-based IHC. An IHC could be established by providing after-the-fact 30-day notice to the Board. Under limited conditions, a Large FBO could request the Board's approval to establish multiple IHCs or to use an alternative organizational structure for its U.S. operations.

Current Board policy permits the top-tier U.S. BHC subsidiary of an FBO that qualifies as a financial holding company to rely on the capital of its parent FBO, rather than comply with the capital requirements generally applicable to domestic BHCs. Section 171 of the DFA, commonly known as the Collins Amendment, overrides this policy effective July 21, 2015, by requiring the top-tier BHC subsidiaries of an FBO to satisfy U.S. capital requirements. In response, some FBOs have reorganized their U.S. operations to eliminate their U.S. BHCs, thereby seeking to avoid capital requirements at the U.S. holding company level. The proposed rules would eliminate this option for Large FBOs that would be required to establish an IHC to house their U.S. banking and nonbanking subsidiaries.

An IHC would be the parent entity for all of an FBO's functionally regulated subsidiaries, such as broker-dealers and investment advisers registered with the Securities and Exchange Commission, commodity pool operators registered with the Commodity Futures Trading Commission and insurance companies regulated by state insurance commissioners, as well as all of an FBO's national and state bank and thrift subsidiaries. Any other U.S.-chartered subsidiaries of an FBO, whether or not they were subject to supervision at the national or state level, also would be required to be held through an IHC. The U.S. branches and agencies of an FBO would continue to be held directly by the FBO and would be outside of the IHC framework.

An IHC and its subsidiaries would be subject to examination by the Board, and the IHC would be required to file reports with the Board to the same extent as if it were a BHC. IHCs with $50 billion or more of total consolidated assets would be subject to more extensive capital, liquidity and other prudential requirements than would smaller IHCs, as discussed further below.

The amount of an FBO's combined U.S. assets would be determined by reference to the financial reports it files with the Board or, if no such reports are filed, based on GAAP. Assets under management by a U.S.-based investment adviser subsidiary of an FBO generally would not be included among the combined U.S. assets of the FBO to the extent those assets were not reflected on the balance sheet of the investment adviser. However, the Board is seeking comment on whether U.S.-based sponsored or advised funds should be included as part of the IHC or the combined U.S. operations of the FBO for purposes of applying the single counterparty credit limits described below.

Enhanced Prudential Standards

As discussed above, the proposed rule would generally have the greatest effect on Large FBOs with significant U.S. operations and on any foreign nonbank financial companies designated as SIFIs. Following is a brief overview of the impact of the proposed prudential requirements on different categories of FBOs.

Risk-Based Capital and Leverage

<u>Large FBOs</u>

- A Large FBO would be required to certify to the Board that it meets capital adequacy standards established by its home country supervisor and applied on a consolidated basis that are consistent with standards recommended by the Basel Committee on Banking Supervision ("BCBS"). Separate capital requirements would not be imposed on a Large FBO's U.S. branch and agency network. A Large FBO would also be required to report its risk-based capital ratios to the Board. If a Large FBO did not satisfy these requirements, the Board could impose conditions or restrictions on the Large FBO's U.S. operations.
- The Board also may undertake in a future rulemaking to impose a consolidated capital surcharge certification requirement on Large FBOs that have been designated by the BCBS to be globally systemically important.

Intermediate Holding Companies

- An IHC would be subject to the same risk-based capital and leverage capital standards that would apply to a BHC, regardless of whether the IHC controls a bank. For IHCs with $50 billion or more of total consolidated assets, this would include the capital planning requirements set forth in the Board's Regulation Y. This would require an IHC to demonstrate its ability to maintain capital above minimum risk-based and leverage requirements under both baseline and severely stressed scenarios over the entire capital planning time horizon. Capital distributions by an IHC would be prohibited unless a satisfactory capital plan was submitted to and accepted by the Board.
- The Board also may undertake in a future rulemaking to impose a capital surcharge on IHCs that it determines to be domestically systemically important.

Liquidity Requirements

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

- A Large FBO with combined U.S. assets of $50 billion or more would be required to meet enhanced liquidity requirements, including liquidity risk management standards, liquidity stress testing, the maintenance of a 30-day liquidity buffer consisting of highly liquid assets and the establishment of a contingency funding plan. This is similar to the Board's proposed requirements for Large BHCs.
- The liquidity buffer requirement would apply separately to a Large FBO's IHC and its U.S. branch and agency network. An IHC would be required to hold its entire liquidity buffer in the U.S. For its branch and agency network, a Large FBO would be required to hold highly liquid assets in the U.S. sufficient to meet the first 14 days' liquidity requirements.
- The Board expects to undertake future rulemaking to implement quantitative liquidity requirements consistent with BCBS recommendations for Large BHCs with $50 billion or more of combined U.S. assets.

Large FBOs with Combined U.S. Assets of Less than $50 billion

- A Large FBO with combined U.S. assets of less than $50 billion would be required to conduct an internal liquidity stress test, either on a consolidated basis or for its U.S. operations separately, and to report the results to the Board on an annual basis.

Single Counterparty Credit Limits

General

- The single counterparty credit limits would apply separately to an IHC and to the combined U.S. operations of a Large FBO. The credit exposure of a subsidiary of an IHC or of any other entity that is part of an FBO's combined U.S. operations generally would be included for purposes of these limits. As noted, the Board is requesting comment as to whether U.S.-based funds sponsored or advised by an FBO should also be included for this purpose.
- A Large FBO must ensure compliance by its IHC and combined U.S. operations with single counterparty credit limits on a daily basis and provide monthly reports to the Board demonstrating its compliance.
- The proposed rules describe the types of transactions subject to the single counterparty credit limits and the methods for measuring gross credit exposures and net credit exposures arising from such transactions. Exposure to the U.S. federal government, federal agencies or Fannie Mae or Freddie Mac while in conservatorship would be exempt from the credit limits, as they are under the Board's comparable proposed rule for BHCs. In addition, exposure to the home country sovereign of a Large FBO would be exempt. On the other hand, exposures to U.S. state and local governments and to other foreign sovereigns would be subject to the credit limits.

Combined U.S. Operations of Large FBOs

- The combined U.S. operations of a Large FBO would be subject to a limit on its aggregate net credit exposure to a single unaffiliated counterparty equal to 25% of the Large FBO's consolidated capital stock and surplus. This is the same limit the Board has proposed for Large BHCs.

- The combined U.S. operations of an FBO with $500 billion or more of global total consolidated assets ("Very Large FBO") would be subject to a more stringent limit on its aggregate net credit exposure to an unaffiliated counterparty of similar size, such as another Very Large FBO or a BHC with $500 billion or more of total consolidated assets ("Very Large BHC"), or any nonbank financial company designated as a SIFI. This more stringent limit would be consistent with the stricter credit limit to be established by the Board for Very Large BHCs and SIFIs, which is proposed to be 10% of capital stock and surplus.

Intermediate Holding Companies

- The single counterparty credit limits would also apply separately to the IHC of a Large FBO. An IHC would be subject to a limit on its aggregate net credit exposure to a single unaffiliated counterparty equal to 25% of the IHCs consolidated capital stock and surplus. An IHC with $500 billion or more of total consolidated assets would be subject to the more stringent limit on its credit exposure described above.
- The credit limits for FBOs and IHCs would be calculated based on differing definitions of capital stock and surplus. For an IHC, capital stock and surplus would consist of the company's total regulatory capital, as calculated under the Board's risk-based capital adequacy guidelines, and the balance of its allowance for loan and lease losses ("ALLL") not included in Tier 2 capital under those guidelines. For a Large FBO or Very Large FBO, capital stock and surplus would consist of the company's total regulatory capital on a consolidated basis, as calculated in accordance with home country capital standards consistent with the BCBS framework, which generally would not include the balance of ALLL not included in Tier 2 capital.

Risk Management

General

- The enhanced risk management requirements that would apply to the U.S. operations of an FBO are comparable to the requirements proposed by the Board for domestic BHCs and nonbank SIFIs.
- Large FBOs with combined U.S. assets of $50 billion or more would be subject to substantially greater risk management responsibilities than would FBOs with a smaller U.S. footprint.

Publicly Traded FBOs with Total Consolidated Assets of More Than $10 Billion and All Large FBOs

- Publicly traded FBOs with total consolidated assets of more than $10 billion and Large FBOs, regardless of whether their stock is publicly traded, would be required to certify to the Board on an annual basis that they maintain a U.S. risk committee to oversee the risk management practices of the combined U.S. operations of the company. The U.S. risk committee must have at least one member with risk management expertise.
- From a governance perspective, the U.S. risk committee may be a committee of the global board of directors of the FBO or a committee of the board of directors of the FBO's U.S. IHC, if one has been established.

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

- In addition to the above requirements, the U.S. risk committee of a Large FBO with $50 billion or more of combined U.S. assets would be subject to additional responsibilities and must have at least one independent member.
- A Large FBO with combined U.S. assets of $50 billion or more also would be required to have a qualified U.S. chief risk officer employed by an IHC, another U.S.-based subsidiary or a U.S. branch or agency of the FBO. The U.S. chief risk officer would be responsible for, among other things, measuring, aggregating and monitoring risks undertaken by the combined U.S. operations and reporting to the U.S. risk committee, the global chief risk officer and the Board about such risks, including how they relate to the global operations of the FBO.

Capital Stress Tests

General

- The proposal would impose separate stress testing requirements on IHCs and FBOs, which would be more extensive for Large FBOs and IHCs with $50 billion or more of consolidated U.S. assets.
- Asset maintenance requirements would be imposed on the branch and agency network of an FBO that failed to satisfy stress testing requirements.

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

- A Large FBO with combined U.S. assets of $50 billion or more would be required to be subject to an annual capital stress testing regime administered by its home country supervisor which was broadly consistent with the Board's stress testing regime for domestic BHCs. The FBO would be required to submit a summary of its stress testing activities and results to the Board.
- If the U.S. branch and agency network of a Large FBO, on a net basis, provided funding to the FBO's non-U.S. offices and non-U.S. affiliates, then the Large FBO would be required to provide additional information to the Board regarding its annual home country capital stress test. In the preamble to the proposal, the Board explains that additional information is necessary in this circumstance as a result of greater risk to U.S. creditors and U.S. financial stability posed by U.S. branches and agencies that serve as funding sources to their foreign parent.
- If an FBO does not satisfy home country stress testing and related requirements, then the FBO's U.S. branches and agencies must maintain eligible assets at least equal to 108% of U.S. branch and agency liabilities and may also be required to maintain a liquidity buffer as determined by the Board.

FBOs with Total Consolidated Assets of More Than $10 Billion and Combined U.S. Assets of Less Than $50 Billion

- An FBO in this category would also be subject to an annual stress testing regime administered by its home country supervisor, as described above. However, these FBOs would not be required to report their stress testing activities and results to the Board.
- If an FBO in this category did not satisfy the home country stress testing requirements, then the FBO's U.S. branches and agencies would be required to maintain eligible assets at least equal to 105% of U.S. branch and agency liabilities.

Intermediate Holding Companies

- An IHC would be subject to the same capital stress test requirements that would apply to a domestic BHC. Capital stress test requirements for BHCs were recently finalized by the Board.
- All IHCs would be required to conduct an annual "company-run" capital stress test in accordance with baseline and stressed economic scenarios established by the Board. IHCs with $50 billion or more of total consolidated assets would also be subject to an annual "supervisory" capital stress test conducted by the Board, and would be required to conduct a second mid-year "company-run" capital stress test based on baseline and stressed economic scenarios established by the company.
- The Board will publicly disclose summary results of the annual "supervisory" stress test and IHCs must publicly disclose summary results of their "company-run" stress tests.

Debt-to-Equity Limits

Large FBOs

- If the Financial Stability Oversight Council determined that a Large FBO posed a "grave threat" to the financial stability of the U.S., the Large FBO's IHC would be required to maintain a debt-to-equity ratio of not more than 15-to-1 and its U.S. branch and agency network would be required to meet a 108% asset maintenance requirement.

Early Remediation

General

- The combined U.S. operations of Large FBOs would be subject to a four-level remediation regime similar to the remediation regime proposed by the Board for Large BHCs and nonbank SIFIs.

- Remediation would be triggered if an IHC or Large FBO evidenced financial weakness based on the capital, capital stress test, liquidity and risk management requirements described herein and certain market indicators to be established in future rulemaking.

<u>Large FBOs with $50 Billion or More of Combined U.S. Assets</u>

- FBOs in this category would be subject to mandatory remedial actions applicable to its IHC, its U.S. branch and agency network, its combined U.S. operations and the FBO itself. Remediation measures would increase in stringency (from Level 1 to level 4) based on the extent of the noncompliance by an IHC or Large FBO with the applicable prudential requirements.
- Remedial actions would include, among other things, dividend limitations on the IHC, inter-company funding limitations on the U.S. branch and agency network, limitations on asset growth and prohibitions on business expansion in the U.S., executive compensation limitations and, ultimately, termination or resolution of the combined U.S. operations of the FBO.

<u>Large FBOs with Less than $50 Billion of Combined U.S. Assets</u>

- For Large FBOs with less than $50 billion of combined U.S. assets, imposition of the early remediation actions described above would not be mandatory, but would be applied on a case-by-case basis in the discretion of the Board.

Conclusion

The Board's proposal represents a sea change in the regulation and supervision of the U.S. operations of FBOs. If the proposed rules are adopted in their current form, the regulatory environment for FBOs in the U.S. will change significantly. FBOs should carefully evaluate the impact of the proposal on their business and consider submitting comments to the Board, as appropriate.

This update was authored by David Ansell and Gordon Miller. If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys below.

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