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Another Shoe Drops: The Federal Reserve Board Proposes Dodd-Frank Systemic Prudential Regulations for Foreign Banks

Making good on Federal Reserve Governor Daniel Tarullo's promise earlier this month of imminent Federal Reserve Board ("Board") action to regulate foreign banks in the U.S. under the Dodd-Frank Act, late Friday afternoon the Board proposed regulations ("Proposal") to implement the enhanced prudential regulation and early remediation requirements of Sections 165 and 166 of the Dodd-Frank Act for systemically important and other foreign banks, and foreign nonbank financial institutions. Comments on these proposals will be due by *March 31, 2013*.

Highlights of the Proposal

The following is a brief summary of Friday's 304-page Proposal. In general, the Proposal tracks the requirements of the Board's December 2011 proposed rules for enhanced prudential regulation and early remediation of U.S. bank holding companies,[1] but with important modifications for affected FBOs.

1. ***Scope of Coverage.*** With two exceptions (see "Risk Management Requirements" and "Stress Testing" below), the Proposal would apply to all foreign banking organizations ("covered FBOs") and nonbank financial institutions ("covered foreign FIs") that have $50 billion or more of consolidated *worldwide* assets, *and* that have any U.S. banking or nonbanking operations.

2. ***Intermediate Holding Company.*** A covered FBO with $10 billion or more of *U.S. banking or nonbanking* assets (*excluding* its U.S. branch and agency assets) would have to organize a U.S. intermediate holding company ("IHC") and place its U.S. operations under the IHC. *U.S. branches and agencies* of covered FBOs, however, would be permitted to operate outside of the IHC structure.

3. ***Capital Requirements.*** IHCs would be subject to the same risk-based capital and leverage requirements that apply to U.S. bank holding companies. Covered FBOs also would be required to meet home-country capital standards that are consistent with the Basel Capital Accord. In addition, any IHC with total consolidated assets of $50 billion or more would be required to comply with the Board's annual capital plan rule and its associated capital planning requirements (including limits on capital distributions).[2]

4. ***Liquidity Requirements.*** Covered FBOs with combined *U.S. assets* of $50 billion or more would have to comply with liquidity requirements that are substantially similar to those set forth in the Board's December 2011 proposals for large U.S. banking organizations. These FBOs, however, would be subject to a specific requirement to maintain a 30-day buffer of highly liquid assets in the U.S., the first 14 days of which would have to be held by the

[1] 77 Fed. Reg. 594 (Jan. 5, 2012).
[2] 12 C.F.R. 225.8.

FBO's U.S. branch and agency network. Covered FBOs with a smaller U.S. presence would be subject to more limited requirements.

5. *Single Counterparty Credit Limits.* The Proposal would impose a two-tier single-counterparty credit limit on the U.S. operations of covered FBOs. An IHC would be prohibited from having an aggregate net credit exposure to an unaffiliated counterparty in excess of 25 percent of the IHC's regulatory capital. Further, the aggregate net credit exposure to an unaffiliated counterparty of the combined U.S. operations of a covered FBO would be limited to 25 percent of the consolidated regulatory capital of the FBO. In addition, the Proposal would impose a more stringent (but unspecified) credit exposure limit between an IHC, or the combined U.S. operations of a covered FBO, with consolidated assets of $500 billion or more, and (i) a U.S. bank holding company or FBO with consolidated assets of $500 billion or more, or (ii) a nonbank financial institution that is systemically important and supervised by the Board.

6. *Risk Management Requirements.* Covered FBOs, *and* FBOs that have total *global* consolidated assets of between $10 billion and $50 billion, would be required to certify that they have a U.S. risk committee that has at least one member with appropriate risk expertise. Covered FBOs with $50 billion or more of U.S. assets would be subject to additional U.S. risk committee requirements, including a requirement that at least one member of the committee be independent, and a requirement to appoint a U.S. chief risk officer, who would have to be employed by a U.S. subsidiary or office of the covered FBO, to be responsible for implementing and maintaining the risk management framework and practices for the covered FBO's combined U.S. operations.

7. *Stress Testing.* The Proposal would impose a series of stress testing requirements on FBOs that have total global consolidated assets of $10 billion or more. First, a FBO with global assets of $10 billion or more would be required to show that it is subject to home-country stress testing that is generally consistent with U.S. requirements. Further, an IHC with assets of between $10 billion and $50 billion would be required to conduct company-run stress tests as if it were a U.S. bank holding company, whereas IHCs of $50 billion or more would also be subject to Board-run stress testing. A more complex process for stress testing of U.S. branches and agencies would be created, the particulars of which would depend on the nature, tenor and adequacy of home-country stress testing. U.S. branches and agencies of covered FBOs that provide net funding to their home offices, however, would have to provide more detailed stress testing information. Failure to meet the stress testing requirements would subject U.S. branches and agencies to an asset maintenance requirement.

8. *Debt to Equity Limitations.* The Proposal would implement the Dodd-Frank Act's conditional 15-to-1 debt-to-equity ratio limitation to covered FBOs by applying this limitation to the IHC (or, if the covered FBO does not have a IHC, to each of its U.S. subsidiaries), and a new federal 108 percent asset maintenance requirement on its U.S. branch and agency network, if applicable.

9. *Early Remediation.* A covered FBO's combined U.S. operations would be subject to early remediation triggers based on capital ratios, stress test results, market indicators, and liquidity and risk management weaknesses. If the U.S. operations were $50 billion or more, violation of a trigger would result in certain non-discretionary regulatory actions with respect to the FBO's U.S. operations.

10. *Foreign Nonbank Financial Firms.* The Board stated that these requirements would apply to systemically important foreign nonbank financial institutions doing business in the U.S., but without specifying how these requirements would be applied. No such foreign financial institutions have yet been designated as systemically important, however, which is a reason why the Board did not see the need to provide specifics at this time.

11. *Effectiveness of Requirements and Transition.* The proposed effective date for the new prudential regulations would be July 1, 2015, in order to allow affected FBOs adequate time to implement the Proposal's requirements.

Initial Observations

In some respects, this lengthy and complex Proposal should not come as a complete surprise to affected FBOs. After all, the Dodd-Frank Act directs the Board and other U.S. regulatory agencies to create a systemic regulation framework for systemically significant foreign banks and nonbank financial institutions, and that is exactly what the Board is trying to accomplish with its Proposal.

That being said, the effects of the Proposal, if it is adopted in substantially the form proposed, on the U.S. operations of foreign banks would be noticeable. For covered FBOs that must establish IHCs — a requirement that is not mandated by Dodd-Frank — the additional regulatory capital and liquidity costs associated with this organizational structure could be considerable, particularly for those FBOs with significant U.S. capital markets or corporate finance operations. In effect, the Board would require covered FBOs to maintain substantial additional capital and liquidity in the U.S., in order to assure that these financial resources are available to these U.S. operations — and U.S. regulators — in times of financial distress. In turn, those additional resources would increase the costs of doing business in the U.S., in some cases materially so, and would expose these resources to U.S. regulatory claims.

More generally, the Proposal would create a range of new and unfamiliar U.S.-specific regulatory requirements (such as U.S.-style stress testing requirements) that would reach, in some cases, FBOs that are not large and/or may have minor U.S. operations. Further, some of the Board's proposed systemic regulations that generated controversy in the U.S. banking industry when they were proposed last December, in particular the single-counterparty credit limits, probably will not be any better received by the foreign banks than they were by their U.S. counterparts.

The Proposal almost certainly will raise questions of international cooperation and comity on matters of cross-border financial regulation. It is possible that some sectors of the foreign banking community, and their national supervisors, will view the Board's Proposal as an excessive encroachment on the global business operations, and home country regulation, of affected FBOs. The Board, however, is plainly uncomfortable with what it perceives as a lack of assurances that major U.S. operations of covered FBOs would be suitably supported by their non-U.S. parents and home-country regulators in the event of financial distress, and for that reason there may not be a great deal of Board willingness to back off these proposals even if there are substantial objections to them. At the same time, the Board has decided to leave the U.S. branch and agency network out of the proposed new requirements, with the exception of new liquidity, (conditional) asset maintenance requirements and qualitative stress testing standards.

Some FBOs may decide to review, and consider scaling back or modifying the nature and extent of, their U.S. operations in light of the Proposal. We would not expect, however, large FBOs with significant U.S. operations to materially reduce their U.S. business lines in general, although some may consider reducing or eliminating non-core or less profitable business lines. But there is a great deal that can occur between the proposal and adoption of these regulations, and it is premature to speculate at length right now how FBOs will respond to the Proposal if it is adopted.

One concluding thought: the Proposal is based on the Board's proposed systemic regulations for U.S. bank holding companies, which have not yet been adopted. The fact that the Proposal looks to what the Board previously has proposed, but has not yet finalized, for U.S. banks signals that the Board now is sufficiently comfortable with the form and content of the proposed U.S. bank regulations such that it is willing to expand that scheme to the foreign banking community. There are, however, substantial arguments as to why a straight application of the U.S. scheme to foreign banks may not be advisable, and we may expect that the foreign banks will make those points forcefully during the Proposal's comment period.

We expect to be reporting further on the Proposal in the near future as we analyze its specific provisions and reflect on their significance.

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