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Federal Reserve Board Introduces Dodd-Frank Enhanced Prudential Supervision and Early Remediation Rules for Foreign Banking Organizations

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The Board of Governors of the Federal Reserve System ("FRB") recently announced the issuance of proposed rules to impose enhanced prudential standards and early remediation requirements on certain foreign banking organizations ("FBOs") and foreign nonbank financial companies operating in the U.S. designated for supervision by the FRB ("FBO Rules").[1] If adopted, the FBO Rules, which implement Sections 165 and 166 of the Dodd-Frank Act,[2] would significantly change the way the FRB has regulated FBOs, establishing enhanced prudential standards and early remediation requirements parallel to those announced by the FRB in December 2011 for U.S. bank holding companies ("BHCs") with greater than $50 billion in total consolidated assets and nonbank financial companies designated by the Federal Stability Oversight Council for supervision by the FRB.[3] The FBO Rules represent a major shift from the FRB's longstanding, largely case-by-case supervisory approach towards the regulation of FBOs. As such, the FBO Rules impact all foreign banks with bank subsidiaries, branches, and agencies in the U.S., and the parent companies of such foreign banks.

The FBO Rules Apply Directly to FBOs Operating in the U.S. — and Could Apply Indirectly to U.S. Banks and BHCs with Foreign Operations

Section 165 of the Dodd-Frank Act requires the FRB to impose enhanced prudential standards on FBOs with total consolidated assets of $50 billion or more in a manner that preserves national treatment and reduces risk to U.S. financial stability. Section 166 of the Dodd-Frank Act requires the FRB to establish an early remediation framework for these companies. In proposing the FBO Rules, the FRB considered the unique aspects of regulating foreign entities with U.S.-based operations, including giving "due regard to the principle of national treatment and equality of competitive opportunity."[4] These principles, however, are a significant reason why the FRB will have to proceed with caution on the FBO Rules. Among the significant risks are that: (1) FBOs directly affected by the FBO Rules may be deterred from expanding their business activities in the U.S., and (2) perhaps more importantly, U.S. banks and BHCs operating

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abroad face significant retaliatory risk and potential for other countries to adopt mirror legislation that imposes similarly burdensome requirements on U.S. banks and BHCs operating in their countries.[5]

The FRB's prior supervisory approach towards the regulation of FBOs has largely been based on a risk-focused and case-by-case approach depending on the unique circumstances and features of each FBO.[6] As noted in the Preamble to the FBO Rules however, this approach may not have proved to be very effective, as demonstrated by challenges that arose during the financial crisis regarding the ability of FBOs to support strains on their U.S. operations.[7] Accordingly, as a reactive measure, the FBO Rules establish certain uniform and baseline prudential requirements for FBOs that are intended to prevent some of the challenges observed during the financial crisis.

Summary of the FBO Rules

The FBO Rules would impose varying standards and requirements on FBOs depending on their total global consolidated assets, as well as their total assets in the U.S. In particular, notwithstanding that an FBO may meet the statutory $50 billion asset size threshold for its total global consolidated assets, a "reduced set of requirements" is proposed for FBOs that have combined U.S. assets of less than $50 billion "in light of the reduced risk that these companies pose to U.S. financial stability."[8] The FBO Rules also distinguish between FBOs operating in the U.S. through one or more subsidiary banks versus FBOs operating in the U.S. through branch or agency offices, in light of distinguishing features of the latter sort of FBOs, including that branches and agencies are not separate legal entities and are not required to hold capital separately from their parent organizations.[9]

Category 1 FBOs: FBOs with Global Assets of Greater than $10 Billion (No Minimum Threshold for U.S. Assets)

At a minimum, the FBO Rules would require that all FBOs with publicly traded stock and total global assets of greater than $10 billion, and regardless of the amount of their U.S. assets, comply with the following requirements:

- certifying to maintenance of a U.S. risk committee with at least one member with appropriate risk management expertise;[10] and
- meeting home country stress test requirements that are broadly consistent with U.S. requirements.[11]

Category 2 FBOs: FBOs with Global Assets of Greater than $50 Billion and U.S. Assets of Less than $50 Billion

FBOs with greater than $50 billion in total global assets but less than $50 billion in U.S. assets would be subject to:

- requirements applicable to Category 1 FBOs (see above); and
- additional prudential standards including:
  - a requirement that the FBO meet home country capital standards that are broadly consistent with Basel standards;
  - single-counterparty credit limits;
  - annual liquidity stress test requirements; and

- early remediation requirements pursuant to Section 166 of the DFA.[12]

New Intermediate Holding Company Requirements

The FBO Rules also distinguish between FBOs operating in the U.S. through banking subsidiaries versus FBOs operating through branch and agency offices. FBOs operating in the U.S. through bank subsidiaries (versus though branch or agency offices) and having non-branch U.S. assets exceeding $10 billion will be required to form a U.S. intermediate holding company ("IHC") that will be subject to capital and other requirements that are similar to those applicable to U.S. BHCs. Like U.S. BHCs, U.S. IHCs with assets between $10 and $50 billion would be subject to an annual company-run stress testing requirement pursuant to the FRB's Stress Testing Rule under the Dodd-Frank Act.[13] U.S. IHCs would also be required to maintain a liquidity buffer of unencumbered, highly liquid assets to meet cash flow needs for their U.S. operations.

FBOs operating in the U.S. only through branch and agency offices would not be required to form a U.S. IHC to hold the FBO's U.S. assets. However, branch and agency offices of FBOs satisfying applicable capital requirements generally would be required to cover the first 14 days of a required 30-day liquidity buffer for U.S. cash flow needs.[14] The remainder of the 30-day liquidity buffer could be held in liquid assets outside the U.S., provided that the FBO demonstrates to the FRB's satisfaction that the FBO or an affiliate could provide the residual liquid assets to the U.S. branch or agency network if and when needed.[15]

Another important restriction in the FBO Rules is that if a FBO with total global consolidated assets of greater than $50 billion and U.S. assets of less than $50 billion fails to report annually to the FRB the results of an internal liquidity stress test (either on a consolidated basis or for its combined U.S. operations), the FBO's U.S. branch and agency network would become subject to intragroup funding restrictions.[16]

Category 3 FBOs: FBOs with Global Assets of Greater than $50 Billion and U.S. Assets of Greater than $50 Billion

FBOs with greater than $50 billion in total global assets and greater than $50 billion in U.S. assets would be subject to:

- requirements applicable to Category 1 and Category 2 FBOs (see above); and
- additional prudential standards that include:
  - U.S. IHCs with greater than $50 billion in assets would be subject to the FRB's capital plan rule, which restricts capital distributions for large BHCs[17] and all Dodd-Frank Act stress test requirements pursuant to supervisory standards under a Comprehensive Capital Analysis and Review (CCAR);
  - the FBO's U.S. IHC and branch and/or agency network would be subject to monthly liquidity stress tests and in-country liquidity requirements;
  - the FBO must have a U.S. risk committee and U.S. Chief Risk Officer; and
  - the FBO would be subject to non-discretionary early remediation requirements pursuant to Section 166 of the Dodd-Frank Act.

Early Remediation

An important component of the FBO Rules, like the FRB's prudential regulations for U.S. BHCs, is that the proposed rules would establish an early remediation program for FBOs with $50 billion or more in total global consolidated assets. The program would specify early remediation triggers based on regulatory capital ratios, stress test results, market-based indicators, as well as risk-management weaknesses identified at an FBO. Identified weaknesses, including

- failing to maintain adequate capital above the minimum ratios;
- inadequate capital planning;
- stress test failures or weaknesses at a U.S. IHC;
- risk-committee deficiencies or failures at U.S. operations; and
- liquidity deficiencies at U.S. operations;

would lead to a set of mandatory remediation actions (ranging in levels of severity) imposed against FBOs with U.S. assets of $50 billion or more, and imposed on a discretionary basis against FBOs with less than $50 billion in U.S. assets.[18] Under the FBO Rules, remediation actions that may be taken by the FRB upon occurrence of associated triggers would include:

- limitations on dividends and stock buybacks;
- growth restrictions on U.S. IHC consolidated operations;
- enhanced liquidity requirements, including requiring the entire 30-day liquidity buffer to be held in the U.S.;
- compensation and bonus limitations to U.S. senior management officials;
- replacement of board of directors of U.S. IHCs and/or dismissal of culpable U.S. senior executive officers who have been in office for more than 180 days;
- informal and formal enforcement actions to improve the condition of U.S. operations; and
- a requirement for the FBO to terminate or divest of its U.S. operations.[19]

Single-Counterparty Credit Limits

Another important aspect of the FBO Rules relate to the proposed limits on the combined credit exposure that: (i) a U.S. IHC could have to a single unaffiliated counterparty; and (ii) an FBO's combined U.S. operations could have to a single unaffiliated counterparty. Generally, the limits in each case would be 25% of total regulatory capital for the total credit exposure that a U.S. IHC or an FBO's combined U.S. operations may have to a single counterparty. However, this limit would be more stringent (but is as yet undefined) for U.S. IHCs with total consolidated assets of $500 billion or more and for FBOs with $500 billion or more of global consolidated assets. Finally, it is important to note that the single-counterparty limits would apply to credit exposures to foreign governments and U.S. state and local governments, but not to exposures to the U.S. government; nor would the exposure limit apply to a FBO's exposure to its own home country.

Timing Considerations

As proposed, the enhanced prudential standards and remediation requirements generally described above for FBOs would become effective July 1, 2015, at the earliest. The FRB has provided for a 90-day public comment period. Public comments on the 300+ page proposal – presenting 103 questions for public comments – are due to the FRB in March 2013. Given the potential impact of the FBO Rules on FBOs with banking operations in the U.S., the rulemaking process will be closely monitored, as the final rules could potentially be substantially different and/or more burdensome than the FBO Rules.

Action Plan

- Understand the potential implications and extraterritorial application of the FBO Rules on your banking organization's activities and operations;
- Monitor for rulemaking developments and viewpoints expressed in public comments regarding the FBO Rules;
- Review the various questions posed by the FRB in the FBO Rules and submit public comments during the public comment process to voice any concerns about how a proposed rule would negatively and/or unfairly impact your worldwide operations or create an unworkable challenge for your operations with respect to implementation;
- Review all compliance policies and procedures and your organization's business plan, and identify any need for updates to successfully implement the FBO Rules;
- Review and develop *pro forma* liquidity plans and procedures to satisfy the proposed new liquidity requirements and develop procedures to comply with the related reporting requirements;
- Review and identify corporate governance procedures and legal steps necessary to form a U.S. IHC and consider plans to restructure operations to satisfy this new requirement; and
- Review and identify appropriate U.S.-based staff to serve on U.S. risk committee.

Appendix A

Scope of Application of the FBO Rules for FBOs

(Source: FBO Rules and accompanying FRB Staff Memo)

Global Assets	U.S. Assets	Summary of Requirements that apply	Approx. # of FBOs per category[1]
> $10 billion and < $50 billion	n/a	• Have a U.S. risk committee • Meet home country stress test requirements that are broadly consistent with U.S. requirements	29
> $50 billion	< $50 billion	All of the above, plus: • Meet home country capital standards that are broadly consistent with Basel standards • Single-counterparty credit limits[2] • Subject to an annual liquidity stress test requirement • Subject to DFA section 166 early remediation requirements • Subject to U.S. intermediate holding company (IHC) requirements: o Required to form U.S. IHC if non-branch U.S. assets exceed $10 billion. All U.S. IHCs are subject to U.S. BHC capital requirements o U.S. IHC with assets between $10 and $50 billion subject to DFA Stress Testing Rule (company-run stress test)	84
> $50 billion	> $50 billion	All of the above, plus: • U.S. IHC with assets >$50 billion subject to capital plan rule and all DFA stress test requirements (CCAR) • U.S. IHC and branch/agency network subject to monthly liquidity stress tests and in-country liquidity requirements • Must have a U.S. risk committee and U.S. Chief Risk Officer • Subject to non-discretionary DFA section 166 early remediation requirements	23

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[1] Approximate number of foreign banking organizations as of September 30, 2012.

[2] Foreign banking organizations with assets of $500 billion or more and U.S. IHCs with assets of $500 billion or more would be subject to stricter limits.

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[1] Sections 165 and 166 of the Dodd-Frank Act, codified at 12 U.S.C. §§ 5365 and 5366. See FRB Proposed Rule, "Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies," (released Dec. 14, 2012), available at http://www.federalreserve.gov/newsevents/press/bcreg/20121214a.htm.

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203; 124 Stat. 1376 (July 21, 2010).

[3] In the December 2011 rulemaking, the FRB noted that the FBO Rules applicable to the U.S. BHC counterparts of FBOs operating in the U.S. did not apply to FBOs in light of the unique considerations applicable to the different groups. In particular, Section 165 of the Dodd-Frank Act instructs the FRB, in applying the enhanced prudential standards of Section 165 to foreign financial companies, to give due regard to the principle of national treatment and equality of competitive opportunity, and to take into account the extent to which the foreign company is subject, on a consolidated basis, to home country standards that are comparable to those applied to financial companies in the U.S. 77 Fed. Reg. 594, 598 (Jan. 5, 2012).

[4] *Id*. 12 U.S.C. § 5365(a)(2).

[5] The FRB notes in the Preamble of the FBO Rules that several countries have already adopted legislation or have considered proposals to modify their regulation of internationally active banks within their geographic boundaries such as by requiring increased liquidity to cover local operations, limits on intragroup exposures, and requirements to prioritize or segregate home country retail operations. FBO Rules at 13, fn. 13. By referencing such actions taken by other governments, the FRB seems to imply that the FBO Rules are, in part, a U.S. reaction to such protectionist actions taken by other governments. This hints at the beginnings of a spiral of reactive and protectionist measures taken by home country governments – including the U.S. – to prevent or avoid future financial crises on their soil, which may have the unintended effect of stifling international banking activity.

[6] *See* SR 08-9 / CA 08-12, "Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations" (Oct. 16, 2008). See generally 12 C.F.R. Part 211, Subpart B (Regulation K, regarding the regulation of FBOs).

[7] *See* SR 08-9 / CA 08-12, "Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations" (Oct. 16, 2008). See generally 12 C.F.R. Part 211, Subpart B (Regulation K, regarding the regulation of FBOs).

[8] FBO Rules, p. 20.

[9] A table distributed by the FRB that summarizes the different prudential requirements that are generally proposed to apply to each category of FBOs is set forth in Appendix A.

[10] If the FBO has total consolidated assets of $50 billion or more, this requirement applies regardless of whether the FBO's stock is publicly traded. FBO Rules, p. 117.

[11] *See* FBO Rules, pgs. 26-27.

[12] Under the early remediation requirements, the combined U.S. operations of a FBO would be subject to early remediation triggers based on capital ratios, stress test results, market indicators, and liquidity and risk management weaknesses. FBOs with less than $50 billion in U.S. assets would not be automatically subject to remediation actions upon the occurrence of early remediation triggers.

[13] Section 165(i)(2) of the Dodd-Frank Act, codified at 12 U.S.C. 5365(i)(2).

[14] Under proposed remediation requirements, this requirement could be increased to a full 30 days.

[15] FBO Rules, pgs. 75-78.

[16] FBO Rules, p. 95.

[17] 12 C.F.R. § 225.8. Large top-tier BHCs with $50 billion or more of total consolidated assets are subject to special capital planning and prior notice and approval requirements for capital distributions under 12 C.F.R. § 225.8(f).

[18] In exercising the authority to impose a discretionary remedial action, the FRB will consider the activities, scope of operations, structure, and risk to U.S. financial stability posed by the foreign banking organization. FBO Rules, p. 169.

[19] *See* FBO Rules, pgs. 147-169.