CLIENT UPDATE

THE FEDERAL RESERVE'S PROPOSAL AND THE FOREIGN BANKING COMMUNITY: A PRACTICAL GUIDE FOR FOREIGN BANKS

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On Friday, December 14, 2012, the Federal Reserve Board (the "Federal Reserve") issued proposed rules (the "Proposed Rules") implementing the enhanced prudential standards and early remediation requirements of Sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"). Once adopted, the Proposed Rules would apply to foreign banking organizations ("FBOs") with $10 billion or more in global consolidated assets – with heightened prudential standards applied to FBOs with at least $50 billion in total global consolidated assets ("$50B FBOs") and foreign nonbank financial companies designated as systemically important by the Financial Stability Oversight Council ("Foreign Nonbank SIFIs").[1] The Proposed Rules are generally consistent with the prudential standards and requirements for large U.S. bank holding companies ("Title I BHCs") that the Federal Reserve proposed in December 2011 (the "U.S. Prudential Rules").[2]

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1 "Foreign Banking Organization" or "FBO" means a banking organization chartered outside the United States that maintains a branch, agency, commercial lending company or an insured depository institution in the United States. The Proposed Rules would not apply to an institution lacking such a U.S. presence, unless such an institution were designated a Foreign Nonbank SIFI.

2 Enhanced Prudential Standards and Early Remediation Requirements for $50B Companies, 77 Fed. Reg. 594 (Jan. 5, 2012).

Under the Proposed Rules certain FBOs may need to reorganize their U.S. subsidiaries (but not branch and agency offices) under an intermediate holding company ("IHC") that generally will be subject to enhanced prudential requirements – including risk-based capital and leverage requirements, liquidity requirements, single counterparty credit limits, risk committee and risk management requirements, stress testing, and debt-to-equity limits – that are similar to the standards that the Federal Reserve proposed for Title I BHCs.[3] In addition, based on asset size thresholds, an FBO's branch and agency offices will be subject to various enhanced prudential requirements, including liquidity requirements. Comments on the Proposed Rules are due by March 31, 2013.

This Client Alert describes the proposed requirements applicable to FBOs, including requirements governing the establishment of IHCs and the enhanced prudential requirements. We seek to provide practical guidance on the 300-page proposal by pointing out what prudential requirements would be applicable to various categories of FBOs based on their total U.S. asset size and organizational structure. As another approach to application of these detailed requirements, Table 1, excerpted from the Proposed Rules, provides a summary overview of the requirements by asset size.

INTERMEDIATE HOLDING COMPANY REQUIREMENT

The Proposed Rules would require $50B FBOs with $10 billion or more U.S. assets (excluding branch or agency assets) to establish an IHC in the United States.[4] Importantly (because of the capital and other requirements applied to IHCs, as described below), this requirement would apply even if the FBO does not control an insured depository institution in the United States.

When determining U.S. assets for purposes of this IHC threshold, a $50B FBO would be permitted to exclude branch and agency assets as well as certain commercial subsidiaries commonly known as "Section 2(h)(2) companies."[5] Branch and agency offices and Section 2(h)(2) companies would not be required to be folded under the IHC structure, given that branch and agency offices are not separate subsidiaries from the parent bank and given the

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[3] Presumably the affected U.S. operations of an FBO also could exist under an existing holding company, with the existing entity designated as the IHC. In addition, if an FBO has a U.S. bank holding company ("BHC") that holds all the FBO's U.S. subsidiaries but less than $10 billion of assets, then the IHC requirements should not apply to that BHC.

[4] The asset thresholds are based on average of total assets reported on the Federal Reserve's FR Y-7Q for the four most recent quarters prior to July 1, 2014.

[5] For purposes of the Bank Holding Company Act of 1956 (the "BHC Act"), a "Section 2(h)(2) company" is a company that is owned by a foreign bank and that is principally engaged in the same line of business as its owner outside the United States. These companies are permitted to engage in commercial activities beyond those generally permitted for U.S. bank holding companies to accommodate the fact that certain foreign countries permit broader linkages between banking and commercial firms than in the United States. *See* 12 USC § 1841(h)(2).

operational challenges posed by integrating Section 2(h)(2) companies into IHCs subject to the enhanced prudential standards.

The proposed deadline for the formation of an IHC is July 1, 2015. FBOs that meet the requirements for establishing an IHC after July 1, 2014, generally would be required to establish an IHC one year after meeting such requirements, unless the Federal Reserve accelerates or extends the time frame.[6]

FBOs are not required to obtain the Federal Reserve's approval prior to establishing an IHC, but rather are only required under the Proposed Rules to provide after-the-fact notice within thirty days of establishing an IHC. However, given the significance of such restructurings, FBOs would be well served to engage in open and transparent dialogue regarding their restructuring plans well in advance of establishing an IHC. Although the Proposed Rules are not yet final, FBOs may wish at least preliminarily to review their restructuring strategy, especially given that conducting business under an alternative organizational structure with significant new supervisory requirements will have far-reaching consequences, including tax, accounting, business model, risk management, contract (*e.g.*, due to change in control provisions) and corporate governance implications. Special attention should be devoted to partial ownership interest structures, such as joint ventures, and to merchant banking activities.

PRUDENTIAL REQUIREMENTS

In addition to requiring the establishment of an IHC for FBOs with material non-branch/agency operations in the United States, the Proposed Rules also apply prudential standards to FBOs and their U.S. branch/agency offices. This analysis now describes the varying requirements placed on various categories of FBOs depending on their global and U.S. asset sizes.

FBOs with Global Consolidated Assets between $10 Billion and $50 Billion

Regardless of the size of their U.S. presence, FBOs with $10 billion or more of total consolidated global assets and that have publicly traded stock would be required to: (i) maintain a U.S. risk committee, and certify to the Federal Reserve to that effect; and

[6] The Proposed Rules indicate that FBOs may be permitted to adopt alternative organizational structures, such as the establishment of more than one IHC. Such exceptions are expected to be rare. The Federal Reserve has noted an alternative structure might be possible in the following three situations: 1) if an FBO controls multiple lower-tier foreign banking organizations that have separate U.S. operations; 2) if an FBO's home country laws prevent the FBO from controlling its U.S. subsidiaries through an IHC; or 3) if the Federal Reserve "in exceptional circumstances" approves a modified U.S. organizational structure based on an FBO's activities, scope of operations, structure, or similar considerations."

(ii) meet home country stress testing requirements imposed by the FBO's home jurisdiction, or otherwise conduct a stress test of their U.S. subsidiaries.[7] In the case of an FBO with more than $10 billion but less than $50 billion total consolidated U.S. assets, the FBO's branches and agencies would be subject to a 105 percent asset maintenance requirement if it is unable to meet stress testing requirements required by its home jurisdiction.[8]

FBOs with Global Consolidated Assets of $50 Billion or More

- Prudential Requirements Regardless of Total U.S. Assets
  - Risk-Based Capital and Leverage Requirements

$50B FBOs with a U.S. banking presence would be subject to certain risk-based capital and leverage requirements regardless of the size of their U.S. banking operations. Specifically, a $50B FBO would need to certify to the Federal Reserve on a quarterly basis that it meets either (i) the capital adequacy standards at the consolidated level imposed by its home country supervisor, provided such standards are consistent with the Basel framework, including Basel III, or, if the standards are inconsistent, (ii) the requirements of the Basel framework itself, including Basel III's minimum risk-based capital ratios and capital buffers. A $50B FBO also would need to certify that it satisfies Basel III's leverage ratio, which currently is scheduled to be fully implemented by 2018.

In addition to the above-noted certifications, a $50B FBO would be required to report its risk-based capital ratios, and, when applicable, its leverage ratios on a quarterly basis to the Federal Reserve (in addition to the FRY-7Q). In the event that the $50B FBO does not satisfy applicable capital requirements, the Federal Reserve would coordinate with the FBO's home jurisdiction and may impose activity restrictions on the FBO's U.S. operations.

  - Single Counterparty Credit Limit

The U.S. operations of $50B FBOs would be subject to the single counterparty credit limits established by Section 165(e) of the Dodd-Frank Act. The $50B FBO's <u>U.S. operations</u> (including branches and agencies) would be prohibited from having net credit exposure to any unaffiliated counterparty in excess of 25 percent of the FBO's consolidated capital stock and surplus.

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7 $50B FBOs would be subject to these requirements regardless of whether they are publicly traded.

8 If the home country of an FBO has no stress testing requirements, this 105 percent requirement also would appear to apply.

- Risk Management

Regardless of U.S. asset thresholds, $50B FBOs would need to certify to the Federal Reserve on an annual basis that they maintained a risk committee responsible for the oversight of risk management practices of the $50B FBO's combined U.S. operations. The risk committee would be required to have at least one member with risk management expertise that is commensurate with the capital structure, risk profile, complexity, activities, and size of the FBO's U.S. operations. A $50B FBO would be permitted to maintain the risk committee as a stand-alone committee of the global board of directors (or equivalent thereof) or as part of an enterprise-wide risk committee thereof, or as a committee of the FBO's IHC, if applicable. If the $50B FBO conducted its U.S. activities solely through the IHC, the risk committee would be required to be maintained at the IHC level.

- Early Remediation Requirements

The Proposed Rules implement an early remediation framework for $50B FBOs. The early remediation framework generally is consistent with the early remediation framework proposed for Title I BHCs in the U.S. Prudential Rules. The early remediation framework establishes triggers based on risk-based capital, leverage, stress tests, liquidity risk management, and risk management standards and specifies remedial actions to be taken as financial performance declines.

For $50B FBOs with less than $50 billion in total U.S. assets, the Federal Reserve will have flexibility to take the remedial actions specified within the Proposed Rules if an FBO meets the triggers but is not required to do so. The early remediation framework does not limit the Federal Reserve's general supervisory authority to require corrective measures and remedial actions by an FBO or an IHC in addition to those enumerated in the early resolution regime.

- Debt-to-Equity Limit

The U.S. subsidiaries of an FBO could be subject to a debt-to-equity ratio of 15-1 in the event that the Financial Stability Oversight Council determines such firms present a "grave threat" to financial stability and that the imposition of a debt-to-equity ratio would mitigate such threat.

- Additional Requirements for FBOs with $10-$50 Billion in Total U.S. Assets (including an IHC)

In addition to the requirements described in II.B.1. above, $50B FBOs with total U.S. consolidated assets of $10 billion or more (excluding branch or agency assets) would also be required to establish an IHC in the United States (as detailed above). This section focuses on the additional requirements imposed on an IHC in such circumstances.

- Risk-Based Capital and Leverage Requirements

All IHCs (regardless of whether they control an insured depository institution) would be required to satisfy minimum risk-based capital requirements, including U.S. leverage requirements and capital buffers, in the same manner and to the same extent as the Federal Reserve's capital standards applicable to U.S. BHCs.

The implications of these capital requirements cannot be overstated. For example, an FBO with a large U.S. broker-dealer – and no bank – would nonetheless have to capitalize the IHC holding company of the broker-dealer in accordance with the U.S. banking agency capital guidelines (which will likely soon be toughened by Basel III). Given the substantially different balance sheets of broker-dealers and banks, this could require substantial capital infusions in the IHC.

- Single Counterparty Credit Limit

IHCs, together with their subsidiaries, would be subject to the single counterparty credit limits of Section 165(e) of the Dodd-Frank Act. The IHC and its subsidiaries would be prohibited from having net credit exposure with any unaffiliated counterparty in excess of 25 percent of the IHC's consolidated capital and surplus.

Given that the IHC is likely materially smaller than its parent, this 25 percent of capital and surplus limit on an IHC's total single counterparty exposure would likely prove very inhibiting to FBOs with U.S. broker-dealers and other counterparty-based entities. Accordingly, to seek more flexibility FBOs may, to the extent feasible: (i) move operations to U.S. branches or agencies (which as stated above have a limit equal to up to 25 percent of the FBO's capital and surplus), or (ii) move the exposure (if not the entire transaction) to the FBO itself.

- Stress Testing

IHCs with more than $10 billion but less than $50 billion in total U.S. consolidated assets would be required to conduct annual company-run stress tests, as provided in the Federal Reserve's recently issued final rule imposing stress testing requirements on BHCs meeting similar asset thresholds.[9]

[9] Annual Company-Run Stress Testing Requirements for Banking Organizations With Total Consolidated Assets Greater Than $10 Billion Other Than $50B Companies, 77 Fed. Reg. 62396 (Oct. 12, 2012).

▪ Additional Requirements for $50B FBOs with $50 Billion or More in Total U.S. Assets

$50B FBOs with $50 billion or more in total consolidated U.S. assets would be subject to the following prudential requirements in addition to those listed above. In some cases, these additional requirements would fall on the IHC, if the IHC has greater than $50 billion of U.S. assets. In other cases, the additional burdens would fall on the FBO and/or its U.S. branches and agencies if the FBO's total U.S. assets (*i.e.*, IHC and branches/agencies) exceeds $50 billion. If the critical factor for a limitation is that total (IHC, branch and agency) U.S. assets exceed $50 billion, this analysis will refer to the prerequisite as the FBO having combined U.S. assets of $50 billion or more.

- Risk-Based Capital and Leverage Requirements

IHCs with $50 billion or more in total consolidated assets as of July 1, 2015, will be required to submit annual capital plans in the same manner as Title I BHCs, including demonstrating the ability to maintain minimum risk-based and leverage ratios under baseline and stressed scenarios over the nine-quarter period required by the CCAR process.[10] The deadline for submission of such capital plans would be January 5, 2016. IHCs would be subject to limits on the ability to dividend capital (among other restrictions) in the event they failed to demonstrate an ability to satisfy minimum capital requirements. The Federal Reserve also stated that it is considering applying a quantitative capital surcharge to any IHC determined to be systemically important at a domestic level.[11]

- Liquidity Requirements

$50B FBOs with combined U.S. assets of $50 billion or more would be subject to liquidity risk management standards broadly consistent with the U.S. Prudential Rules. Such FBOs would be required to provide cash flow projections over short and long time horizons. Although the Proposed Rules do not require specific cash flow information on U.S. dollar activity, the Federal Reserve is considering whether $50B FBOs with combined U.S. assets of $50 billion or more should report all of their global consolidated U.S. dollar cash flows.

The Proposed Rules also require $50B FBOs with combined U.S. assets of $50 billion or more to conduct separate monthly liquidity stress tests on its branch and agency network and any IHC. Such FBOs would be required to assume that for the first thirty days only highly liquid assets (*i.e.*, cash or securities issued or guaranteed by the U.S. government, a

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[10] 12 C.F.R. 225.8; 76 Fed. Reg. 74631 (December 1, 2011).

[11] *See* Basel Committee, *A framework for dealing with domestic systemically important banks* (Oct. 2012), *available at* http://www.bis.org/publ/bcbs233.pdf

U.S. government agency, or a U.S. government-sponsored entity) may be used to meet projected funding needs for U.S. operations. $50B FBOs with combined U.S. assets of $50 billion or more would be required to establish liquidity limits, including with respect to concentrations of funding by instrument, single counterparty, secured and unsecured funding, off-balance sheet items and other sources of liquidity risk, and would also be required to monitor intraday liquidity risk exposure.

The FBO's branches and agencies, as well as its IHC would also be required to maintain a thirty day liquidity buffer based on net stressed cash flow needs. The FBO's U.S. branches and agencies would be required to maintain highly liquid assets sufficient to cover their net stressed cash flows for the first fourteen days of the thirty-day period, and the liquidity buffer could not be held by an IHC, the head office or affiliate. The IHC would be required to maintain the full thirty-day liquidity buffer, and that buffer similarly could not be held by a branch, the head office, or an affiliate.

- Single Counterparty Credit Limit

IHCs and the U.S. operations of FBOs with $500 billion or more in total consolidated assets would be subject to an undefined more stringent limit on transactions with unaffiliated counterparties. A more stringent limit for these entities would be consistent with the U.S. Prudential Rules. Under the Prudential Rules, transactions in which both parties are either Title I BHCs or SIFIs would be subject to a limit of 10 percent of consolidated capital stock and surplus.

- Risk Management

$50B FBOs with combined U.S. assets of $50 billion or more would be subject to a number of additional risk management requirements, including that the risk committee meet on at least a quarterly basis, have at least one independent member, and that the FBO appoint a Chief Risk Officer for the U.S.

- Stress Testing

IHCs would be subject to the stress testing requirements of section 165 of the Dodd-Frank Act to the same extent as if the IHC were a U.S. BHC. Thus, IHCs with $50 billion or more combined U.S. assets would be subject to annual supervisory stress tests and would be required to conduct annual company-run stress tests involving scenarios provided by the Federal Reserve as well as other scenarios developed internally, in accordance with a recently issued final rule.[12]

[12] Supervisory and Company-Run Stress Tests for Covered Companies, 77 Fed. Reg. 62378 (Oct. 12, 2012).

In addition, FBOs with $50 billion or more combined U.S. assets would be subject to consolidated capital stress tests that include either an annual supervisory stress test conducted by the FBO's home country supervisor or an annual evaluation and review by its home country supervisor of an internal capital adequacy stress test. The FBO would be required to submit certain information to the Federal Reserve regarding the stress tests, including (i) a description of the types of risks included in the stress test; (ii) a description of the conditions or scenarios used in the stress test; (iii) a summary description of the methodologies used in the stress test; (iv) estimates of the FBO's projected financial and capital condition; and (v) an explanation of the most significant causes for changes in the FBO's regulatory capital ratios.

If an FBO did not meet the stress testing requirements described above, the FBO's branches and agencies would be subject to a 108 percent asset maintenance requirement. In addition, if the non-compliant FBO had $500 billion or more total consolidated U.S. assets, it would be required to conduct an annual stress test of any U.S. subsidiary held under the IHC (other than a company held under section 2(d)(2) of the BHC Act) to determine whether the subsidiary had the necessary capital to absorb losses as a result of adverse economic conditions.

- Early Remediation Requirements

As discussed, $50B FBOs would be subject to early remediation requirements. For $50B FBOs with $50 billion or more in combined U.S. assets, the Federal Reserve would be required to take the remedial actions specified in the Proposed Rules if an FBO meets the triggers, *i.e.* the early remediation regime is non-discretionary. The early remediation framework does not limit the Federal Reserve's general supervisory authority to require corrective measures and remedial actions by an FBO or an IHC in addition to those enumerated in the early resolution regime.

CONCLUSION

As is apparent, the Proposed Rules would affect aspects of how $50B FBOs or FBOs with over $10 billion of global assets organize their U.S. operations and which activities they conduct in the United States, how these activities are conducted and what additional requirements apply to these activities. The Proposed Rules could have pervasive effects beyond risk management and financial reporting practices that will likely shape the contours and structure of an FBO's U.S. business model. The Proposed Rules will ultimately determine, among other things, the role and capacity of U.S. branches and agencies to provide U.S. dollar funding on a cost-effective basis, thereby impacting enterprise-wide capital and liquidity planning. Given the significant single counterparty and capital requirements proposed for large IHCs, the Proposed Rules also could promote FBOs to migrate activities to their U.S. branch network to the extent possible – although in the preamble to the Proposed Rule warns that the Federal Reserve will "monitor" how FBOs adopt to the Proposed Rules and could apply additional requirements on branches and agencies to avoid "regulatory arbitrage" by FBOs.

In the preamble to the Proposed Rules, the Federal Reserve indicated that it was motivated to act because of concerns that it may no longer be able to rely on one of the "fundamental elements" of its historical approach as a host supervisor to the U.S. operations of FBOs; namely, that an FBO will act as a "source of strength" to its U.S. operations when the FBO is under financial stress. The Federal Reserve emphasized in the preamble to the Proposed Rules and in recent speeches by Governors Tarullo and Stein that the U.S. operations of FBOs have in the last decade become more reliant on less stable, short-term, U.S. dollar wholesale funding that is increasingly used to fund parent bank operations outside the United States. The Federal Reserve also expressed concern that ring-fencing in home countries has diminished the likelihood that FBOs will support their U.S. operations, particularly nonbanking operations, when they are experiencing financial distress. Regardless of these stated justifications, one concern is that the Proposed Rules will lead to retaliatory actions by foreign jurisdictions, with potentially significant negative implications for cross-border banking groups. Indeed, it is ironic that the Proposed Rules were published only days after a heralded FDIC/UK "MOU" on large bank resolution; an MOU that expressly states it is designed to discourage the very ring-fencing the Proposed Rules would appear to establish.

Finally, it is important to note that the Proposed Rules may provide clues about the final form of the U.S. Prudential Rules. Given the similarities between the Proposed Rules and the U.S. Prudential Rules, the Federal Reserve, having reviewed public comments on the U.S. Prudential Rules, may adopt many of the originally proposed standards with minimal revisions. If the Federal Reserve were going to depart in any significant respect from the U.S. Prudential Rules, the Proposed Rules likely would not have so closely mirrored that proposal.

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Please do not hesitate to contact us with any questions.

December 21, 2012

Table 1: Scope of Application for FBOs

>$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
>$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[13] ▪ 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: ▪ 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 ▪ U.S. IHC with assets between $10 and $50 billion subject to DFA Stress Testing Rule (company-run stress test)
>$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 nondiscretionary DFA section 166 early remediation requirements

[13] FBOs with assets of $500 billion or more and U.S. IHCs with assets of $500 billion or more would be subject to stricter limits.