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## The Fed's Warning Shot at Foreign Banks

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**Federal Reserve Governor Daniel K. Tarullo announced yesterday that the Federal Reserve is rethinking its historical approach to the regulation of US operations of foreign banks, a move with potentially serious consequences for foreign banks.**

The full significance of the announcement can only be assessed when a detailed regulatory proposal is issued, which Governor Tarullo said is likely in the “coming weeks”. However, on the surface it appears that there could be significant restructuring of foreign banks’ US subsidiaries and new limits on the internal management of funding and liquidity by all US arms of foreign banks, potentially leading to significantly increased costs of doing US business and threatening the attractiveness of the US dollar as the world’s reserve currency.

Governor Tarullo’s announcement came in a speech he gave at the Yale School of Management Leaders Forum.<sup>1</sup> It has long been known that the Federal Reserve would issue a proposal to implement several aspects of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) requiring enhanced supervision of large financial organizations; a proposal for implementing that requirement for US organizations was issued almost a year ago, with the statement that an analogous proposal for foreign banks would be issued “shortly”.<sup>2</sup>

The speech says that the Federal Reserve will propose, among other unidentified limits, that foreign banks subject to Federal Reserve jurisdiction be subject to three new requirements:

- Foreign banks would have to establish a US intermediate holding company (an “IHC”) that would be the parent of all US subsidiaries, apparently both US bank subsidiaries and non-bank subsidiaries such as securities broker-dealers.
- An IHC would be subject to US capital adequacy requirements and to liquidity constraints on a consolidated basis.
- US branches and agencies would be subject to liquidity constraints and limits on cross-border and cross-currency funding and derivatives activities, but not as stringent as those applicable to IHCs.

<sup>1</sup> “Regulation of Foreign Banking Organizations,” Remarks by Daniel K. Tarullo, on the Federal Reserve’s website at <http://www.federalreserve.gov/newsevents/speech/tarullo20121128a.htm>.

<sup>2</sup> If you wish to review the 2011 proposal, you may refer to our client memorandum, “Tightening the Limits on Big US Banks” (Jan. 4, 2012). Dodd-Frank is at Pub. L. No. 111-203, 124 Stat. 1376 (2010).

There is no explicit indication of the target implementation date and transition period for these actions, and statutory requirements on regulatory proposals likely mean that regulations will not be in final form until sometime in mid-2013, with implementation some months, if not longer, after that.

The speech gives the following reasons for imposing these requirements:

- The nature of foreign bank activities in the United States has changed during the 34 years since banks with US branches were made subject to Federal regulation. Among other things, US branches were primarily used for engaging in US lending activities with funding support from the head office, but they have reversed that position so that branches now serve to a much greater extent as funding sources for head offices, obtaining US dollar financing to be used offshore.
- US assets of foreign banks have remained relatively steady during that time, constituting about one-fifth of all US banking assets, but have become concentrated in several very large foreign banks, with ten foreign banks accounting for over two-thirds of foreign bank third-party assets. Also, five of the top-ten US broker-dealers are owned by foreign banks.
- Foreign banks have increased their reliance on short-term wholesale funding. Short-term liabilities were a serious problem during the financial crisis as organizations worldwide faced considerable difficulty rolling over the massive amounts needed to fund their longer-term assets.
- A fundamental tenet of the Federal Reserve's supervisory approach to foreign banks—relying on the head office to support US operations in times of stress—has “come into question”, and the likelihood that some home-country governments will backstop their banks' foreign operations in a crisis “appears to have diminished”. Moves such as the United Kingdom's proposal to ring-fence wholesale and retail operations are considered evidence of a desire by some countries to limit local institutions' foreign exposure. Measures such as strengthening capital requirements through Basel III and using the supervisory process to deal with US problems of foreign banks on a case-by-case basis are seen as insufficient.
- The IHC requirement will enhance the supervisors' ability to use the alternative resolution authority of Title II of Dodd-Frank, applicable to US top-tier holding companies of major financial institutions, in the event that a foreign bank's US operations pose a risk of insolvency threatening the financial system.

Some observations on these points:

- It is natural that Governor Tarullo would be the official to make this announcement. He has been the member of the Board of Governors most active in supervisory matters. In addition, since joining the Board in 2009, he has apparently been the loudest voice internally for tightening the Federal Reserve's approach to regulation and supervision generally, not just for foreign banks.
- These ideas are consistent with recent Federal Reserve supervisory actions and informal guidance during the past few years, which have been gradually winnowing away some of the differences in treatment between US and foreign organizations that had developed over time in order to accommodate the differences with non-US regulatory regimes.
- Will the proposals mean that US compliance with the tenets of the Basel Concordat is dead? The Concordat generally established the principle that consolidated supervision of an internationally active banking organization's global operations is the responsibility of the home country supervisor, and the Federal Reserve generally based its supervisory approach on relying to a great extent on home country supervisors. Governor Tarullo seems to say that the Federal Reserve cannot rely on foreign supervisors to protect their organizations' US operations. In addition, it is becoming “more difficult” to manage international regulatory initiatives, which is a reason to move away from international harmonization of regulatory regimes. He also says that this would not be a “complete departure” from prior Federal Reserve practice,

which seems clearly to mean that it is a departure to a significant degree. Query what this means for the feeling of collegiality among supervisors at future meetings of the Basel Committee on Bank Supervision.

- While some non-US jurisdictions had in fact been moving to strengthen their internal liquidity and supervisory requirements, even to the point of requiring local subsidiaries rather than branches of the foreign bank, the absence of a Federal Reserve proposal may have put some limit on their eagerness to impose significant constraints. With a Federal Reserve proposal to reverse some elements of its longstanding supervisory approach to foreign banks, they may be freer to impose their own requirements in stronger form.
- The requirement to establish an IHC seems clearly a response to moves earlier this year and in 2011 by some major foreign organizations to transfer their US bank subsidiaries out from under their US holding companies and hold them directly by the head office. This move allowed the holding companies not to comply with new Dodd-Frank capital requirements; by not owning a US bank, the intermediate holding company would cease to be a *bank* holding company, which requires increased capital under Dodd-Frank. The Federal Reserve seems to be saying that such moves have negative supervisory consequences and that it should effectively take discretion away from foreign banks not to have such holding companies for all US operations (other than branches). The cost of capital for this requirement could be large.
- The speech seems to emphasize the attention being given to US broker-dealer operations and specifically mentions their reliance on short-term funding as a possible source of instability in the US financial system. This may be a reason to require that they be held by an IHC and be subject to consolidated capital and liquidity requirements. Query whether this is an implicit criticism of the Securities and Exchange Commission's net capital requirements and other regulations, and whether it could lead to a reconsideration by some foreign banks of both the size and nature of their broker-dealer operations.
- Some foreign banks have been considering "de-banking" in order to avoid the burden of US bank regulation, including the new Dodd-Frank requirements. A foreign bank that does not have a US branch or agency or US bank subsidiary is generally not subject to these requirements. Many foreign banks currently have US broker-dealer and other financial subsidiaries without a banking presence other than a representative office, which does not bring them within the ambit of these rules. Along with all the other regulatory burdens, including the infamous Volcker Rule still being crafted, the new Federal Reserve approach might be yet another factor motivating some foreign banks to close their US branches and conduct US operations through non-bank financial subsidiaries.
- US banking organizations might be heartened to see that the Federal Reserve will impose some additional requirements on foreign bank operations that might tend to limit the competitive advantage that foreign banks might have. However, they should not be too quick. If the Federal Reserve believes that there should be liquidity constraints on foreign banks' US branches in relation to offshore offices of the bank, it might believe that US banks should be subject to similar constraints in managing US dollar liquidity between their US head offices and non-US branches. Currently the management of cross-border liquidity among branches is reviewed as a supervisory matter without formal requirements.
- More broadly, it seems possible that constraints such as these could have an effect on the attractiveness of the US dollar as the world's reserve currency. Foreign banks that are considered to be in good financial condition and based in politically stable countries have had a great deal of freedom to obtain US dollar funding and lend it offshore. Constraining that freedom could provide an impetus to change. Whether this happens will depend on a variety of factors, such as the availability of a reliable substitute. The euro is currently not likely to fill that bill. Many foreign banks may decide that having direct access to the Federal Reserve's discount window as the ultimate source of US dollar liquidity will remain sufficiently important to carry on an international banking business that de-banking is not practical.

- At this point it seems at best speculative, and at worst futile, to try to spot all the detailed questions that arise. Among the horde: How will offshore “shell” branches of foreign banks be handled; will they be subject to the same liquidity constraints if they are managed by a US branch? Are the Comptroller of the Currency and the Federal Deposit Insurance Corporation, which are the supervisors of Federally-licensed branches and insured branches respectively, on board with the liquidity requirement, or is the Federal Reserve asserting jurisdiction to impose these requirements on its own? Was the US Treasury consulted on these issues, or discussions held with the Financial Stability Oversight Council? To what extent will these requirements apply only to large foreign banks, perhaps only to those with over \$50 billion in US assets? The formal proposal may provide answers to such questions; or, of course, perhaps it will not.

We will follow this issue and prepare additional memoranda as more details become available.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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