December 18, 2012

Dodd-Frank: The Fed's Proposal for Enhanced Supervision of Foreign Banks

The Federal Reserve on Friday, December 14, issued the detailed proposal to impose tightened regulations on the US operations of foreign banks that was foreshadowed two weeks ago. The proposal would impose significant new constraints on foreign banks' US operations. The extent to which these constraints, if adopted as proposed, would impose such a burden on foreign banks as to affect the competitiveness of the US financial market, the openness of the United States to foreign firms and the continued supremacy of the US dollar as the world's reserve currency is very unclear.

The proposal, which is on the Federal Reserve's website, is consistent with the outline given in a speech by Governor Daniel K. Tarullo two weeks ago that attracted a great amount of attention among foreign banks and their advisers.[1] The speech said that the Federal Reserve would propose that foreign banks under Federal Reserve supervision be subject to requirements that (1) they establish a US intermediate holding company for all US subsidiaries, (2) the holding company comply with US capital adequacy requirements and liquidity constraints, and (3) US branches and agencies comply with unspecified liquidity constraints and limits on cross-border funding and derivatives activities. The Proposal confirms those requirements, puts flesh on their bones, and adds a few more.

[1] The proposal may be found at http://www.federalreserve.gov/newsevents/press/bcreg/20121214a.htm (the "Proposal"). The speech, "Regulation of Foreign Banking Organizations," Remarks by Daniel K. Tarullo, is on the Federal Reserve's website at http://www.federalreserve.gov/newsevents/speech/tarullo20121128a.htm. If you wish to review a summary of the speech, you may refer to our client memorandum, "The Fed's Warning Shot at Foreign Banks" (Nov. 29, 2012).

Summary

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") authorizes the Federal Reserve to impose so-called "enhanced" supervisory requirements on major financial institutions, including foreign banks with US banking operations. Enhanced requirements were proposed almost a year ago for US financial institutions (the "Domestic Proposal"), and at that time it was stated that an analogous proposal applicable to foreign institutions would be issued "shortly".[2]

The Proposal provides an escalating scale of restrictions on foreign banks depending on both the amount of their global assets and the amount of their US assets. Its most important elements are the following:

- A foreign bank with total global consolidated assets of $50 billion or more would be required to organize its US subsidiaries into a US intermediate holding company ("IHC"), with an exception for foreign banks with less than $10 billion in US subsidiaries' assets (that is, excluding US branch and agency assets).
- All IHCs, and all US branches and agencies for foreign banks of $50 billion or more in global consolidated assets, would be subject to liquidity requirements that would generally require holding sufficient liquid assets to cover 30 days of their average cash flow under stressed conditions. Liquidity management plans would be required and a chief liquidity risk officer appointed. Periodic liquidity stress tests, with reports to be sent to the Federal Reserve, would be required.
- All IHCs would be subject to US capital adequacy and leverage requirements and to the Federal Reserve's rule on capital plans imposing limitations on such things as dividends. Branches and agencies would not, but foreign banks with $50 billion or more in global assets would be required to certify that they meet consolidated capital adequacy standards based on the Basel Capital Framework.
- All IHCs, and in some cases the US non-bank subsidiaries not held by an IHC, would be subject to generally the same restrictions as the Domestic Proposal, including single-counterparty credit limits, risk management and risk committee requirements, stress test requirements, and an early remediation framework.
- Foreign banks with total global assets of less than $50 billion but more than $10 billion would be required to have a US risk committee and comply with the home-country stress test requirement noted above, with the alternative of complying with the asset maintenance requirement.
- These requirements would apply to foreign systemically important financial institutions ("SIFIs"), possibly with revisions after a foreign SIFI is designated by the Financial Stability Oversight Council.[3]
- Most of these requirements would become effective in mid-2015 for those foreign banks meeting the size standards as of mid-2014.

[2] If you wish to review the proposal for US institutions, 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).

[3] If you wish to review the procedure for designating SIFIs, you may refer to our client memorandum, "Dodd-Frank: FSOC Deals the Remaining Cards, But Still Does Not Reveal Its Hand" (April 19, 2012).

IHC Requirements

The Proposal's IHC requirement is not one that Dodd-Frank provides but appears to be one that the Federal Reserve believes necessary in order to implement the requirement to have a remediation plan for large financial organizations. It is also a convenient way to impose US capital adequacy and leverage requirements on the US operations of foreign banks, even if the foreign bank does not have a US bank subsidiary. It appears that this requirement is motivated by the large size of many securities subsidiaries of foreign banks and the apparent reticence of some foreign jurisdictions to allow their major institutions to provide support to operations outside their home countries. Effectively the Federal Reserve will require that foreign banks with sizable operations park capital in the United States for use in the event that another financial panic develops.

It may be that the requirement was also motivated by certain foreign banks' decisions to move their US bank subsidiaries out from under their existing US holding companies. This was done apparently to avoid the high capital requirements imposed by the so-called "Collins" amendment to Dodd-Frank, which effectively reversed a 10-year-old policy of the Federal Reserve allowing US intermediate bank holding companies to rely on support from the parent bank to supply capital if needed. The Proposal's IHC requirement would have the effect of reversing those moves.

Liquidity Requirement

The new liquidity requirement for over-$50 billion foreign banks is effectively the same as the Federal Reserve's longstanding guidance on liquidity management. It has two parts. First, the bank must calculate its net cash flow requirement in a stressed environment, covering both market and "idiosyncratic" stresses. Second, the bank must maintain "highly liquid assets" sufficient to cover 30 days' cash flow.

Banks will have some degree of discretion in determining their cash flow requirements. The proposed regulation would require the bank to establish a methodology for making cash flow projections for its US operations, including reasonable assumptions on the future behavior of assets, liabilities and off-balance-sheet exposures. The idea is to identify maturity mismatches between assets and liabilities and calculate the amounts needed to cover the mismatches.

Highly liquid assets must be held by the IHC and the branches and agencies, separately, to cover estimated cash flow needs, called the "liquidity buffer". Such assets consist of cash, securities issued or guaranteed by the US Government or its agencies or sponsored agencies, and other assets that the bank demonstrates "to the satisfaction of the Federal Reserve" have low credit and market risk and are actively traded. The regulation does not specify how this demonstration is to be made. There is no provision for a foreign bank's home country government securities to qualify, presumably because the liquidity requirement is intended to satisfy obligations required to be paid in the United States in dollars; however, the "other-asset" option described above might include non-US securities, and at the Federal Reserve meeting it was stated that required cash holdings need not be in US dollars.

Highly liquid assets must be held in the United States by IHCs. Branches and agencies would have to hold at least 14 days of highly liquid assets in the United States and may hold assets sufficient to cover the 15-day to 30-day period at the bank's head office so long as the Federal Reserve is satisfied that the assets would be provided as needed.

The Proposal includes much detail on the calculation of cash flows, including requirements directed to internal and external cash flows for the US operations of the organization. It also includes provisions requiring a liquidity management system generally, including the appointment of a liquidity management officer and preparation of a liquidity contingency plan to be reviewed by the Federal Reserve. In addition, the Federal Reserve is considering a requirement by foreign banks with large global cash flows in US dollars to report all of their US dollar cash flows to the Federal Reserve periodically.

Capital Adequacy Requirements

Each IHC would have to satisfy US capital adequacy requirements both on risk-based assets and on a leverage basis as those requirements apply to US organizations generally. Thus, the outstanding proposal to implement so-called "Basel III" requirements in the United States would apply to IHCs.[4]

Other Enhanced Supervisory Requirements

IHCs, and in some cases branches and agencies, would be subject to generally the same enhanced supervisory requirements as the Domestic Proposal.

IHCs would have to limit their total credit exposure, which would include exposure on derivatives and repurchase transactions, to any one counterparty to 25 percent of the IHC's capital and surplus. If the IHC has over $500 billion in total assets, its exposure to any "major" counterparty, i.e., one that also has over $500 billion in total assets, would be subject to a lower limit, but apparently not as low as the 10% limit proposed for US organizations. Branches and agencies would be subject to the same limit but based on the parent foreign bank's global capital and surplus.

IHCs would have to appoint risk committees at the board level, and a chief risk officer, responsible for developing a risk management plan subject to Federal Reserve approval. Branches and agencies would be subject to the same requirement but would be allowed to rely on a risk management committee at the level of the board of directors of the parent foreign bank so long as it generally satisfies US requirements.

IHC would have to conduct stress tests subject to the same requirements currently imposed on US organizations, including the conduct of tests using Federal Reserve-supplied assumptions and tests using the IHC's own assumptions. Branches and agencies would be subject to the same requirement but the test may be conducted by the parent bank under the home country's stress test requirements; if the bank is not subject to such requirements or does not conduct the tests, then the US branches and agencies would be subject to an asset maintenance requirement requiring the holding of sufficient US assets to cover 108 percent of the branch/agency liabilities (apparently not just third-party liabilities, as many States require).

Debt-to-equity limitations and early remediation steps required by Dodd-Frank would be applicable to foreign banks suffering financial difficulties pursuant to elaborate requirements detailed in the Domestic Proposal.

[4] If you wish to obtain information on the US proposal, and a comparison of the US proposal with the versions proposed for adoption in the European Union, you may wish to review our client memorandum, "Implementation of the Basel III Framework: Comparison of US and EU Proposals" (Oct. 18, 2012).

Observations

- The Proposal states that it does not constitute a reversal of the Federal Reserve's longstanding policy of relative openness to foreign banking operations. However, it seems clearly to be a reversal of its reliance on foreign banks in good financial condition to provide support from overseas to their US operations. The Proposal cites legal restraints in some countries on doing so. This may be a reference to proposals to "ring-fence" local operations, a step that was taken in the United States long ago to deal with branch and agency insolvencies. The Federal Reserve's proposal may, of course, provide an impetus to even more limiting actions by other countries, creating limitations on liquidity and imposing costs for operating globally. This might not be completely unintentional in light of the desire to rein in so-called "too-big-to-fail" institutions.
- The Federal Reserve's action can be understood in political terms as well. One can imagine what the Federal Reserve would hear from Congress and others if a second financial panic, like that of September 2008, were to occur and the failure of US operations of a major foreign institution occurred because its home government would not allow the bank to move funds to the United States. Requiring both capital for US subsidiaries and liquidity for both subsidiaries and branches theoretically would provide resources already in the United States to address such a crisis. The Congressionally-required release of information concerning use of the discount window during 2008 and 2009 showing heavy usage by foreign institutions probably did not help.
- The Proposal does not dwell on the transfer by US branches of dollars to offshore operations, but at the open meeting at which the Proposal was discussed Federal Reserve staff indicated that the dollar's status as the world's reserve currency provided a reason to impose liquidity requirements on the branches. Use of the dollars overseas, where the Federal Reserve is not able to obtain timely information on maturity mismatches, makes it more difficult to assure the availability of liquidity in times of stress.[5] Whether this might have an effect at the margin on continuation of the dollar's status as the reserve currency might be questioned.
- Comments may be submitted by March 31, 2013. The Proposal has 103 numbered questions on which the Federal Reserve specifically requests comment. The timing of issuance of a final version of the regulation is unknown. However, because the Domestic Proposal has been outstanding for one year, it may be that the Federal Reserve believes that it is in a position to finalize the Domestic Proposal, and would then conform the Proposal. If so, then adoption of a final version might be accomplished by mid-2013.

[5] A Federal Reserve Governor spoke to this point on December 17, 2012. "Dollar Funding and Global Banks," Remarks by Jeremy C. Stein (Dec. 17, 2012), available at http://www.federalreserve.gov/newsevents/speech/stein20121217a.htm.

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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