December 16, 2012

Regulation of U.S. Operations of Non-U.S. Banks

Federal Reserve Issues Proposed Rules That Would Fundamentally Revise the Regulation and Structure of the U.S. Operations of Foreign Banking Organizations

SUMMARY

On December 14, 2012, the Board of Governors of the Federal Reserve System (the "*FRB*") issued for public comment a notice (the "*Notice*") of proposed rulemaking (the "*Proposed FBO Rules*") that would implement the enhanced prudential standards and early remediation requirements mandated by Sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "*Dodd-Frank Act*") for foreign banking organizations ("*FBOs*") and systemically important foreign nonbank financial companies designated by the Financial Stability Oversight Council (the "*Council*") for FRB supervision. The Notice is 304 pages and poses 103 specific questions; comments are due by March 31, 2013.

If implemented in their current form, the Proposed FBO Rules would represent a fundamental revision and restructuring of the regulatory regime for FBOs operating in the United States.[1] The Proposed FBO Rules do not take the ultimate step of requiring "subsidiarization" of foreign bank branches and agencies, and the Notice refers to the Proposed FBO Rules as "supplementary rather than departing from existing supervisory practice." Nonetheless, the Proposed FBO Rules would create a form of regulatory ring-fencing—through the imposition of an "intermediate holding company" (the "*IHC*") structure—of the U.S. operations of FBOs conducted through subsidiaries, and impose a comprehensive, prescriptive and granular array of new requirements on IHCs. In addition, U.S. branches and agencies of FBOs would be subject to liquidity requirements, which may limit the ability of FBOs to use those offices as a source of dollar funding for overseas operations, as well as other new requirements.

The Proposed FBO Rules follow in many respects, both conceptually and as to their details, the approach taken by the FRB in the proposed rules it issued in December 2011 to implement the Dodd-Frank Act Section 165 enhanced prudential standards for U.S. bank holding companies ("*BHCs*") with total consolidated assets of $50 billion or more and systemically important U.S. nonbank financial companies designated by the Council for FRB supervision (the "*Proposed U.S. Rules*"). The highly complex and detailed Proposed U.S. Rules are discussed further below under "Background."[2]

The potential consequences of the Proposed FBO Rules, if adopted, could include: encouraging FBOs to operate in the U.S. through branches and agencies rather than subsidiaries; increasing significantly the regulatory cost of operating in the U.S.; and discouraging substantial nonbank operations of FBOs in the United States. The Proposed FBO Rules can be read as reversing a decades-old U.S. government policy of welcoming FBOs and encouraging them to expand their U.S. operations. The impact of such a reversal could have a substantial impact on international comity with respect to the regulation of banking organizations, the regulation of U.S. banking organizations operating abroad, the willingness of FBOs to engage in "rescue" acquisitions in the U.S.,[3] the United States' position as a global financial center and the U.S. dollar's role as the world's reserve currency.

The Proposed FBO Rules are the most recent manifestation of a global regulatory response to the recent financial crisis. The legislative response in the U.S. has dictated, as its overarching policy objective, a sharply more restrictive and stringent regulatory regime designed to prevent future bank failures. The second sentence of the Notice states, "The financial crisis also demonstrated that large [FBOs] operating in the United States could pose financial stability risks [similar to those posed by domestic financial institutions]." The FRB recognizes that the "presence of [FBOs] in the United States has brought competitive and countercyclical benefits to U.S. markets" and that the "current [regulatory] approach has facilitated cross-border banking and increased global flows of capital and liquidity." Nonetheless, the "financial stability lessons learned during the crisis have raised questions about the continued stability of this approach," and the FRB is prepared to "incrementally increase costs and reduce flexibility of internationally active banks."

Relatedly, the Proposed FBO Rules are particularly focused on the overall size of the U.S. operations of FBOs and their capital market activities. A particularly illuminating statement in the Notice with respect to the FRB's underlying philosophy is the description of the Proposed FBO Rules as "increas[ing] in stringency with the level of systemic risk posed by and the risk characteristics of the U.S. operations . . . [thereby] provid[ing] incentives for large [FBOs] to reduce the riskiness of their U.S. operations." Because the only specific way in which the increase in regulatory stringency embodied in the Proposed FBO Rules is effectuated is on the basis of size, an intended effect of the Proposed FBO Rules may be to encourage foreign banks to reduce the size of their presence in the United States. With respect to investment banking operations of foreign banks in the U.S., the Notice suggests a similarly negative view by noting the "financial risks associated with the increased capital market activity" and that "five of the top ten U.S. broker-dealers are currently owned by [FBOs]."

One other key factor that appears to have motivated the approach taken in the Proposed FBO Rules was the suggestion made by several non-U.S. regulators that, in the event of a failure of a large home country financial institution, they would seek first to protect home country creditors and would not be willing to provide financial support to benefit the institution's foreign operations. The Notice refers to actions by "government authorities during the crisis period [including] restrictions on the cross-border movement of assets during the crisis period" and "requirements to prioritize or segregate home country retail operations." In such an event, the U.S. creditors could be at risk unless there were a regulatory ring-fence of the type envisioned by the Proposed FBO Rules. The FRB highlights that in the "lead up to the crisis, many [FBOs] used their U.S. operations to raise short-term debt in U.S. markets to fund longer-term assets held in other jurisdictions, exposing them to substantial amounts of liquidity risk in the United States." This liquidity risk, in the FRB's view, further necessitates regulatory ring-fencing of FBOs' U.S. operations.

This Memorandum outlines the principal new requirements that the Proposed FBO Rules would impose on covered FBOs, in most cases on the FBOs' U.S. operations (whether consolidated through an IHC or through branches and agencies of the FBO) but in some cases on the FBO itself. They include, in the case of IHCs (which must be established by FBOs with total global consolidated assets of $50 billion or more and combined U.S. assets (excluding U.S. branch and agency assets) of $10 billion[4] or more):

- risk-based capital and leverage requirements;
- liquidity requirements (both substantive and procedural);
- single-counterparty credit limits ("*SCCL*");
- risk management and risk committee requirements;
- stress test requirements, including public disclosure of the results;
- a debt-to-equity limit for companies determined by the Council to pose a "grave threat" to financial stability; and
- a framework for early remediation of financial weaknesses.

In addition, separate liquidity requirements would apply to foreign bank branches and agencies. The effective date for the Proposed FBO Rules is July 1, 2015 (unless otherwise noted herein).

BACKGROUND

During the recent financial crisis, a number of developments caused both U.S. and non-U.S. regulators to re-examine the regulatory structure and oversight of foreign banks operating in a host country. In response to the financial crisis, the U.S. Congress enacted the Dodd-Frank Act, which includes provisions specifically addressing the financial stability risk that may be posed by non-U.S. banks. Section 165 of the Dodd-Frank Act subjects large U.S. BHCs, FBOs, as well as nonbank financial companies, to stricter prudential standards. The Dodd-Frank Act requires that these enhanced prudential standards be more stringent than the standards applicable to other BHCs and nonbank financial companies that do not present similar risks to U.S. financial stability. The enhanced prudential standards must also increase in stringency based on a company's systemic footprint and risk characteristics. Additionally, Section 166 of the Dodd-Frank Act requires the FRB to establish a regulatory framework for the early remediation of financial weaknesses for large U.S. BHCs, FBOs and systemically important nonbank financial companies designated by the Council for FRB supervision in order to minimize both the probability that such companies will become insolvent and the potential harm of such insolvencies to the financial stability of the United States. Further, the Dodd-Frank Act authorizes, but does not require, the FRB to establish additional enhanced prudential standards for these companies relating to contingent capital, public disclosures, short-term debt limits, and such other prudential standards as the FRB determines to be appropriate.

In December 2011, the FRB issued the Proposed U.S. Rules to implement the Section 165 enhanced prudential standards for U.S. BHCs with total consolidated assets of $50 billion or more and U.S. systemically important nonbank financial companies designated by the Council. The Proposed U.S. Rules, like the Proposed FBO Rules, included risk-based capital and leverage requirements, liquidity requirements, SCCL, overall risk management and risk committee requirements, stress test requirements, a debt-to-equity limit and early remediation requirements. On October 9, 2012, the FRB finalized, in separate rulemakings, the supervisory and company-run stress test requirements contained in the Proposed U.S. Rules.

The Proposed FBO Rules are intended to be "broadly consistent" with the standards embodied in the Proposed U.S. Rules. According to the FRB, differences between the domestic and FBO proposals reflect the different regulatory framework and structure under which FBOs operate. The FRB stresses in the Notice that the differences between the Proposed FBO Rules and the Proposed U.S. Rules "do not reflect potential modifications that may be made to the [Proposed U.S. Rules]," and notes that "[c]omments on this proposal will help inform how the enhanced prudential standards should be applied differently to [FBOs]." Nevertheless, certain differences between the Proposed FBO Rules and the Proposed U.S. Rules may be indicative of the FRB's thought process as it considers comments on the Proposed U.S. Rules. Examples include: (i) the Proposed FBO Rules' single counterparty credit limit provisions to replace the 10% limit, suggested in the Proposed U.S. Rules, on exposures by certain "major" FBOs or U.S. IHCs to unaffiliated "major" counterparties with "[x%]," apparently pending the results of a forthcoming SCCL quantitative impact study referred to in the FRB's staff memo accompanying the Notice (the "*Staff Cover Memo*"), and (ii) the Proposed FBO Rules' liquidity and risk management provisions assign a covered institution's U.S. chief risk officer, instead of its risk management committee, the task of reviewing and approving significant new business lines and products.

Similarly, comments on the Proposed FBO Rules may well influence the FRB's consideration of the Proposed U.S. Rules.

SCOPE OF APPLICATION

The Proposed FBO Rules would tier, based on size, their applicability to the U.S. operations of an FBO depending on the amount of the FBO's total global consolidated assets and its combined U.S. assets.[5] The tiered structure of the Proposed FBO Rules reflects the FRB's recognition that "not all [FBOs] that meet the statutory asset size threshold [of $50 billion in global assets], particularly those with a small U.S. presence, present the same level of risk to U.S. financial stability." Some of the Proposed FBO Rules apply to the FBO's U.S. IHC considered separately, others to its U.S. branches and agencies considered separately (including federal branches and agencies, for which the Office of the Comptroller of the Currency is the primary regulator) (the "*U.S. Branch/Agency Network*"), others to each of the U.S. IHC and the U.S. Branch/Agency Network, others to the U.S. IHC and the U.S. Branch/Agency Network on a combined basis (the "*Combined U.S. Operations*"), and still others to the FBO itself at the parent level.

The following chart illustrates this tiering approach.

Global consolidated assets	**U.S. assets (including branches and agencies)**	**U.S. assets (excluding branches and agencies)**	**Requirements Applicable**
>$10 billion and <$50 billion	**n/a**	**n/a**	A publicly traded FBO with $10 billion or more in global consolidated assets, irrespective of the size of its U.S. asset holdings: • Required to maintain (and annually certify to the FRB that it maintains) a U.S. risk committee • Required to meet home country stress test requirements that are broadly consistent with U.S. requirements

>$50 billion	**n/a**	**>$10 billion and <$50 billion**	An FBO with total global consolidated assets of $50 billion or more and combined U.S. assets (excluding U.S. branch and agency assets) of $10 billion or more, in addition to the requirements above:
			• Required to establish a U.S. IHC, regardless of whether the FBO controls a U.S. depository institution
			    • The U.S. IHC would be subject to U.S. BHC capital requirements but not the FRB's Capital Plan Rule
			    • The U.S. IHC would be subject to the company-run stress test requirements under the Dodd-Frank Act
			    • The U.S. IHC would be subject to an annual liquidity stress test requirement
			• Required to meet home country capital standards that are broadly consistent with Basel standards
			• Subject to single-counterparty credit limits
			• With respect to its Combined U.S. Operations, subject to the early remediation requirements set forth under Section 166 of the Dodd-Frank Act

>$50 billion	**<$50 billion**	**n/a**	An FBO with total global consolidated assets of $50 billion or more but combined U.S. assets of less than $50 billion, in addition to the requirements above: • Required to report the results of an internal liquidity stress test (either on a consolidated basis or for its Combined U.S. Operations) to the FRB on an annual basis
>$50 billion	**n/a**	**>$50 billion**	An FBO with global consolidated assets of $50 billion or more and combined U.S. assets of $50 billion or more, in addition to the requirements above to: • U.S. IHC would be subject to CCAR conducted under the FRB's Capital Plan Rule • Required to conduct for its U.S. Branch/Agency Network and U.S. IHC internal liquidity stress test, maintain a 30-day buffer of highly liquid assets and

			required to meet liquidity risk management standards • Required to maintain a U.S. risk committee, hire a U.S. chief risk officer, establish and maintain an independent review function, produce comprehensive cash flow projections and establish a contingency funding plan • With respect to its combined U.S. operations, subject to non-discretionary early remediation requirements under Section 166 of the Dodd-Frank Act
>$50 billion	**n/a**	**<$10 billion**	An FBO with combined U.S. assets (excluding U.S. branch and agency assets) of less than $10 billion would not be required to form a U.S. IHC

FBOs with Combined U.S. Assets of $50 Billion or More

The most stringent standards would apply to any FBO with $50 billion or more in global consolidated assets and combined U.S. assets (excluding branch and agency assets) of $50 billion or more. These FBOs' U.S. IHCs would be subject to the FRB's Comprehensive Capital Analysis and Review ("*CCAR*"), now conducted under the FRB's capital plan rule (the "*Capital Plan Rule*").[6] Moreover, these FBOs would be subject to more stringent liquidity standards, risk management standards, stress test requirements and early remediation requirements than would apply to the U.S. operations of other FBOs. Each of the U.S. IHC and the U.S. Branch/Agency Network would be subject to monthly liquidity stress tests and in-country liquidity requirements. Additionally, the FBO also would be required to have a U.S. risk committee and a U.S. chief risk officer.

FBOs with $50 Billion or More in Global Consolidated Assets and Combined U.S. Assets of Less Than $50 Billion

Somewhat less stringent requirements than those described above would be imposed on FBOs with $50 billion or more in total global consolidated assets and combined U.S. assets of less than $50 billion (excluding branch and agency assets). Nonetheless, such FBOs would be required to meet home country capital standards that are broadly consistent with the Basel standards and would be subject to SCCL; annual liquidity stress test requirements; the early remediation requirements of Section 166 of the Dodd-Frank Act; and the U.S. IHC requirements (if the FBO has U.S. non-branch assets of $10 billion or more), although such U.S. IHC would not be subject to the FRB's Capital Plan Rule. Additionally, U.S. IHCs with assets between $10 and $50 billion would be subject to company-run stress test.

FBOs with $10 Billion or More in Global Consolidated Assets and a Nominal U.S. Presence

Any publicly traded FBO with $10 billion or more in global consolidated assets, irrespective of the size of its U.S. asset holdings, would be required to form a U.S. risk committee and meet home country stress test requirements that must be broadly consistent with U.S. requirements.

Foreign Nonbank Financial Companies

As indicated above, the Proposed FBO Rules also would apply to systemically important foreign nonbank financial companies designated by the Council for FRB supervision, although no such designations have been made to date.

The FRB specifically solicits public comment regarding the proposed tiering and whether alternative asset thresholds would be more appropriate.

CREATION OF A U.S. INTERMEDIATE HOLDING COMPANY

The Proposed FBO Rules would require an FBO with total global consolidated assets of $50 billion or more and combined U.S. assets (excluding U.S. branch and agency assets) of $10 billion or more to establish a U.S. IHC,[7] *regardless of whether the FBO controls a U.S. depository institution*.[8] As a result, FBOs with significant securities, insurance or other operations in the U.S. that are an FBO only because they operate a branch, agency or commercial lending company in the U.S. (regardless of their size), would be required to establish a U.S. IHC that would be subject to a series of prudential and supervisory requirements described below.

An FBO that establishes a U.S. IHC would be required to hold its interest in any U.S. subsidiary, other than a subsidiary held under Section 2(h)(2) of the Bank Holding Company Act of 1956, as amended (the "*BHC Act*"), through the U.S. IHC.[9] The Proposed FBO Rules also would require an FBO to transfer to the U.S. IHC any controlling interests in U.S. companies acquired pursuant to merchant banking authority. U.S. branches and agencies are excluded from the U.S. IHC requirement.

The Proposed FBO Rules utilize the BHC Act's broad definition of "control." Accordingly, FBOs required to transfer all U.S. "subsidiaries" (as that term is defined in the BHC Act) may have difficulty in attempting to comply with the U.S. IHC requirement because such FBOs would be required to transfer into the U.S. IHC structure their ownership interests in entities over which the FBO has limited or no practical control, such as subsidiaries of joint ventures or other vehicles.

Under the Proposed FBO Rules, a series of prudential and supervisory requirements would be imposed on U.S. IHCs, including risk-based capital and leverage rules and early remediation requirements on a consolidated basis. The U.S. IHC would not, however, be separately subject to the enhanced prudential standards applicable to U.S. BHCs even if the U.S. IHC would otherwise qualify for such enhanced prudential standards. As noted above, a U.S. IHC with total consolidated assets of $50 billion or more would be subject to CCAR, now conducted under the FRB's Capital Plan Rule.

According to the Notice, the U.S. IHC requirement would provide the FRB with "a more uniform platform on which to implement its supervisory program across the U.S. operations of [FBOs]." Furthermore, the FRB believes the IHC requirement would assist in the resolution or restructuring of the U.S. operations of an FBO.

The FRB retains the discretion to permit an FBO to establish multiple U.S. IHCs where an FBO owns multiple lower-tier FBOs that have separate U.S. operations or when, under applicable home country law, an FBO may not control its U.S. subsidiaries through a single U.S. IHC.

It will be important for any FBO subject to the U.S. IHC requirement to recognize the potential tax implications that may arise in interposing a U.S. IHC into its organizational structure or otherwise reorganizing the FBO's organizational structure under a U.S. IHC. The Proposed FBO Rules do provide, however, flexibility regarding the legal form of the U.S. IHC and would allow an FBO to utilize, for example, a limited liability company structure, so long as the entity has a board of directors or managers (or an equivalent thereto) with the same rights and duties (e.g., the duties of loyalty and care) as a board of directors of a corporation. The use of a limited liability company or other form may be helpful to FBOs in addressing potential tax structure concerns. The FRB recognizes this issue, and in the Notice specifically seeks public comment on it.

Finally, the FRB plans to monitor how FBOs adapt to the implementation of this part of the Proposed FBO Rules—specifically whether, in response to the IHC requirement, FBOs seek to shift significant assets to a branch or agency network.

RISK-BASED CAPITAL, CAPITAL DISTRIBUTION AND LEVERAGE REQUIREMENTS

All U.S. IHCs

The Proposed FBO Rules would apply the same risk-based capital requirements and leverage limits applicable to U.S. BHCs to all U.S. IHCs irrespective of its size and regardless of whether the U.S. IHC controls a depository institution. The capital rules for U.S. BHCs that are proposed to be applied to U.S. IHCs include the general risk-based capital rule,[10] the leverage rule,[11] the market risk rule[12] and the advanced approaches risk-based capital rule.[13] A U.S. IHC that does not meet these requirements generally would not be allowed to make any capital distributions until it has provided a satisfactory capital plan to the FRB. The FRB also indicated in the Notice that it may, through a separate future rulemaking, apply a quantitative risk-based capital surcharge in the U.S. on U.S. IHCs determined to be systemically important banking organizations ("D-SIB"), "aligned with the international requirement," such as the proposed Basel Committee D-SIB regime or a similar framework.[14]

U.S. IHCs with Total Consolidated Assets of $50 Billion or More

As noted above, a U.S. IHC with total consolidated assets of $50 billion or more would be subject to the FRB's Capital Plan Rule and, under that rule, if the U.S. IHC crossed the $50 billion asset threshold as of July 1, 2015, would be required to submit to the FRB its first capital plan on January 5, 2016 and annually thereafter (unless extended by the FRB).[15] The capital plan must demonstrate the ability to maintain capital above the FRB's minimum risk-based capital ratios under baseline and stressed conditions for at least the following nine quarters. If a U.S. IHC is unable to meet this requirement, it would be prevented from making capital distributions unless and until it presents a compliant capital plan. The FRB specifically seeks comment on whether it should consider modifying the requirements of the Capital Plan Rule as it would apply to U.S. IHCs.

The FRB anticipates in its Notice that the capital adequacy standards for U.S. BHCs—and if the Proposed FBO Rules are adopted, for U.S. IHCs with total consolidated assets of $50 billion or more—will incorporate the Basel III capital standards on July 1, 2015. The FRB specifically seeks comment on whether there are any provisions in the FRB's Basel III proposals that would be "inappropriate" to apply to U.S. IHCs.

U.S. IHCs with Total Consolidated Assets of Less Than $50 Billion

A U.S. IHC with total consolidated assets of less than $50 billion would not be subject to the FRB's Capital Plan Rule but, as noted above, would be subject to the same capital adequacy standards—both risk-based and leverage—as U.S. BHCs.

FBOs with Total Consolidated Assets of $50 Billion or More

An FBO with total global consolidated assets of $50 billion or more would be required to certify to the FRB that it meets capital requirements at the consolidated level that are consistent with the Basel Committee framework. The FBO may demonstrate such compliance either by certifying that it meets the capital requirements of its home country regulator (including the types of instruments that satisfy requirements for common equity tier 1, additional tier 1, and tier 2 capital and for calculating its risk-weighted assets), provided that the home country's standards are deemed consistent with the Basel framework, or "[i]f [an FBO's] home country standards are not consistent with the Basel Capital Framework, the [FBO] may demonstrate to the FRB's satisfaction that it meets standards consistent with the Basel Capital Framework." The FBO also would be required to report to the FRB its consolidated risk-based capital ratios and component capital ratios, risk-weighted assets and total assets. FBOs would not be subject to the existing minimum leverage ratio for U.S. BHCs, although when the international leverage ratio set forth in Basel III is implemented internationally (expected in 2018), FBOs would then have to certify that they comply with the international leverage ratio. If an FBO cannot certify that it meets these capital standards, the FRB may impose conditions or restrictions on the FBO's U.S. activities.

LIQUIDITY REQUIREMENTS

The FRB's 2010 "Interagency Policy Statement on Funding and Liquidity Risk Management,"[16] established liquidity principles that are carried forward in the Proposed U.S. Rules for U.S. BHCs. The Proposed FBO Rules establish a regulatory liquidity framework for U.S. operations of FBOs that is largely consistent with those requirements proposed for U.S. BHCs in the Proposed U.S. Rules.

In particular, the Proposed FBO Rules apply enhanced liquidity standards to the U.S. operations of FBOs with combined U.S. assets of $50 billion or more. Some of those standards are applied separately to the FBO's U.S. Branch/Agency Network, some to its U.S. IHC, and some to the Combined U.S. Operations.

U.S. Branches and Agencies and U.S. IHCs

The two principal standards that apply separately to the FBO's U.S. Branch/Agency Network and to its U.S. IHC are monthly liquidity stress test requirements and a liquidity buffer requirement.

- ***Liquidity Stress Test.*** The Proposed FBO Rules would require an FBO with combined U.S. assets of $50 billion or more to conduct, at least monthly, stress tests of cash flow projections separately for its U.S. Branch/Agency Network and its U.S. IHC and to use those stress tests in determining the size of the liquidity buffers, discussed below, for its U.S. Branch/Agency Network and its U.S. IHC.
    - Consistent with the Proposed U.S. Rules, the stress tests must incorporate a range of stress scenarios, taking into consideration, among other things, market stress, idiosyncratic stress and combinations of the two, and address potential actions of other market participants experiencing liquidity stress.
    - Consistent with the Proposed U.S. Rules, the time horizons, at a minimum, must include an overnight time horizon, and time horizons of 30 days, 90 days and one year.
    - Finally, consistent with the Proposed U.S. Rules, the stress test must incorporate the following assumptions:
        - for the first 30 days of a liquidity stress scenario, only highly liquid assets that are unencumbered may be used as a cash flow source to offset projected funding needs;
        - for periods beyond the first 30 days, highly liquid assets that are unencumbered and other "appropriate funding sources" may be used as cash flow sources;
        - if an asset is used as a cash flow source, the fair market value of the asset "must be discounted to reflect any credit risk and market volatility of the asset"; and
        - assets used as funding sources must be diversified by collateral, counterparty, or borrowing capacity, or other factors associated with the liquidity risk of the assets.
- ***Liquidity Buffer.*** An FBO with combined U.S. assets of $50 billion or more would be required to maintain a liquidity buffer for its U.S. Branch/Agency Network and a separate liquidity buffer for its U.S. IHC. Each liquidity buffer, consistent with the Proposed U.S. Rules, must consist of highly liquid assets that are unencumbered and that are sufficient to meet the net stressed cash flow need over a 30-day stress horizon. For purposes of the liquidity buffer:
    - A U.S. IHC would be required to calculate its liquidity buffer based on both net internal stressed cash flow and net external stressed cash flow needs. Importantly, the IHC would be required to hold all of the assets comprising its liquidity buffer in the United States. To the extent such assets consist of cash, the cash could <u>not</u> be held in an account located at a U.S. branch or agency of the affiliated foreign bank or other affiliate.
    - A U.S. Branch/Agency Network would be required to calculate its separate liquidity buffer for the first 14 days of the 30-day stress period based on both net internal stressed cash flow needs and net external stressed cash flow needs. During the first 14 days, the U.S. branch or agency network would be required to hold these highly liquid assets in the U.S. and, to the extent such assets consist of cash, the cash may <u>not</u> be held in an account located at the U.S. IHC or other affiliate. For days 15 through 30 of the stress test horizon, a U.S. Branch/Agency Network would be required to calculate its separate liquidity buffer based on the net external cash flow need. In addition, for days 15 through 30, the U.S. Branch/Agency Network would be permitted to maintain its liquidity buffer outside the U.S. at the head office of the foreign bank. The methodology allows intra-company cash flow sources of U.S. Branch/Agency Networks to count toward the liquidity buffer only to the extent that the term of the cash flow source is the same or shorter than the term of the intra-company cash flow need.

- The terms "highly liquid assets" and "unencumbered" are defined very narrowly and nearly exactly as such terms are defined in the Proposed U.S. Rules. Those definitions in the Proposed U.S. Rules were the subject of extensive industry comment.
  - The term "highly liquid assets" is defined to mean cash,[17] securities issued or guaranteed by the U.S. government, a U.S. government agency or a U.S. government-sponsored entity ("*GSE*"), or any other asset that the FBO demonstrates to the satisfaction of the FRB has low credit and low market risk, is traded in an active secondary two-way market that has observable prices and meets other standards, and is of a type that investors historically purchased in periods of financial market distress during which market liquidity is impaired.
  - The Proposed FBO Rules define the term "unencumbered" broadly to mean that the asset is not pledged in any respect, subject to legal or contractual restrictions on liquidation or transfer, or designated as a hedge in a trading position.[18]

Combined U.S. Operations

The principal standards of the Proposed FBO Rules that apply to the Combined U.S. Operations of FBOs with combined U.S. assets of $50 billion or more are its requirements for a U.S. risk committee and a U.S. chief risk officer, an independent review function, cash flow projections and a contingency funding plan.

- ***U.S. Risk Committee and U.S. Chief Risk Officer.*** Similar to the Proposed U.S. Rules, the Proposed FBO Rules require the U.S. risk committee to review and approve the liquidity risk tolerance for the FBO's Combined U.S. Operations at least annually. "Liquidity risk tolerance" is defined as the acceptable level of liquidity risk the FBO may assume in connection with its operating strategies for its Combined U.S. Operations. In contrast to the Proposed U.S. Rules, the Proposed FBO Rules require the U.S. chief risk officer to review and approve the liquidity costs, benefits and risks of each significant new business line engaged in by the Combined U.S. Operations and each significant new product offered, managed or sold through the Combined U.S. Operations before the FBO implements the line or product. Under the Proposed U.S. Rules, the risk committee or a designated sub-committee must review and approve the foregoing. The U.S. chief risk officer also must review and approve the contingency funding plan. Under the Proposed U.S. Rules, the board of directors of a U.S. BHC must review and approve the contingency funding plan.
- ***Independent Review Function.*** Largely consistent with the Proposed U.S. Rules, the Proposed FBO Rules require an FBO with combined U.S. assets of $50 billion or more to establish and maintain an independent review function to evaluate the liquidity risk management of its Combined U.S. Operations. The review function would be independent of management functions that execute funding (the treasury function) and would be required to review and evaluate the adequacy and effectiveness of the U.S. operations' liquidity risk management processes regularly (but no less frequently than annually). The review function also would be required to assess whether the U.S. operations' liquidity risk management complies with applicable laws and sound business practices, and to report statutory and regulatory noncompliance and other material liquidity risk management issues to the U.S. risk committee and the enterprise-wide risk committee (or designated sub-committee) in writing for corrective action.
- ***Cash Flow Projections***. Consistent with the Proposed U.S. Rules, the Proposed FBO Rules require an FBO with combined U.S. assets of $50 billion or more to produce comprehensive cash flow projections for its Combined U.S. Operations that, among other things, take into account cash flows arising from assets, liabilities and off-balance-sheet exposures over "short-term and long-term periods that are appropriate to the capital structure, risk profile, complexity, activities, size, and other relevant characteristics of the company and its Combined U.S. Operations." They also require FBOs to identify and quantify discrete and cumulative cash flow mismatches. While the Proposed FBO Rules do not require FBOs with combined U.S. assets of $50 billion or more to report the global cash flows of the FBO, the FRB is considering whether to require FBOs with combined U.S. assets of $50 billion

or more to report all global consolidated cash flows that are in U.S. dollars in order to understand the funding needs of the FBO.

- ***Contingency Funding Plan.*** Under the Proposed FBO Rules, FBOs with combined U.S. assets of $50 billion or more would be required to establish a contingency funding plan to identify liquidity sources in liquidity crisis events and ensure continued operation. Additionally, such FBOs would have to establish limits on sources of liquidity risks—such as concentrations of funding by investment type, single-counterparty, and secured and un-secured funding—and would be required to establish a monitoring system to track liquidity risk in collateral positions, legal entities, currencies, business lines and intraday liquidity.

FBOs

Finally, an FBO with $50 billion or more in total assets and combined U.S. assets of less than $50 billion must report to the FRB annually on the results of a global or U.S. liquidity stress test or be forced into a net due-to funding position, or a net due-from funding position, with non-U.S. affiliated entities equal to no more than 25% of the third-party liabilities of its Combined U.S. Operations, on a daily basis. The preamble to the Proposed FBO Rules states that the FRB will, in future rulemakings, implement the quantitative liquidity standards included in the Basel III Accord for the U.S. operations of some or all FBOs with $50 billion or more in combined U.S. assets, consistent with the international timeline.

SINGLE-COUNTERPARTY CREDIT LIMITS

Under Section 165(e) of the Dodd-Frank Act, the FRB is directed to establish concentration limits on credit exposure applicable to U.S. BHCs and FBOs with total consolidated assets of $50 billion or more and systemically important nonbank financial companies designated by the Council. In response to this requirement, the FRB included provisions that would implement these limits for U.S. BHCs and nonbank financial companies in the Proposed U.S. Rules. The SCCL was among the most controversial elements of the Proposed U.S. Rules and was the subject of significant industry comment. In an apparent response to industry comment, the Staff Cover Memo notes that FRB staff is preparing a quantitative impact study ("*QIS*") related to the SCCL to help inform the rulemaking process. The Proposed FBO Rules are substantially similar to the Proposed U.S. Rules with respect to the SCCL, but the results of the QIS could result in changes to both the domestic and FBO SCCL proposals. An industry-sponsored study of the impact of the proposed domestic SCCL, which included data compiled from 13 BHCs, including the U.S. operations of two large FBOs, found that large U.S. BHCs would need to reduce their market-making and credit intermediation activities significantly in order to comply with the SCCL in the Proposed U.S. Rules.[19]

Mechanics of the SCCL

The SCCL in the Proposed FBO Rules applies a credit exposure limit on a consolidated basis both to an FBO's U.S. IHC and to its Combined U.S. Operations. In particular, the proposed SCCL would impose a limit on the credit exposure of (i) a U.S. IHC and all of its subsidiaries to (ii) a single unaffiliated counterparty and all of its subsidiaries and on the credit exposure between (i) an FBO's Combined U.S. Operations, together with each subsidiary of an entity within the Combined U.S. Operations, to (ii) a single unaffiliated counterparty and all of its subsidiaries. The credit limit would be a percentage of the U.S. IHC's or the FBO's consolidated capital stock and surplus. A U.S. IHC's capital stock and surplus would be calculated as the sum of the company's total regulatory capital as calculated under the risk-based capital adequacy guidelines applicable to that U.S. IHC and the balance of the allowance for loan and lease losses of the U.S. IHC not included in tier 2 capital under the Proposed FBO Rules' capital guidelines, as described above. An FBO's capital stock and surplus would not reflect the balance of the allowance for loan and lease losses not included in tier 2 capital but instead would include the total regulatory capital of the FBO on a consolidated basis under the Proposed FBO Rules' capital guidelines.

In applying the SCCL, a "counterparty" would include (i) a company and all of its subsidiaries, and (ii) the United States, a state, and a foreign sovereign entity, in each case collectively with all of its agencies and instrumentalities (and, with respect to a state, its political subdivisions). However, exposures to the U.S. federal government, agencies and GSEs and an entity's home country would be exempted.

Two-Tier Approach to SCCL

Similar to the Proposed U.S. Rules, the Proposed FBO Rules would impose a two-tier SCCL for U.S. IHCs and U.S. operations of FBOs. First, the Proposed FBO Rules would impose a net credit exposure limit of 25% of consolidated stock and surplus on any U.S. IHC and a single unaffiliated counterparty and on the Combined U.S. Operations of an FBO and a single unaffiliated counterparty. Second, "*Major FBOs*" and "*Major IHCs*," defined as those with consolidated assets of $500 billion or more, would be subject to a lower—as yet undefined—limit with respect to exposures to "major" counterparties. In the Notice, "major counterparties" are defined as counterparties with at least $500 billion in consolidated assets, but the FRB states in the Notice that it is considering whether other criteria, such as the FBO's or U.S. IHC's scope, scale, concentration and interconnectedness, should also trigger the imposition of a lower counterparty limit. The FRB also states that it may amend the "major" counterparties limit if an international agreement is reached regarding large exposure limits for banking organizations. In the corresponding provision of the Proposed U.S. Rules, the FRB proposed a 10% limit on exposures between major domestic covered companies and major counterparties. This two-tiered aspect of the Proposed U.S. Rules received significant comment and, as noted in the Staff Cover Memo, is a subject of the FRB's QIS. The Proposed FBO Rules do not appear to limit the application of the SCCL to the credit transactions of a Major FBO to the Major FBO's U.S. operations. Imposing such a provision on the non-U.S. operations of an FBO would represent a very substantial change from existing law, and, given the lack of justification in the Notice for the absence of an explicit territorial limitation, it appears that this may be an oversight, particularly given that the 25% credit limit specifically refers only to an FBO's U.S. operations.

Attribution Rule

The Proposed FBO Rules' SCCL includes the statutory attribution rule, which requires that a covered company treat transactions with any person as a credit exposure to a counterparty to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, that counterparty. The notice relating to the Proposed U.S. Rules stated that the FRB would interpret the attribution rule as a means to prevent evasions, rather than as an expansive increase in the scope of the SCCL's reach. Commenters on the Proposed U.S. Rules requested that the FRB put the anti-evasion language into the rule itself.

The Notice relating to the Proposed FBO Rules does not contain language similar to the language of the notice relating to the Proposed U.S. Rules. However, in the absence of a specific statement by the FRB that it is reversing the position it took in the notice relating to the Proposed U.S. Rules, it is unlikely that the FRB is proposing to take a more expansive view of the attribution rule. Furthermore, it is not likely that the attribution rule would be applied differently to non-U.S. companies and U.S. companies.

Definition of Credit Transaction

In measuring its exposure to a counterparty, a U.S. IHC or an FBO's Combined U.S. Operations (a "*Covered Entity*") must aggregate all credit transactions between it and the counterparty. "Credit transactions" is broadly defined to include:

- extensions of credit, including loans, deposits, and lines of credit;
- repurchase or reverse repurchase agreements;
- securities lending or securities borrowing transactions;
- guarantees, acceptances, or letters of credit issued on behalf of a counterparty;
- purchases of, or investments in securities issued by a counterparty;
- credit exposure to a counterparty in connection with a derivative transaction;
- credit exposure to a counterparty in connection with a credit or equity derivative where the counterparty is the reference entity; and
- transactions that are the functional equivalent of the above and any similar transaction that the FRB determines to be a credit transaction for these purposes.

Exemptions

Section 165(e)(6) of the Dodd-Frank Act permits the FRB to exempt transactions from the definition of the term "credit exposure" if the FRB finds that the exemption is in the public interest and is consistent with the purposes of this subsection of the Dodd-Frank Act. As noted, the Proposed FBO Rules include certain exemptions similar to those contained in the Proposed U.S. Rules, including those for claims that are fully guaranteed as to principal and interest by the United States and its agencies, Fannie Mae and Freddie Mac (while under conservatorship), any other GSE obligations as determined by the FRB, and claims that are fully guaranteed as to principal and interest by the FBO's home country government. In addition, intraday credit exposure and claims would be exempt.

Calculation Methodology

Again, similar to the Proposed U.S. Rules, the Covered Entity is required to calculate its gross credit exposure under all credit transactions with a single counterparty in accordance with the specific methodologies provided in the Proposed FBO Rules for each type of credit transaction. A Covered Entity may net exposures from securities financing transactions that are subject to a bilateral netting agreement and exposures from derivatives transactions subject to a qualifying master netting agreement, subject to certain limitations. In general, a Covered Entity may, at its option, reduce exposures from many types of credit transactions by eligible collateral but would then be required to include the exposure to the collateral issuer when calculating its credit limit with respect to that collateral issuer—a shift of the exposure from the initial counterparty to the collateral issuer. A Covered Entity is required to reduce an exposure that is covered by an eligible guarantee or eligible credit or equity derivative and must shift that exposure to the protection provider. This was also the subject of considerable comment and controversy in the case of the Proposed U.S. Rules. Consistent with the Proposed U.S. Rule, derivatives that are not subject to a qualifying master netting agreement would be measured using the gross valuation methodology, which is the current exposure of the derivative contract equal to (i) the greater of the mark-to-market value of the derivative contract or zero and (ii) the potential future exposure of the derivative contract, calculated by multiplying the notional principal amount of the derivative contract by the applicable conversion factor specified in the Proposed FBO Rules. However, because the qualifying master netting agreement that a U.S. branch or agency may be subject to may cover exposures of the FBO outside of the U.S. branch or agency network, the Proposed FBO Rules provide that the gross exposure methodology may be used instead of CEM. Although this provides some flexibility to account for the differences in the branch and agency structure, it generally will result in a higher valuation of the exposure.[20]

As noted, the Proposed U.S. Rules relating to the SCCL and the Proposed FBO Rules relating to the SCCL are substantially similar. As a result, many of the controversial elements of the Proposed U.S. Rules relating to the SCCL remain issues in the Proposed FBO Rules relating to the SCCL. Some of the key issues raised in response to the Proposed U.S. Rules relating to the SCCL include:

- Exposures from derivative transactions that are subject to a qualifying master netting agreement would be measured under the "current exposure methodology," or "*CEM*" (12 CFR Part 225, Appendix G, Sec. 32(c)(6)), which is calculated as net current exposure plus potential future exposure. Because CEM limits the amount of netting that may be taken into account in determining the measure of potential future exposure and does not give credit for collateral that will be posted against future exposures, CEM generally results in a significant overstatement of exposure relative to other measurement methodologies. In particular, internal models that banking organizations have developed to comply with regulatory capital requirements and for internal risk management purposes generally would lead to considerably lower exposure amounts because they take netting and collateral into account to a greater extent when measuring potential future exposure.
- The requirement in the Proposed U.S. Rule and the Proposed FBO Rule to shift an exposure from the counterparty to a protection provider (for example, to shift the exposure from the issuer of a corporate bond to the provider of a CDS on that counterparty reference entity) concentrates exposure in protection providers, which are often large banking organizations. This requirement ignores the risk mitigation benefit of the protection because it does not take into account the fact that the lender is exposed to the risk of loss only if both the counterparty and the protection provider default. Furthermore, because relatively few entities have the capital and infrastructure necessary to provide credit and equity derivatives, the concentration of risk associated with a large number of reference

names in these protection providers may limit their ability to provide this risk mitigation tool to market participants.

- Under both proposed rules, exposure under repurchase agreements and securities lending transactions would be measured as the value of securities transferred or loaned plus an add-on representing the collateral haircut applicable to the securities. The collateral haircut would be determined using a static conversion factor provided in the proposed rules that may not be closely correlated to the risk actually posed by the transaction and may therefore result in an overstatement of the exposure. In addition, although a bilateral netting agreement and collateral may be taken into account to reduce the amount of the exposure in such a transaction, the collateral also is subject to a standard haircut. Furthermore, when collateral is taken into account, the risk would be shifted to the collateral provider. Because high-quality non-U.S. sovereign obligations are frequently posted as collateral in securities lending transactions, a securities lender could become credit-constrained with respect to these non-U.S. sovereigns when the transactions are aggregated with the other transactions with such sovereign.
- Consistent with the Proposed FBO Rules, central counterparties would be counterparties subject to the 25% credit limit, which may be in tension with the mandatory clearing requirement imposed under Title VII of Dodd-Frank.
- Consistent with the Proposed FBO Rules, exposures to all non-U.S. and non-home country sovereigns are subject to the 25% credit limit regardless of the quality of the exposures. Among other issues, this could result in limiting the ability of Covered Entities to accept high-quality collateral issued by non-U.S. and non-home country sovereigns. The problem is compounded by the counterparty definition, which aggregates a sovereign with all of its agencies, instrumentalities, and political subdivisions.
- The SCCL proposals apply to the Covered Entity and the counterparty together with their respective subsidiaries. Under the proposals, a subsidiary is defined as a company that is "directly or indirectly controlled." A company "controls" another if it "(a) Owns, controls, or holds with power to vote 25 percent or more of a class of voting securities in the company; (b) Owns or controls 25 percent or more of the total equity of the company; or (c) Consolidates the company for financial report purposes." The 25% of voting securities and 25% of total equity prongs of the definition raise particular issues because they require aggregation of exposures even where it is unlikely that the source of funds to repay the exposure would be the same. Furthermore, it creates significant administrative issues because a Covered Entity will not necessarily have access to the information to make the necessary control determinations with respect to a potential counterparty.

Compliance

An FBO would be required to comply with the SCCL requirements on a daily basis as of the end of each day and to submit a monthly compliance report demonstrating its daily compliance. According to the Staff Cover Memo, credit exposure reporting requirements for the U.S. operations of FBOs, required by Section 165(e) of the Dodd-Frank Act, will be proposed separately in the future, which is consistent with the treatment of U.S. BHCs. If either the U.S. IHC or the Combined U.S. Operations are not in compliance with the SCCL with respect to any counterparty, both would be prohibited from engaging in any additional credit transactions with the counterparty, except in cases where the FRB grants a special temporary exemption to preserve the safety and soundness of the FBO or financial stability.

RISK MANAGEMENT AND RISK COMMITTEE REQUIREMENTS

Risk Management

Under Section 165(b) of the Dodd-Frank Act, the FRB must impose overall risk management requirements on U.S. BHCs and FBOs with $50 billion or more in assets and systemically important nonbank financial companies designated by the Council. In addition, Section 165(h) of the Dodd-Frank Act requires publicly traded BHCs with total consolidated assets of $10 billion or more to establish risk committees. In this regard, the Proposed FBO Rules would apply to covered FBOs substantially the same requirements as those proposed to be applied to covered U.S. BHCs and U.S. nonbank financial companies under the Proposed U.S. Rules. The Proposed FBO Rules would provide an FBO with some flexibility to structure the oversight of the risks of its U.S. operations in a manner that is efficient in light of its broader enterprise-wide risk management structure.

In the Notice, the FRB stresses that the risk committee and risk management requirements supplement the FRB's existing risk management guidance and supervisory expectations, such as the FRB's Supervision and Regulation Letters SR 08-8 (Compliance Risk Management Programs and Oversight at Large Banking Organizations with Complex Compliance Profiles) and SR 08-9 (Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations).

The risk management requirements also would mandate that a U.S. IHC of an FBO with total consolidated assets of $50 billion or more have a board of directors (or equivalent thereto) to ensure a strong, centralized corporate governance system.

Risk Committee Requirements

Publicly traded FBOs with total consolidated assets of $10 billion or more and all FBOs with total consolidated assets of $50 billion or more, regardless of whether their stock is publicly traded, must annually certify to the FRB on Form FR Y-7 that they have a U.S. risk committee overseeing their U.S. risk management practices with at least one member with risk management expertise that is commensurate with the capital structure, risk profile, complexity, activities and size of their Combined U.S. Operations.

In general, an FBO would be permitted to maintain its U.S. risk committee either as a committee of its global board of directors or as a committee of the board of directors of the U.S. IHC. An FBO's enterprise-wide risk committee could serve as the U.S. risk committee. An FBO with combined U.S. assets of $50 billion or more that conducts its operations in the U.S. solely through a U.S. IHC, however, would be required to maintain its U.S. risk committee at its U.S. IHC.

The Proposed FBO Rules establish additional requirements for the U.S. risk committee of an FBO with combined U.S. assets of $50 billion or more. The Proposed FBO Rules, like the Proposed U.S. Rules, require a U.S. risk committee to (i) review and approve the risk management practices of the Combined

U.S. Operations of the FBO and (ii) oversee the operation of an appropriate risk management framework for the FBO's Combined U.S. Operations that is commensurate with the capital structure, risk profile, complexity, activities and size of the FBO's Combined U.S. Operations and consistent with the FBO's enterprise-wide risk management policies. Unlike the Proposed U.S. Rules, the Proposed FBO Rules do not include a requirement that the committee be chaired by an independent director. A U.S. risk committee of an FBO with combined U.S. assets of $50 billion or more must have at least one independent member who is not, and during the previous three years was not, an officer or employee of the FBO (or its affiliates), or an immediate family member of a person who is, or has been an executive officer of the FBO (or its affiliates) during the previous three years.

U.S. Chief Risk Officer

Each FBO with combined U.S. assets of $50 billion or more also would be required to appoint a U.S. chief risk officer to oversee and implement the risk management framework of the FBO's Combined U.S. Operations. The Proposed FBO Rules require the U.S. chief risk officer to:

- consistent with the Proposed U.S. Rules,
  - have risk management expertise that is commensurate with the capital structure, risk profile, complexity, activities and size of the FBO's Combined U.S. Operations;
  - receive appropriate compensation and other incentives to provide an objective assessment of the risks taken by the combined U.S. operations of the FBO;
  - implement and maintain ongoing compliance with appropriate policies and procedures relating to risk management governance and practices;
  - develop appropriate processes and systems for identifying and reporting risks and risk-management deficiencies;
  - manage risk exposures and risk controls within the parameters of the risk control framework of the Combined U.S. Operations;
  - monitor and test the risk controls of the Combined U.S. Operations;
  - ensure that risk management deficiencies with respect to the Combined U.S. Operations are resolved in a timely manner;
- be employed by the U.S. branch, U.S. agency, U.S. IHC or another U.S. subsidiary;
- report directly to the (i) U.S. risk committee and (ii) global chief risk officer (or equivalent management official) of the FBO responsible for overseeing, on an enterprise-wide basis, the implementation of and compliance with policies and procedures relating to risk management governance, practices and risk controls of the FBO (under the Proposed U.S. Rules, the chief risk officer reports to the risk committee and the chief executive officer);
- directly oversee the measurement, aggregation and monitoring of risks undertaken by the FBO's Combined U.S. Operations;
- regularly provide information to the U.S. risk committee, global chief risk officer and FRB supervisory staff regarding the nature of any changes to material risks undertaken by the FBO's Combined U.S. Operations, including risk management deficiencies and emerging risks, and how such risks relate to the global operations of the FBO (under the Proposed U.S. Rules, there is no requirement for the chief risk officer to regularly provide information to FRB supervisory staff regarding changes to material risks, although such interaction would likely be anticipated even without the formal requirement); and

- meet regularly and as needed with FRB supervisory staff to assess compliance with the FBO's risk management responsibilities and be available to respond to supervisory inquiries from the FRB as needed (under the Proposed U.S. Rules, there is no requirement for the chief risk officer to regularly meet with FRB supervisory staff).

If an FBO fails to satisfy the risk management or risk committee requirements, the FRB may impose conditions or restrictions relating to the activities or business operations of the Combined U.S. Operations of the FBO.

STRESS TEST REQUIREMENTS

Dodd-Frank Act Section 165(i)(1) requires the FRB to conduct annual stress tests of U.S. BHCs and FBOs with total consolidated assets of $50 billion or more, and Section 165(i)(2) requires the FRB to establish standards governing company-run stress tests for U.S. BHCs and FBOs with consolidated assets of more than $10 billion. The FRB proposed stress test requirements for U.S. BHCs in December 2011, and issued final rules implementing the Dodd-Frank Act's stress test requirements for U.S. entities on October 9, 2012 (which final stress test rules for purposes of this Memorandum are included within the term "Proposed U.S. Rules," as noted in endnote 2).[21] The Proposed FBO Rules would (i) essentially impose on U.S. IHCs the same stress test requirements as those applicable to U.S. BHCs under the Proposed U.S. Rules and (ii) adopt separate stress-test related provisions for certain FBOs that could impose asset maintenance requirements on U.S. branches and agencies, as well as other requirements, on FBOs which are not subject to a FRB-prescribed home country capital stress test regime.

U.S. IHCs with consolidated assets of $50 billion or more; U.S. IHCs with consolidated assets of more than $10 billion but less than $50 billion

Because the Proposed FBO Rules would apply to U.S. IHCs the same FRB stress test rules as those applicable to U.S. BHCs, U.S. IHCs with total consolidated assets of $50 billion or more would be subject to subparts F and G of the FRB's Regulation YY and thereby subject to annual supervisory stress tests and semi-annual company-run stress tests to the same extent as U.S. BHCs with an equivalent amount of total consolidated assets. Similarly, U.S. IHCs with less than $50 billion but more than $10 billion in consolidated assets would be subject to the FRB's Regulation YY and subpart H's requirement of annual company-run stress tests to the same extent as U.S. BHCs with an equivalent amount of total consolidated assets.[22] The results of both supervisory stress tests and the company-run stress tests would be publicly disclosed by the FRB and IHCs, as applicable. In addition, as described above, IHCs with $50 billion or more in assets also would be subject to the stress test requirements of the FRB's Capital Plan Rule[23] as implemented on an annual basis through the FRB's CCAR program.[24] The IHC stress test requirements would generally come into effect starting with the stress test cycle commencing in October 2015—later than under the Proposed U.S. Rules applicable to U.S. BHCs.

FBOs with combined U.S. assets of $50 billion or more

FBOs with $50 billion or more in combined U.S. assets that are not subject to appropriate home country stress tests as described below would be required to maintain within its U.S. Branch/Agency Network eligible assets at their U.S. branch/agency network equal to 108%[25] of third-party liabilities of such branches and agencies and give the FRB the ability to impose intra-group funding restrictions on FBOs.[26] In order not to be subject to the asset maintenance requirements, covered FBOs (i) must be subject to an annual home country consolidated (that is, involving the FBOs world-wide operations and not just the U.S.) capital stress test regime either conducted or evaluated by the relevant regulator and which has board-of-directors and management-related stress test governance and controls requirements and (ii) demonstrate to the FRB that they have adequate capital to withstand stressed conditions if, on a net basis, their U.S. branch or agency provides funding to the home office and non-U.S. affiliates. The Proposed FBO Rules do not appear to provide guidance as to exactly how and under what standards the FRB would evaluate whether a particular FBO would have adequate capital to withstand stressed conditions. In addition, covered FBOs not meeting the exemption also would be required to provide a summary of home country stress test results to the FRB[27] by January 5 of each year. Unlike the IHC stress test requirements, the FBO stress test-related rules appear to be applicable immediately upon the Proposed FBO Rules' effective date, subject to a 30-day advance notice by the FRB if it determines to impose the intra-group funding restrictions described above.

FBOs with consolidated assets of $10 billion or more, but less than $50 billion in combined U.S. assets

The Proposed FBO Rules' stress test-related requirements for FBOs with $10 billion or more in consolidated world-wide assets, but less than $50 billion in U.S. assets are similar to the requirements for FBOs with combined U.S. assets of more than $50 billion, except that (i) these FBOs are not required to report the results of home country stress tests to the FRB and (ii) if not subject to appropriate home country stress test as described in the Proposed FBO Rules, they would be subject to maintenance within their U.S. Branch/Agency Networks, only a 105% asset maintenance requirement and no intra-group funding restrictions.

The IHC and FBO stress test regimes would appear to apply separately so that, for example, an FBO with $110 billion in combined U.S. assets (e.g., a U.S. branch with $53 billion in assets and an IHC with $57 billion in assets) would be subject to the supervisory and company-run stress test requirements of the Proposed U.S. Rules *and* the separate requirements concerning home country stress tests for the FBO (as well as branch asset maintenance and other requirements if the FBO cannot meet the FRB's standards for home country stress test standards).

DEBT-TO-EQUITY LIMITS FOR CERTAIN COVERED COMPANIES

Section 165(j) of the Dodd-Frank Act provides that the FRB must require a U.S. BHC or an FBO with $50 billion or more in total consolidated assets to maintain a debt-to-equity ratio of no more than 15-to-1, upon a determination by the Council that such company poses a "grave threat" to the financial stability of the U.S. and that the imposition of a debt-to-equity ratio requirement is necessary to mitigate the risk to the U.S. financial stability posed by such company. To date, the Council has not made any such determinations.

The Proposed FBO Rules would implement the debt-to-equity ratio requirement with respect to a covered FBO within 180 days of such a determination by the Council by applying the 15-to-1 debt-to-equity requirement to the FBO's U.S. IHC and any U.S. subsidiary not organized under the U.S. IHC (except for any subsidiary held under Section 2(h)(2) of the BHC Act). Additionally, the Proposed FBO Rules would implement a 108% asset maintenance requirement on the FBO's U.S. Branch/Agency Network (if applicable). The debt-to-equity ratio requirement would be effective on the effective date of the final rule.

Although the Proposed FBO Rules do not set forth a specific set of actions that an FBO can take in order to comply with the debt-to-equity ratio requirement, the FRB would expect an FBO to come into compliance with the debt-to-equity ratio "in a manner that is consistent with the [FBO's] safe and sound operation and preservation of financial stability." For instance, the FRB would expect an FBO to make a good faith effort to come into compliance with the debt-to-equity ratio requirement by increasing equity capital through limits on distributions, share offerings or other capital-raising efforts before selling margined assets. The Proposed FBO Rules would allow an FBO subject to the debt-to-equity ratio requirement to request up to two extension periods of 90 days each to come into compliance with this requirement upon a showing that the FBO has made good faith efforts to comply with the requirement and that each extension is in the public interest.

The Proposed FBO Rules indicate that the debt-to-equity ratio requirement would no longer apply to an FBO as of the date the Council determines that such FBO no longer poses a grave threat to the financial stability of the U.S. and that imposition of a debt-to-equity ratio requirement is no longer necessary.

APPLICABILITY OF THE EARLY REMEDIATION FRAMEWORK

Consistent with the Proposed U.S. Rules, the Proposed FBO Rules implement Section 166 of the Dodd-Frank Act and establish an "early remediation" regime for FBOs with $50 billion or more in total global consolidated assets. The Proposed FBO Rules would adapt the requirements of the Proposed U.S. Rules to the U.S. operations of FBOs with $50 billion or more in total global consolidated assets, tailored to address the risk to U.S. financial stability posed by the U.S. operations of FBOs and taking into consideration their structure. The Notice indicates that the U.S. operations of covered FBOs with combined U.S. assets of $50 billion or more that meet the relevant triggers (detailed below) would automatically be subject to the remediation standards upon a trigger event, while the U.S. operations of covered FBOs with combined U.S. assets of less than $50 billion would be subject to those remediation standards on a case-by-case basis.

The proposed "early remediation" rule would establish four levels of remediation requirements, of increasing severity as required (discussed below), and would establish five categories of "forward-looking" triggers. These triggers would be based on:

- ***Capital and leverage.*** Level 1 remediation of the combined U.S. operations would be triggered if the FRB determines that the FBO's capital position is not commensurate with the level and nature of risks to which it is exposed in the U.S. or that the U.S. IHC is not in compliance with rules regarding capital plans or that the amount of capital it holds is not commensurate with the level and nature of the risks to which it is exposed, even though it is in compliance with applicable minimum capital standards. Additional levels of remediation would be required as capital levels decline, with Level 4 remediation required where any of the FBO's or U.S. IHC's risk-based capital ratios fell [100-250][28] basis points or more below the applicable minimum risk-based capital ratios or where any of the FBO's or U.S. IHC's leverage ratios fell [50-150] basis points or more below applicable leverage requirements.
- ***Stress tests.*** Level 1 remediation would be triggered if an FBO or its U.S. IHC is not in compliance with any of the FRB's capital planning and stress test regulations. Increasing levels of remediation are required if the results of U.S. IHC's stress tests indicate that a breach of capital requirements would occur under the "severely adverse scenario" of its stress test, with Level 3 remediation required if the U.S. IHC's stress test results under the severely adverse scenario reflect a Tier 1 common risk-based capital ratio of less than 3.0% during any quarter in the planning horizon.
- ***Risk management.*** Level 1 remediation would be required if the FRB determines that any part of the Combined U.S. Operations of an FBO has "manifested signs of weakness" in meeting the proposed risk management and risk committee requirements described above. Level 3 remediation would be required if the FRB determines that any part of the Combined U.S. Operations of an FBO is in substantial noncompliance with those requirements.
- ***Liquidity.*** Level 1 remediation would be required if the FRB determines that any part of the Combined U.S. Operations of an FBO has "manifested signs of weakness" in meeting the enhanced liquidity risk management requirements described above. Level 3 remediation would be required if the FRB determines that any part of the Combined U.S. Operations of an FBO is in substantial noncompliance with those requirements.
- ***Market indicators.*** The Proposed FRB Rule provides for early remediation based upon market indicators, and states that it will publish market indicators for this purpose on an annual basis, but does not set forth any indicators that could be used to trigger early remediation procedures at this time. The FRB indicates in its Notice that it is not proposing to use market-based triggers to subject the Combined U.S. Operations of an FBO directly to remediation levels 2, 3, or 4 at this time but expects to review this approach after gaining additional experience with the use of market data in the supervisory process.

The four levels of remediation for FBOs with combined U.S. assets of $50 billion or more are:

- ***Level 1:*** Heightened supervisory review, in which the FRB would evaluate whether the Combined U.S. Operations of an FBO are experiencing financial distress or material risk management weaknesses, including with respect to exposures that the combined operations have to the FBO, such that further decline of the Combined U.S. Operations is probable. The FRB also would be able to utilize its other supervisory powers, under the Proposed FBO Rules and otherwise, to cause the U.S. operations of an FBO to address the problems identified as a result of this review.
- ***Level 2:*** Initial remediation, in which the FBO's growth and capital distributions would be restricted by placing limitations on the FBO's U.S. IHC, its U.S. Branch/Agency Network, and its Combined U.S. Operations. The U.S. IHC would be prohibited from distributing, in any calendar quarter, more than 50% of the average of its net income for the preceding two calendar quarters. The FBO's growth would be restricted to no more than 5% growth in total assets or risk-weighted assets per quarter or per annum, and generally would be prohibited from establishing new branches or other offices in the U.S. or directly or indirectly acquiring controlling interests in any U.S. company. The FBO would be

subject to a non-public Memorandum of Understanding ("MOU") (or other enforcement action) with the FRB, and to any other limitations and conditions on its conduct or activities that the FRB deems appropriate. Although the MOU would be non-public, the other limitations imposed by a Level 2 determination may well require public disclosure under federal securities law. Additionally, the U.S. Branch/Agency Network would be required to remain in a net due to position to the FBO's home office and non-U.S. affiliates, calculated on a daily basis. The U.S. Branch/Agency Network would be required to maintain a liquid asset buffer in the U.S. sufficient to cover 30 days of stressed outflows.

- ***Level 3:*** Recovery, in which the FBO's U.S. operations would be subject to a prohibition on growth and capital distributions, restrictions on executive compensation, requirements to raise additional capital, and additional requirements on a case-by-case basis. The FBO would be required to enter into a written agreement or other formal enforcement action with the FRB, which would be public, prohibiting all capital distributions, any quarterly or annual[29] growth in total assets or risk-weighted assets and any material acquisitions. The FBO and its U.S. IHC would be barred from increasing in the compensation of, or paying any bonus to, an executive officer or member of the board of directors. Moreover, the U.S. Branch/Agency Network would be prohibited from providing funding to the FBO's head office and non-U.S. affiliates, and would be required to remain in a net due position to the FBO's home office and non-U.S. affiliates, calculated on a daily basis, and maintain eligible assets that equal at least 108% of the U.S. Branch/Agency Network's third-party liabilities. The U.S. Branch/Agency Network, however, would not be subject to the liquid asset buffer required by Level 2 remediation.
- ***Level 4:*** Recommended resolution, in which the FRB would consider whether the Combined U.S. Operations of the FBO warrant termination or resolution based on the decline of the Combined U.S. Operations, applying the factors contained in Section 203 of the Dodd-Frank Act as applicable, or any other relevant factor.

The U.S. operations of FBOs with total consolidated assets of $50 billion or more and combined U.S. assets of less than $50 billion would be subject to the same triggers and notification requirements applicable to the U.S. operations of FBOs with a larger presence in the United States. When the FRB is aware that an FBO breached a trigger, the FRB would have the discretion apply any of the remedial provisions that would be applicable to an FBO with combined U.S. assets of $50 billion or more. In exercising this authority, the FRB will consider the activities, scope of operations, structure and risk to U.S. financial stability posed by the FBO.

* * *

ENDNOTES

[1] This proposed restructuring was foreshadowed in a speech by Governor Daniel Tarullo on November 28, 2012. *See* our Client Memorandum "Federal Reserve Governor Tarullo Previews Proposals for Major Revisions to the Regulation of U.S. Operations of Non-U.S. Banks," dated November 30, 2012, available at http://www.sullcrom.com/files/Publication/601dcf5c-14b0-4822-89f9-a079f69d2a3d/Presentation/PublicationAttachment/84c9c1c6-e3f9-4638-b898-cf6d34bcbd3f/SC_Publication_Regulation_of_U.S._Operations_of_Non_U.S._Banks.pdf.

[2] Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594 (Jan. 5, 2012). *See* our Client Memorandum "Federal Reserve Issues Proposed Rules Implementing Enhanced Prudential Supervision Regime," dated December 22, 2011, available at http://www.sullcrom.com/files/Publication/9302aa5a-e29c-4b55-8020-28042c4aa822/Presentation/PublicationAttachment/d14671a2-7d80-4bef-bade-2966a2d2104a/SC_Publication_Systemically_Important_Financial_Companies_12-22-11.pdf. The comment period for the Proposed U.S. Rules ended April 30, 2012. The subpart addressing stress tests was adopted as a final rule in October 2012. 12 CFR part 252, subparts F and G ($50 billion or more in U.S. assets); 12 CFR part 252, subpart H (more than $10 billion in U.S. assets). *See* our Client Memorandum "Federal Banking Agencies Publish Final Stress Test Rules on Supervisory and Company-Run Stress Test Requirements Imposed by Dodd-Frank," dated October 26, 2012, available at http://www.sullcrom.com/files/Publication/08cc1481-e374-44a3-8298-10681bbb1eb3/Presentation/PublicationAttachment/c4e988cf-cd03-4a2d-b34e-1383896b6a89/SC_Publication_Stress_Test_Rules.pdf. For ease of presentation, we use the term "*Proposed U.S. Rules*" to include the already final stress test rule.

[3] These transactions included Barclay Bank PLC's acquisition of Lehman's brokerage operations and purchases of failed banks by Bank of Montreal and Mitsubishi UFJ Financial Group.

[4] The FRB states in the Notice that it chose the $10 billion threshold because it is "aligned with the $10 billion threshold established by the Dodd-Frank Act for stress test and risk management requirements." However, the FRB also specifically requests comment on whether the $10 billion asset threshold is appropriate and asks whether an alternative asset threshold should be considered.

[5] The Proposed FBO Rules would measure the total consolidated assets of an FBO, which would include its global consolidated assets, by calculating the four-quarter average of total assets reported on the FBO's quarterly regulatory report filed with the FRB (the Form FR Y-7Q). The proposal would measure the combined U.S. assets of an FBO as the sum of (i) the average of the total assets of each U.S. branch and agency of the FBO for the four most recent consecutive quarters and (ii) the average of the total consolidated assets of the U.S. IHC for the four most recent consecutive quarters.

[6] *See* 12 CFR part 225.8 for the Capital Plan Rule and *see* our Client Memorandum, "Federal Reserve FRB Issues Final Rule Regarding Capital Plan and Formal Stress Test Requirements for Certain Large Bank Holding Companies," dated November 29, 2011, available at http://www.sullcrom.com/files/Publication/98fdbafe-2326-48ee-b7fa-45ccbe44571b/Presentation/PublicationAttachment/cc880d1d-a8ac-4779-91bc-461cf78098e8/SC_Publication_Bank_Capital_Plans_11-29-11.pdf, for a description of the FRB's CCAR 2013 instructions and guidance. See 12 CFR part 252, subparts F and G for the final stress test rules for BHCs with $50 billion or more in U.S. assets and 12 CFR part 252, subpart H for the final stress test rules for BHCs with more than $10 billion in U.S. assets. *See* our Client Memorandum "Federal Banking Agencies Publish Final Stress Test Rules on Supervisory and Company-Run Stress Test Requirements Imposed by Dodd-Frank," dated October 26, 2012, available at http://www.sullcrom.com/files/Publication/08cc1481-e374-44a3-8298-10681bbb1eb3/Presentation/PublicationAttachment/c4e988cf-cd03-4a2d-b34e-1383896b6a89/SC_Publication_Stress_Test_Rules.pdf.

7 The Proposed FBO Rules would allow an FBO to provide after-the-fact notice to the FRB within 30 days of its formation of a U.S. IHC. The FRB specifically seeks comment on whether the FRB should require a before-the fact application to form a U.S. IHC.

8 The FRB notes that in connection with the Proposed FBO Rules, as well as other rulemakings, it is conducting a review of existing supervisory guidance to identify guidance that may be relevant to the operations and activities of a U.S. IHC that does not control a U.S. depository institution. The FRB proposes to apply such guidance to such U.S. IHCs on a rolling basis, either by revising and reissuing the guidance or by publishing a notification that references the applicable guidance.

9 Section 2(h)(2) of the BHC Act and the FRB's implementing rules allow qualifying FBOs to retain their interest in certain foreign commercial firms, even when those firms conduct business in the United States. This long-standing statutory exception was enacted in recognition of the fact that some foreign jurisdictions do not impose a clear separation between banking and commerce. The Notice states that the Proposed FBO Rules would not require FBOs to hold Section 2(h)(2) investments under the U.S. IHC because these commercial firms have not been subject to FRB supervision, are not integrated into the U.S. financial operations of FBOs, and FBOs often cannot restructure their foreign commercial investments.

10 12 CFR part 225, Appendix A.

11 12 CFR part 225, Appendix D.

12 12 CFR part 225, Appendix E.

13 12 CFR part 225, Appendix G.

14 *See* our Client Memorandum, "Regulatory Capital Surcharge for Global Systemically Important Banks," dated July 26, 2011, available at http://www.sullcrom.com/files/Publication/d2074741-d55b-4c97-b42d-eb2da2520b50/Presentation/PublicationAttachment/35640a9d-58dc-4371-8466-ecfb6a6e8500/SC_Publication_Bank_Capital_Requirements_7-26-11.pdf.

15 Some intermediate U.S. BHCs of FBOs are already subject to the Capital Plan Rule because they did not rely on the FRB's Supervision and Regulation Letter SR 01-01.

16 SR Letter 10-6, Interagency Policy Statement on Funding and Liquidity Risk Management (March 2010), available at http://www.federalreserve.gov/boarddocs/srletters/2010/sr1006.htm.

17 The FRB specifically seeks comment on whether the cash portion of the liquidity buffer could be held in a currency other than the U.S. dollar.

18 The FRB states in the Notice that the liquidity buffer for the U.S. IHC and the U.S. branch/agency network is "not intended to increase the [FBO's] overall consolidated liquidity requirements." Rather, the liquidity buffer proposal is aimed at ensuring that the portion of the consolidated liquidity requirement attributable to short-term third-party U.S. liabilities would be held in the United States. The FRB goes on to state that FBOs "that raise funding through U.S. entities on a 30-day or longer basis and match the term structures of intra-company cross-border cash flows would be able to minimize the amount of liquid assets they would be required to hold in the U.S. under this proposal."

19 The Clearing House, "Single Counterparty Credit Limits: The Clearing House Industry Study," dated July 2012, available at http://www.theclearinghouse.org/index.html?f=074112.

20 For a complete description of the calculations of gross credit exposure with a single counterparty, see our Client Memorandum "Federal Reserve Issues Proposed Rules Implementing Enhanced Prudential Supervision Regime," dated December 22, 2011, available at http://www.sullcrom.com/files/Publication/9302aa5a-e29c-4b55-8020-28042c4aa822/Presentation/PublicationAttachment/d14671a2-7d80-4bef-bade-2966a2d2104a/SC_Publication_Systemically_Important_Financial_Companies_12-22-11.pdf.

21 12 CFR part 252, subparts F and G ($50 billion or more in U.S. assets); 12 CFR part 252, subpart H (more than $10 billion in U.S. assets).

[22] *See* our Client Memorandum, "Federal Banking Agencies Publish Final Stress Test Rules on Supervisory and Company-Run Stress Test Requirements Imposed by Dodd-Frank," dated October 26, 2012, available at http://www.sullcrom.com/files/Publication/08cc1481-e374-44a3-8298-10681bbb1eb3/Presentation/PublicationAttachment/c4e988cf-cd03-4a2d-b34e-1383896b6a89/SC_Publication_Stress_Test_Rules.pdf, for a more detailed description on the applicable supervisory and company-run stress test regime applicable to U.S. BHCs. We note that the Proposed FBO Rules do not appear to specifically address exactly if and how the stress test process would differ for IHC as opposed to U.S. BHCs, including, for example, whether the FRB would use alternative or modified macro-economic stress scenarios for IHCs or would subject some IHC to different trading shock scenarios than are used for comparable U.S. institutions.

[23] *See* 12 CFR Section 225.8.

[24] *See* our Client Memorandum, "Federal Reserve Issues Final Rule Regarding Capital Plan and Formal Stress Test Requirements for Certain Large Bank Holding Companies," dated November 29, 2011, available at http://www.sullcrom.com/files/Publication/98fdbafe-2326-48ee-b7fa-45ccbe44571b/Presentation/PublicationAttachment/cc880d1d-a8ac-4779-91bc-461cf78098e8/SC_Publication_Bank_Capital_Plans_11-29-11.pdf, for a description of the FRB's CCAR 2013 instructions and guidance.

[25] This asset-maintenance requirement reflects the 8% minimum risk-based capital standard currently applied to U.S. banking organizations.

[26] The FRB may also require separate stress test for subsidiaries not otherwise part of a U.S. IHC (except U.S. subsidiaries held under Section 2(h)(2) of the BHC Act) either separately or under an enterprise-wide stress test. This would seem to apply to U.S. depository institution subsidiaries of an FBO which have less than $10 billion is consolidated assets. Such subsidiaries are not subject to formal stress test requirements under the Dodd-Frank Act or the Proposed U.S. Rules, although the applicable U.S. regulators may nevertheless require some sort of stress test by these institutions as a prudential supervisory matter.

[27] The reporting requirements for the FBO would include, among other things: a description of the risks, test scenarios and methodologies involved; estimates of aggregate losses, pre-provision net revenues, total loan losses, net income before taxes, and pro forma regulatory capital ratios; and an explanation of the most significant causes for changes in regulatory capital ratios. FBOs whose U.S. branches and agencies provide funding to their home office (that is, are in a net due-from position *vis à vis* the home office) will have to provide additional and more detailed stress test-related information to the FRB. Unlike the results of the IHC stress tests, the Proposed FBO Rules do not appear to contemplate the public release of this information regarding FBOs.

[28] The risk-based capital ranges are bracketed in the Notice itself; the FRB is seeking comment on what the ranges should be in the final rule.

[29] Unlike the Proposed FBO Rules for FBOs with combined U.S. assets of $50 billion or more, the Proposed U.S. Rules only prohibit quarter-to-quarter growth for Covered Companies in the third level of remediation but do not contemplate a prohibition against growth on a year-to-year basis.

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