Clients&FriendsMemo

Federal Reserve Governor Tarullo Calls for Increased U.S. Regulation of Foreign Banking Organizations

December 3, 2012

In a speech delivered last week to the Yale School of Management, Federal Reserve Governor Daniel K. Tarullo signaled that the Board of Governors of the Federal Reserve System (**FRB**) is considering major changes to the regulation of foreign banks and their affiliates in the United States. Governor Tarullo, the FRB's banking expert and the Governor most likely to take the lead role on matters relating to financial reform, indicated that the FRB is considering requiring that foreign banks with subsidiaries in the United States hold those banking and nonbanking subsidiaries in a U.S.-based holding company that would be regulated by the FRB with respect to prudential matters, including capital and liquidity.

The Current Regulation of Foreign Banking Organizations and Foreign Banks

Foreign banks play a significant role in the U.S. economy. There are nearly 250 branches and agency offices in the U.S., representing more than 150 foreign banks. These branches and agency offices are responsible for nearly 17% of commercial loans in the U.S., and hold more than 9% of U.S. deposits. According to Governor Tarullo, at least 23 foreign banks have U.S. banking assets exceeding $50 billion,[1] the threshold subjecting banking institutions to heightened regulation under Dodd-Frank. In addition, half of the ten largest broker-dealers in the U.S. are owned by foreign banks. The manner in which these foreign banks are regulated depends on the manner in which the foreign bank conducts banking operations in the U.S. (whether by establishing branch or agency offices in the U.S., or by acquiring a U.S. banking subsidiary in the U.S.), as further explained below.

Foreign Banking Organizations. Under current law, foreign banks are permitted to establish deposit-taking branches or non-depository offices (known as "agency offices") in the U.S., provided the foreign bank submits an application to the FRB. In reviewing the application, the FRB considers a number of factors, including whether the foreign bank is subject to "comprehensive consolidated

[1] Current publicly available data from the FRB (based on June 30, 2012, statistics) lists 20 FBOs with U.S. *banking* assets in excess of $50 billion. *See* http://www.federalreserve.gov/releases/iba/201206/bycntry.htm.

supervision" (**CCS**) by its home country regulator.[2] Assuming the FRB approves the creation of a branch or agency office, the branch or agency office must then, in the case of a state branch or agency office, be approved by a state banking department or, in the case of a Federal branch or agency office, be approved by the Office of the Comptroller of the Currency (**OCC**).

The branch or agency office must then adhere generally to the activity requirements applicable to state or Federally-chartered national banks, as appropriate,[3] is subject to U.S. reserve requirements,[4] and is examined by the FRB and either the OCC or the state banking department, as appropriate,[5] but the branch or agency office is not a separately capitalized entity and is not itself subject to standalone capital regulation. However, a Federal branch or agency office is required to maintain certain liquid assets in an account with a U.S. depository institution, known as a ***capital equivalency deposit***; the amount of the deposit is required to be at least 5% of the assets of the branch or agency office, or the capital that would be required if it were a freestanding national bank.[6] The insolvency of such branches or agency offices is not governed by the Bankruptcy Code but rather by special insolvency regimes under federal or state banking law.[7]

Foreign banks that obtain approval to establish a branch or agency office (or a banking subsidiary) in the U.S., referred to as "foreign banking organizations" (**FBOs**), are required to comply with the Bank Holding Company Act as if they are a bank holding company. As a result, FBOs are subject to examination and supervision by the FRB (although the FRB largely confines itself to the FBO's U.S. operations), and the U.S. activities of the FBO are required to comply with the activity restrictions of the Bank Holding Company Act (and therefore cannot engage in nonfinancial activities in the U.S. and cannot engage in certain insurance and securities activities in the U.S. unless the FBO becomes a "financial holding company" (**FHC**)).

In considering any application by a foreign bank to establish a branch or agency office in the United States, the FRB requires the foreign bank's capital ratio to be equivalent, but not identical, to the minimum ratio required of a U.S. bank. For foreign banks whose home country has adopted Basel-compliant capital regulations, the FRB permits the foreign bank to calculate its capital ratios consistent with the home country standards. With respect to a foreign bank whose home country

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[2] The CCS requirement and the requirement for FRB approval of a branch or agency office were added by the Foreign Bank Supervision Enhancement Act of 1991.

[3] *See, e.g.,* 12 U.S.C. §§ 3102(b), 3105(h).

[4] *See* 12 U.S.C. § 3105(a). The reserve requirements apply only if the foreign banking organization has worldwide assets exceeding $1 billion. *Id.*

[5] *See* 12 U.S.C. § 3105(c).

[6] 12 U.S.C. § 3102(g). State branches and agency offices are subject to similar requirements under State law. *See, e.g.,* N.Y. Banking Law § 202-b.

[7] *See* 12 U.S.C. § 3102(j); *see generally* N.Y. Banking Law, Article 13.

is not Basel-compliant, the FRB must make a determination whether its capital is consistent with the level of capital required of U.S. banking organizations generally.[8]

FBOs with U.S. Banking Subsidiaries. If the foreign bank has a U.S. banking subsidiary (i.e., a separate national bank, state-chartered bank, or thrift organized under state or federal law), U.S. law directly regulates the capital of the U.S. banking operations, and the U.S. banking subsidiary of course must comply with capital ratios applicable to U.S. banks generally. If the U.S. banking subsidiary is held via an intermediate U.S. bank holding company, the FRB historically has ***not*** required the intermediate bank holding company to comply with U.S. capital requirements. This FRB policy, known as **SR 01-01**, currently waives the capital requirements otherwise applicable to these intermediate bank holding companies.[9] However, a provision of Dodd-Frank (known as the **Collins Amendment**) will require that all bank holding companies meet the capital standards applicable to depository institutions generally and thus overrides SR 01-01; the Collins Amendment specifically requires that FBOs that have relied on SR 01-01 with respect to their U.S. intermediate bank holding companies must come into compliance with applicable capital requirements by July 2015.[10]

The Dodd-Frank Act has several provisions designed to tighten the regulation of FBOs. As mentioned previously, the Collins Amendment will require FBOs with U.S. banking holding company subsidiaries to increase capital in these U.S. banking holding companies commensurate with the capital requirements applicable to U.S. depository institutions generally, effective July 2015. In addition, the Dodd-Frank Act also authorized the FRB to adopt various "prudential regulations" on bank holding companies with assets above $50 billion, including FBOs. These prudential regulations include increased capital requirements, leverage limits, liquidity requirements, risk

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[8] 12 C.F.R. § 225.2(r).

[9] FRB Supervision & Regulation Letter 01-01 (Jan. 5, 2001). SR 01-01 is applicable only if the FBO has met the standards of, and has elected to be, a "financial holding company." An FBO that is not a financial holding company may not rely on SR 01-01.

[10] 12 U.S.C. § 5371(b)(4)(E) (as added by Dodd-Frank Act § 171(b)(4)(E)).

management requirements, resolution planning, credit exposure reports, and early remediation requirements.[11]

Non-FBO Foreign Banks. Foreign banks that do not establish a branch, agency office, or banking subsidiary in the U.S. (and thus are not FBOs) are subject to little U.S. banking regulation. These foreign banks historically are not subject to any capital regulation in the U.S. and are not required to conform the activities of their U.S. subsidiaries to the requirements of the Bank Holding Company Act.

The Tarullo Speech

At the Yale School of Management, Governor Tarullo outlined what he termed a "practical and reasonable way forward" in the U.S. regulation of foreign banks. Governor Tarullo noted that the profile of foreign bank operations in the United States changed significantly in the run-up to the financial crisis, shifting from a "lending branch" model to a "funding branch" model, in which U.S. branches of foreign banks began borrowing large amounts of U.S. dollars "to upstream to their parents." The financial crisis, Governor Tarullo argued, has served to reveal the financial stability risks associated with the foreign banking model as it has evolved in the United States. One of these dangers, Governor Tarullo noted, is that a global bank's capital and liquidity can end up "trapped at the home entity" in the event of a failure.

Governor Tarullo stated that as a result of the changes in the activities of foreign banks and the risks attendant to those changes, regulators will need to adjust the regimes applicable to foreign banks. In particular, Governor Tarullo outlined the following prospective changes:

- A "more uniform structure" for the "largest" U.S. operations of foreign banks, which would require that they establish a top-tier U.S. ***intermediate holding company*** (IHC) over all U.S. bank and non-bank subsidiaries. Governor Tarullo argued that this would allow for more consistent supervision across foreign banks, and would also reduce the ability of

[11] *See* 12 U.S.C. §§ 5365 & 5366 (as added by Dodd-Frank Act §§ 165 & 166). While the FRB has issued proposed prudential regulations, these proposals would not apply to FBOs. Instead, the FRB indicated that it would issue a separate proposed regulation with respect to prudential regulation of FBOs. See Board of Governors of the Federal Reserve System, Proposed Regulation, Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed Reg. 594 (Jan. 5, 2012). The FRB's stress testing regulations, which have been issued in final form, also do not apply to FBOs (other than with respect to any U.S. subsidiary bank holding company). See Board of Governors of the Federal Reserve System, Final Regulation, Annual Company-Run Stress Test Requirements for Banking Organizations With Total Consolidated Assets Over $10 Billion Other Than Covered Companies, 77 Fed. Reg. 62396 (Oct. 12, 2012); Board of Governors of the Federal Reserve System, Final Regulation, Supervisory and Company-Run Stress Test Requirements for Covered Companies, 77 Fed. Reg. 62378 (Oct. 12, 2012). Again, the FRB indicated that it would issue a separate regulations with respect to stress-testing by FBOs. On the other hand, the FRB has finalized its living will regulations required by Section 165(d), which do apply to the U.S. operations of FBOs. See Board of Governors of the Federal Reserve System, Final Regulation, Resolution Plans Required, 76 Fed Reg. 67323 (Nov. 1, 2011).

foreign banks to avoid U.S. consolidated-capital regulations. The U.S. branches of foreign banks would themselves remain outside the IHC structure.

- The same capital and prudential rules applicable to U.S. bank holding companies would also apply to U.S. IHCs.

- There should be liquidity standards for large U.S. operations of foreign banks (including, apparently, U.S. branches of foreign banks). For IHCs, the standards would be "broadly consistent with the standards the Federal Reserve has proposed for large domestic [bank holding companies]."

Governor Tarullo provided a number of reasons as to why such a shift in U.S. policy is required, including the following: (i) non-U.S. banks have become net borrowers in the U.S., rather than net lenders to the United States; (ii) during the financial crisis, non-U.S. banks were directly supported by the FRB (as well as their home country regulators); (iii) in a future financial crisis, Governor Tarullo believes that non-U.S. governments may be less willing or able to support the U.S. branches of their home country banks, thus increasing their potential need for support from the FRB or the potential that their failure disrupts the U.S. economy; and (iv) non-U.S. banking organizations play a major role in the U.S. banking and securities markets.

Governor Tarullo noted that the Fed expects to issue a notice of proposed rulemaking in line with the basic approach outlined above "in the coming weeks."

Far Reaching Implications

Governor Tarullo suggests a significant change in the manner in which the U.S. operations of non-U.S. banks are regulated. While his remarks indicate that the changes would apply only to "large" foreign banks, Governor Tarullo does not indicate what that threshold would be. While his remarks imply that the FRB may incorporate the $50 billion threshold in Dodd-Frank, it is not clear whether this threshold would be measured only against the foreign bank's total worldwide assets, its U.S. assets or its U.S. *banking* assets. That being said, his concerns expressed about the U.S. securities operations of foreign banks, as well as his references to the $50 billion threshold used in Dodd-Frank, suggest that the FRB is considering a broader measure than just U.S. *banking* assets.[12]

[12] On the other hand, in the footnotes to his remarks, Governor Tarullo does suggest that a worldwide asset test may not be appropriate, either:

For those foreign banks deemed to be large, his remarks foreshadow a number of important changes in U.S. regulation:

- FBOs *with* U.S. banking subsidiaries will be required to maintain an intermediate U.S. bank holding company. This appears to be a direct response to decisions by several FBOs to effect corporate reorganizations so as to hold their U.S. banking subsidiaries directly from abroad, which resulted in the FBOs not being subject to capital requirements that would apply to the U.S. bank holding companies from the repeal of SR 01-01, the Collins Amendment and the rollout of prudential capital requirements on U.S. bank holding companies with assets above $50 billion.

- FBOs *without* U.S. banking subsidiaries would be required to establish an IHC as a U.S. holding company. While this IHC would not be a *bank* holding company (because it would not own a bank), the IHC would nonetheless be subject to examination and supervision by the FRB, as well as the capital requirements imposed by the Bank Holding Company Act. In addition, the IHC would be subject to the prudential requirements imposed by Dodd-Frank Act Sections 165 & 166 (including increased capital requirements, leverage limits, liquidity requirements, risk management requirements, resolution planning, credit exposure reports, and early remediation requirements). The branches and agency offices of the FBO would exist outside of the IHC structure (and thus remain as a U.S. office of the foreign bank) and would not be subject to new standalone capital requirements, but would be subject to liquidity requirements.

- It is unclear whether, or how, the proposal would apply to non-FBO foreign banks, *i.e.*, foreign banks without a branch or agency office, or banking subsidiary, in the United States. While Governor Tarullo's concerns regarding the risk posed by large U.S. broker-dealer subsidiaries of foreign banks could be construed to apply equally to foreign banks that do not have a U.S. banking presence but conduct other business here, it is not clear whether the FRB can regulate such entities without Congressional action, inasmuch as the International Banking Act confers on the FRB the authority to regulate only those foreign banks that maintain a branch or agency office in the United States. If the FRB does attempt to regulate such non-FBO foreign banks, it would subject such entities to FRB regulation for the first time.

Sections 165 and 166 apply to all foreign banks with $50 billion or more in global consolidated assets and a U.S. banking presence of any size. More than 100 foreign banks operating in the United States would meet this threshold today (source: FR Y-7Q). Whether such a bank with relatively small U.S. operations should be subject to the same prudential requirements as those with U.S. operations in excess of $50 billion is an open question.

Tarullo Speech, n. 20.

These regulatory changes suggested by Governor Tarullo would substantially expand the authority of the FRB to regulate capital, liquidity, and risk management of the U.S. operations of FBOs, and would result in the creation of a new form of FRB-regulated vehicle, the IHC. In that regard, he is suggesting a very substantial re-thinking of the manner in which the U.S. operations of global financial institutions are regulated, as well as increasing the cost of FBOs conducting business in the United States. Moreover, such changes, if adopted, would likely result in corresponding, if not retaliatory, regulation in other countries, eventually leading to increased cost and regulation of U.S. banking entities operating abroad.[13]

Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this memorandum.

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[13] In that regard, it should be noted that, in applying Sections 165 and 166 to FBOs, Dodd-Frank specifically requires the FRB to "give due regard to the principle of national treatment," and take into account the extent to which the [FBO] is subject on a consolidated basis to home country standards that are comparable to those applied to financial companies in the United States. 12 U.S.C. § 5365(b)(2) (as added by Dodd-Frank Act § 165(b)(2)). Governor Tarullo's remarks suggest that the new IHC proposal is not subject to these considerations:

> Some observers will, I am sure, ask if it is necessary to depart from the prevailing firm-by-firm approach to foreign banking regulation and to adopt generally applicable requirements in implementing the Dodd-Frank enhanced prudential standards for foreign banks. It is difficult to see how reliance on this approach can be effective in addressing risks to U.S. financial stability, at least in the absence of extraterritorial application of our own standards and supervision, and perhaps not even then. We would, at a minimum, need to make regular and detailed assessments of each firm's home-country regulatory and resolution regimes, the financial stability risk posed by each firm in the United States, and the financial condition of the consolidated banking organization. In fact, such an approach might result in the worst of both worlds--an ongoing intrusiveness into the consolidated supervision of foreign banks by their home-country regulators without the ultimate ability to evaluate those banks comprehensively or to direct changes in a parent bank's practices necessary to mitigate risks in the United States. Although the Federal Reserve will continue to cooperate with its foreign counterparts in overseeing large, multinational banking operations, that supervisory tool cannot provide complete protection against risks engendered by U.S. operations as extensive as those of many large U.S. institutions.