Federal Reserve Board Governor Describes Significant Changes to be Proposed for the US Operations of Non-US Banks

On November 28, 2012, Federal Reserve Board Governor Daniel Tarullo provided a preliminary glimpse at new requirements to be imposed on non-US banks that have US banking operations. A proposed rule to be published by the Federal Reserve within weeks will include the most significant changes in over a decade to the way that the Federal Reserve regulates the operations of non-US banks.

Governor Tarullo's speech focused on three specific items to be included in the proposal, but he made clear that the Federal Reserve would be taking a "new approach" to the regulation of non-US banks. Tarullo asserted that this new approach was made necessary not only by the terms of the Dodd-Frank Act, but also by the major shift that has occurred in the US operations of non-US banks. Governor Tarullo explained that the US operations of non-US banks have moved from primarily using parent bank capital for traditional lending to relying on short-term wholesale funding for a much wider range of activities and to upstream funds to the parent bank. He also noted that while the proportionate share of non-US banking assets to total US banking assets has remained static, the "concentration and complexity of those [non-US bank] assets have changed noticeably."

Governor Tarullo said that the new approach "must address the vulnerabilities that have been created by the shift in [non-US bank] activities" while maintaining the principles of national treatment and competitive equity. Nonetheless, his emphasis was clearly on protecting US financial stability and the new approach will not necessarily take into account how regulators in other countries are seeking to address similar concerns. He went as far as stating that "it is not clear that we should aim toward extensive harmonization of national regulatory practices related to [non-US] banking organizations."

Tarullo's speech identified three specific changes that the Federal Reserve intends to include in its proposed rule:

- Each non-US bank that operates a US subsidiary must establish an "intermediate holding company" (an "IHC");
- Each non-US bank's IHC should be subject to the same capital rules as a US bank holding company ("BHC"); and
- The US operations of non-US banks should be subject to liquidity standards.

Establish "Intermediate Holding Companies"

According to Tarullo, non-US banks and their domestic counterparts should be structured more uniformly. To that end, Tarullo said that the Federal Reserve will propose to require that each non-US bank that operates a US subsidiary establish a so-called "IHC", which would oversee all of that non-US bank's US bank and nonbank subsidiaries. Centralizing a non-US bank's US operations under a single entity would help streamline compliance efforts and reduce administrative burdens. Furthermore, IHCs would facilitate more consistent prudential supervision and compel non-US banks to comply with US consolidated-capital regulations. The branches and agencies of non-US banks would remain outside of the IHC structure."

BHC Capital Rules Would Apply to Intermediate Holding Companies

Tarullo said that the Federal Reserve proposal will require IHCs to comply with the same capital requirements to which BHCs are subject. The 2007-2008 financial crisis revealed significant systemic risks in the US financial markets, and these capital requirements were designed specifically to address such risks. Requiring the establishment of IHCs to which these requirements would apply (*e.g.*, stress testing, single counterparty credit limits, early remediation requirements) would help to accomplish the FRB's risk management goals.

Impose Liquidity Standards on Non-US Banks

Finally, Tarullo stated that the US operations of non-US banks should be subject to liquidity standards that approximate those proposed for domestic BHCs. By doing so, non-US banks could more easily ensure that their US operations have sufficient, high-quality assets in the United States to respond to, and recover from, financial stressors. For an IHC, this would mean that the IHC would have liquidity requirements similar to BHCs. It is less clear how the Federal Reserve proposal will apply a liquidity requirement to a branch or agency of a non-US bank. Tarullo's speech only said that there should be such a requirement.

We intend to circulate further details and analysis on the Federal Reserve's proposals, and their impact on your business, in the coming weeks.

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