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ENHANCED PRUDENTIAL STANDARDS FOR BANKS IN THE US

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FW moderates a discussion on enhanced prudential standards for banks in the US between Jeff Berman, a partner at Clifford Chance, Robin Maxwell, a partner at Linklaters, and Brian D. Christiansen, a partner at Skadden, Arps, Slate, Meagher & Flom.

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FW: Could you briefly highlight the key points of the Federal Reserve Board's Final Rule for enhanced prudential standards for banks? What factors have driven the creation and implementation of this rule?

Berman: Particularly with respect to non-US banks – that is, foreign banking organisations (FBOs) – the implementation of enhanced prudential standards responds to the challenges expected to arise in connection with the resolution of large, cross-border banking groups. Like the Proposed Rule, the Final Rule represents a marked shift in focus – away from coordinated supervision of internationally active banks at the consolidated level, and toward reduction of the risks that the cross-border activities of multinational banking organisations are thought to pose to the financial stability of host countries, primarily the United States. A key driver of this shift in focus appears to be a loss of confidence in the current regulatory framework and its reliance on international standards and cooperative supervision – which is especially evident in the intermediate holding company (IHC), local liquidity buffer and 'backup' asset maintenance requirements of the Final Rule.

Maxwell: The Final Rule represents a fundamental sea change in the way in which the US operations of the largest FBOs will be regulated – and a genuine capital cost to these FBOs of maintaining a significant US footprint. Even though these FBOs are all subject to home-country Basel III capital and liquidity requirements already, the Final Rule requires the US operations of the largest FBOs to be organised under a so-called IHC which itself must satisfy US Basel III requirements – even if the FBO has no US bank subsidiary at all. This will inevitably lead to 'trapped' capital and liquidity, as banks are forced to allocate capital and liquidity to US operations in a manner that may not reflect an internal assessment of risk. Much of the Final Rule is, of course, responsive to the statutory requirements of Section 165 of Dodd-Frank, but many of the provisions –and particularly the IHC and other requirements that affect the largest FBOs – reflect a regulatory agenda that the Fed has acknowledged goes beyond statutory requirements.

Christiansen: The Dodd-Frank Act directed the Federal Reserve to establish prudential standards for large banking organisations that are more stringent than the standards applicable to smaller institutions. The underlying premise is that larger institutions present greater risk to US financial stability than do smaller institutions – and therefore require a more rigorous regulatory framework. The Final Rule implements enhanced prudential standards across a number of topics, including Basel III and leverage capital requirements, capital planning and stress testing, risk management and governance requirements, and liquidity. Most – but not all – of the Final Rule's requirements apply only to banking organisations with total assets of $50bn or more. The Final Rule is certainly an important new regulation for large US banking organisations. But it represents a far more significant development for *non-US* banking organisations that have banking operations in the United States – such as a US branch or US bank subsidiary.

FW: To what extent does the Final Rule resemble the Proposed Rule? What adjustments have been made, and were these expected?

Maxwell: The Final Rule raises to $50bn – from $10bn – the US non-branch assets threshold that triggers the burdensome requirement to establish and capitalise an IHC. Other asset thresholds were also raised, and compliance deadlines pushed further out. But, in broad outline, the Final Rule hews much closer to the proposal than many had hoped.

Christiansen: The Final Rule largely follows the substance of the Proposed Rule. One notable adjustment to the

Final Rule is what it did not contain. Unlike the Proposed Rule, the Final Rule did not include the requirements related to early remediation or single counterparty credit limits. The Federal Reserve indicated that these provisions would be finalised later. The Basel Committee issued its framework for measuring and controlling large counterparty exposures in April 2014. For this reason, it is expected that the Federal Reserve will finalise its single counterparty credit limit soon.

Berman: The Final Rule reflects a reconsideration of certain elements of the Proposed Rule affecting FBOs. The IHC requirement now applies only to FBOs with US non-branch assets of $50bn or more. Although IHCs are still subject to the same capital adequacy requirements as US bank holding companies, they are not required to comply with the 'advanced approaches' rules. The liquidity buffer for the US branches and agencies of an FBO with combined US assets of $50bn or more has been reduced from 30 days to 14 days of projected cash flow requirements. The Final Rule also extends certain deadlines; for example, the initial compliance date for FBOs has been postponed by a year to 1 July 2016 – although the largest FBOs must submit implementation plans by 1 January 2015 – and leverage capital requirements will not apply to IHCs until January 1, 2018. With respect to other, particularly controversial or difficult elements of the Proposal Rule, the Final Rule 'kicks the can', postponing the adoption of early remediation requirements for FBOs as well as the implementation of single counterparty credit limits.

FW: The Final Rule imposes new liquidity and risk management requirements on large domestic bank holding companies. In your opinion, will banks need to make significant changes to meet these standards and satisfy regular reviews?

Christiansen: The Final Rule requires US bank holding companies with total assets of $50bn or more to meet liquidity risk management standards, conduct internal liquidity stress tests, and maintain a 30-day liquidity buffer of highly liquid assets. The Final Rule also creates new liquidity requirements for FBOs – although the scope and substance of those requirements varies depending on the structure and size of the FBO. The liquidity provisions of the Final Rule are intended to complement two other expected liquidity requirements: the liquidity coverage ratio proposed in October 2013 and the so-called net stable funding ratio. The combined effect of these heightened liquidity requirements will impose new costs on banking organisations. First, there will be the opportunity cost associated with holding an additional portion of the balance sheet in low yielding liquid assets. Second, there will be significant investments required in systems and procedures to ensure compliance. Third, there will likely be unexpected consequences from the interplay of new capital rules along with the new liquidity requirements of the Final Rule, the LCR and the net stable funding ratio.

Berman: In the case of US bank holding companies, the enhanced prudential standards had been largely finalised prior to adoption of the Final Rule, leaving only a few matters for implementation: risk management requirements, liquidity stress testing and buffer requirements, and potential debt-to-equity limits for institutions found to pose a 'grave threat' to financial system stability. Many – if not most – of these matters had already been addressed through extensive supervisory guidance and other ad hoc measures directed at the domestic banking sector. It therefore seems reasonable to expect that the necessary operational and compliance changes have been underway for some time – and their costs duly provided for – at US bank holding companies, and that the impact of the Final Rule on FBOs in the near-to-medium term will be costlier and more disruptive by comparison.

FW: What impact do you believe the capital planning and stress testing requirements of the Final Rule will have on bank activities in the US?

Berman: Again, these elements of the enhanced prudential standards had been adopted for US bank holding companies well in advance of the Final Rule – the capital planning requirements in 2011 and the stress testing requirements in 2012. Yet it remains to be seen – and may never be known – whether such testing and reporting measures are an effective bulwark for the US financial system against the material distress or failure of large institutions, or are instead mere bureaucratic make-work that saddles the system with deadweight losses. Effective or not, capital planning and stress testing requirements have consequences that involve an undeniable trade-off between the reduction of risk and the availability of credit. Extending these requirements from US bank holding companies to FBOs makes striking the right balance that much more critical as a matter of economic as well as regulatory policy.

Maxwell: Looking at the big picture, capital planning and stress testing are part and parcel of significantly increased bank capital requirements which have, and will continue to have, a real impact on what services banks can and can't provide – and at what cost to their customers. And of course they will also inevitably reduce return on equity.

Christiansen: For large US banking organisations, the Final Rule simply affirms capital adequacy, capital planning and stress testing requirements that were already in place. On the other hand, for FBOs that are required to form a US IHC, the Final Rule imposes a new set of US-based capital adequacy, capital planning and stress testing requirements. The Final Rule requires the US IHC to comply with generally the same capital adequacy, capital planning and stress testing requirements that apply to a $50bn US bank holding company. I highlight two practical consequences. First, FBOs with large US nonbanking operations – such as large US investment banking or trading operations – will be required to capitalise those businesses in a manner similar to a large US bank holding company. These FBOs may choose to shrink or exit capital intensive businesses in the United States. Second, the Final Rule creates a formalised process by which the Federal Reserve exercises significant discretion in evaluating capital adequacy, assessing the quality of capital planning, risk management, and information systems, and determining whether to allow capital distributions from the US IHC.

FW: What are the implications of the Final Rule for the US operations of FBOs? Will the cost of operating in the US rise dramatically as a result of the required adjustments?

Maxwell: It is clear that the Final Rule will have both short and long-term operational costs for affected FBOs. The short-term costs are all of those associated with legal entity review and reorganisation, which can be a massively expensive exercise both in terms of actual dollars and cents and, just as important, in terms of management time and attention. Longer term, the IHC requirement will fundamentally change the way in which US operations of the largest FBOs are capitalised and funded. These changes may well change the cost-benefit analysis for some banks of maintaining large trading operations in the US.

Christiansen: As a formal matter, the Final Rule does not depart from the historical international framework of deference to home country regulators. But as a practical matter, the Final Rule signals a more aggressive role of the Federal Reserve in supervising FBOs not only with respect to their US banking offices, but also with respect to their nonbanking activities and global risk profile. The costs of this more rigorous approach will be felt most significantly by those FBOs with large nonbank balance sheets in the United States.

Berman: In addition to the IHC requirement, the Final Rule imposes enhanced risk-based and leverage capital requirements and enhanced liquidity risk management, stress tests, and buffer requirements on all FBOs with consolidated worldwide assets of $50bn or more. The Final Rule establishes capital stress test requirements for FBOs with consolidated worldwide assets of $10bn or more, and US risk committee requirements for FBOs meeting the $10bn threshold that are also publicly traded. Statements accompanying both the Proposed Rule and the Final Rule paid lip service to the policies of national treatment and competitive equity that have long guided the Federal Reserve Board's supervision of non-US banks. At the same time, however, the imposition of enhanced prudential standards on FBOs represents a nearly unprecedented increase in Federal Reserve oversight aimed specifically at FBOs' US operations. Particularly for FBOs required to establish IHCs, the Final Rule seems bound to bring substantially increased compliance costs, decreased organisational flexibility, and an assortment of unwelcome restructuring charges.

FW: Could you explain why the Proposed Rule, and in particular the IHC and asset maintenance requirements, was criticised as "ring-fencing" the US operations of FBOs? Did the Final Rule do anything to mitigate this concern?

Christiansen: The Proposed Rule would have required an FBO with $10bn or more of US assets – excluding assets held in US branches of the foreign bank parent – to form a US IHC, within which it would be required to hold all of its US banking and *nonbanking* subsidiaries. The US IHC must then comply with generally the same capital adequacy, capital planning and stress testing requirements that apply to a similarly sized US bank holding company. The Final Rule keeps the US IHC requirement, but it increases the triggering US non-branch asset threshold from $10bn to $50bn. With this change, less than 20 FBOs are expected to be subject to the US IHC requirement. But for those FBOs, the Final Rule will greatly limit their ability to move capital and liquid assets from the United States to other parts of the organisation – including in times of stress. In this regard, the Final Rule is a form of 'ringfencing'. On the other hand, neither the Proposed Rule nor the Final Rule require an FBO – of any size – to 'subsidiarise' or separately capitalise its US branches, although US branches will be required to meet new liquidity requirements.

Berman: The term 'ring-fencing' describes a protectionist regulatory policy – followed to a greater or lesser degree by most jurisdictions that are home to internationally active banks or that host their cross-border operations – aimed at protecting local depositors and other creditors by keeping foreign banks' unimpaired assets and other sources of capital and liquidity from migrating abroad, particularly during periods of financial stress. In adopting enhanced prudential standards in the United States, regulators noted the evolution of FBOs' US operations from being net recipients of funding from non-US offices and affiliates to being net providers of funding, resulting in an across-the-board shortfall of third-party US assets available to cover third-party US liabilities. This observation revealed a deeper concern – the possibility that an FBO's unimpaired, third-party assets and other sources of capital and liquidity, rather than serving as a source of strength for its US operations, might be trapped overseas – or deliberately immobilized by home country authorities – in a crisis. The ring-fencing impact of the IHC requirement – and the threat it poses to the ability of home country regulators to affect a cross-border resolution of the parent banking group – has been widely discussed. But other elements of the Final Rule, such as the asset maintenance requirements applicable to the US branch network of an FBO that fails to comply with the Final Rule's annual capital stress test requirements, have a ring-fencing impact as well. Requiring US branch networks to maintain third-party US assets equal to 105 percent or 108 percent of third-party US liabilities seems much like the first step on the way to full 'subsidiarisation' of FBOs' US operations.

Maxwell: 'Ring-fencing' is an inexact term, and the IHC requirement is not a 'ring fence' in the sense that, say, the UK Vickers retail ring-fence will be. But, insofar as it expressly requires local capital and local liquidity to be held against US assets, it is very much a 'ring-fence'. The IHC requirement is, at its core, an admission by the Fed that, notwithstanding a long history of deference to many home country regulators of banks with branches here, it no longer trusts them to 'get it right'. It is not a full subsidiarisation requirement, which is of course very important; in other words, FBOs can still avail themselves of the benefits of doing business in this country through unincorporated branches. But the Fed has made clear that it will be watching closely to ensure that US assets aren't pushed into branches in order to escape the capital impact of being held beneath the IHC.

FW: How has the Final Rule been received by the banking industry? What major criticisms have emerged, if any?

Berman: Some of the most compelling criticism of the US implementation of enhanced prudential standards has come not just from the banking industry, but from home country governments and supervisory authorities – that if the Federal Reserve Board's goal is, as it claims, to meet the challenge of resolving large, cross-border banking groups, then the approach taken in the Final Rule is obviously counterproductive. From an international perspective, the Final Rule appears to abandon the goal of cooperative supervision and resolution planning based on a global 'single point of entry' in favour of an 'every country for itself and the devil take the hindmost' strategy. The Federal Reserve Board has created a US-centric cross-border resolution framework in which the IHC is said to represent the single point of entry, but for an FBO's US subsidiaries only – turning the entire concept on its head and leaving the FBO and its non-US subsidiaries, as well as their non-US supervisors, to fend for themselves.

Christiansen: For US banking organisations, the Final Rule is yet another layer of the post-crisis regulatory environment. For FBOs, the Final Rule represents a more fundamental change in the regulatory framework. FBOs are deeply concerned about the impact of the Final Rule. A principal criticism of the Final Rule from FBOs is that the Final Rule will make cross-border financial services less efficient and therefore more costly.

FW: In your opinion, what will be the overall impact of the Final Rule on banking activity in the US? Are banks adequately prepared for its implementation?

Christiansen: FBOs are re-evaluating the size and nature of their US activities – particularly balance sheet intensive businesses. FBOs with non-branch US businesses only moderately above the $50bn threshold will consider shrinking their US footprint to avoid the US IHC requirement. Other FBOs above the US IHC threshold may make a strategic decision to grow their US footprint in an effort to achieve greater scale and offset the additional regulatory burdens of the Final Rule. Many large US banking organisations and FBOs have been following the enhanced prudential standards rule since it was first proposed. Nevertheless, for those institutions most affected by the Final Rule, there is a lot of work to be done.

Berman: First, the Final Rule's impact will not be limited to banking activity in the US – I think the most costly effects are likely to be on international capital flows, enterprisewide risk and operational management, and financial market liquidity. Second, at this point I'm afraid that implementation of the Final Rule is something for which few, if any, large FBOs are adequately prepared.

FW: What steps do US banking institutions and FBOs need to take now to ensure compliance prior to implementation deadlines?

Berman: The coming months will be critical for FBOs in particular. The Final Rule requires an FBO with US non-branch assets of $50bn or more as of 30 June 2014 to submit an implementation plan to the Federal Reserve Board, outlining its proposed process for establishing an IHC, by 1 January 2015. An FBO that is not too far above the $50bn threshold on 30 June 2014 may instead submit an implementation plan that describes how the FBO will reduce its US non-branch assets below $50bn for four consecutive quarters prior to 1 July 2016, consistent with safety and soundness considerations.

Maxwell: As with many of the Dodd-Frank regulations, there is something of a hidden early compliance deadline embedded in the Final Rule. For example, even though FBOs subject to the IHC requirement have now been given a longer period in which to implement the transfer of subsidiaries, they are required to submit a relatively fleshed-out implementation plan to the Fed by 1 January 2015. So there is a great deal of work to be done in a very short time.

Christiansen: The Final Rule will generally become effective for US banking organisations starting 1 January 2015, and for FBOs starting 1 July 2016. Compliance will require affected banking organisations to make substantial investments of management attention, time and financial resources. For example, many banking organisations will need to implement board-level US risk committees and hire US risk officers. FBOs required to form a new US IHC will face even more significant and complex challenges. Restructuring multiple businesses conducted within multiple legal entities will require coordinated work across a number of functions, including management, operations, treasury, legal, accounting and tax. FBOs required to form a US IHC are required to submit an implementation plan to the Federal Reserve by 1 January 2015. The implementation plan process provides an important opportunity for FBOs to address any unique structural challenges or to seek focused relief or interpretation from the Federal Reserve. ■