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Federal Reserve Proposes Enhanced Prudential Standards and Intermediate Holding Companies for Non-US Banks

On December 14, 2012, the Federal Reserve Board published its proposed enhanced prudential standards for the US operations of non-US banks. The highly anticipated proposal would implement the "rebalanced approach" to the regulation of non-US banks that Fed Governor Daniel Tarullo announced last month, respond to expected challenges in connection with the resolution of large cross-border banks, and represent 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 organizations are thought to pose to the financial stability of host countries, particularly the United States.

While the Federal Reserve release proposal states that the new rules are intended to parallel the proposed enhanced prudential requirements for US banks, they would impose significant new burdens on non-US banks that have US operations. Many non-US banks will be forced to restructure their US operations. In particular, the Federal Reserve proposal takes the steps that Governor Tarullo described last month by requiring that:

- Certain non-US banks with US operations in addition to their branch and agency networks establish an "intermediate holding company" ("IHC");
- Each IHC be subject to the same capital requirements as a US bank holding company;
- US operations of non-US banks be subject to liquidity standards and a “local liquidity buffer” requirement; and
- US operations of non-US banks also be subject to enhanced risk management, stress testing and remediation requirements.

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Although the preamble to the Federal Reserve proposal and the prepared statements of several Fed Governors pay lip service to the policies of national treatment and competitive equity that have guided the supervision of non-US banks' US operations since the International Banking Act of 1978, the proposal reveals a loss of confidence in the current regulatory framework and its reliance on international standards. Much is made of the fact that the US operations of non-US banks have moved from being net recipients of funding from their home country organizations to being net providers of funding, generally in order to finance US dollar-denominated investments by non-US affiliates. The Federal Reserve also takes note of the marked increases in the concentration of non-US banking organizations' third-party US assets and in their overall ownership share of the largest US broker-dealer firms. The real driver behind the proposed enhanced prudential standards, however, seems to be an increasingly acute concern about the *location* of an internationally active bank's capital and liquidity and the possibility that such resources, rather than serving as a source of strength for the bank's US operations, will be trapped overseas or deliberately "ring-fenced" by home country authorities in a crisis.

Accordingly, the new rules would substantially increase Federal Reserve control over US operations of non-US banks and with it, bring increased compliance costs and related burdens. Not since the Foreign Bank Supervision Enhancement Act of 1991 has there been such an increase in Federal Reserve oversight aimed specifically at the US operations of non-US banks. Nonetheless, we should not expect a retreat from this proposal. The Dodd-Frank Act gave the Federal Reserve plenary authority to adopt enhanced prudential standards and there is sufficient similarity between this proposal and last year's proposal for US banks that the Federal Reserve could easily defend its approach. The Federal Reserve is accepting comments on the proposed enhanced prudential standards until March 31, 2013.

Requirements Increase With Size

The proposal is written so that the requirements become more stringent as an organization increases in asset size. Before describing the threshold amounts, there are several general points on applicability that are worth noting. First, the proposal would apply to any non-US bank that has US banking operations. That essentially means any non-US bank that has a US branch or agency. Second, the proposal would also apply to any foreign non-bank financial company supervised by the Federal Reserve. This refers to certain non-banking companies designated by the Financial Stability Oversight Council as systemically significant. Those designations have not been finalized. Third, most of the requirements of the proposal apply to organizations with $50 billion in total consolidated assets. That threshold is actually quite low because it is not based on US assets, but rather on an organization's global consolidated assets.

The proposal does not impose new requirements on non-US banks that have less than $10 billion in global consolidated assets. For organizations with more than $10 billion, but less than $50 billion in global consolidated assets, the proposal generally would only require that there be a US risk committee and home-country stress tests comparable to US requirements.

Most of the additional requirements kick in for non-US banks that have $50 billion or more in global consolidated assets. As discussed more fully below, these organizations will also be subject to: (i) single-counterparty credit limits; (ii) liquidity stress test requirements; (iii) early remediation requirements; and (iv) the IHC requirement. The IHC requirement only applies if the non-US bank has US non-branch assets of $10 billion or more. As the amount of US assets increases, so do the requirements of the proposal. At $50 billion or more of combined US assets, the stress test, capital plan, risk management, and remediation requirements increase. At $500 billion or more of combined US assets, the single-counterparty credit limits become more stringent.

The following table summarizes the relationship between the proposed enhanced prudential requirements and the various asset size parameters:

Total Consolidated Assets	Combined US Assets	Combined US Assets (excluding branches and agencies)	Applicable Requirements
less than $10 billion	—	—	No new requirements
$10 billion or more, but less than $50 billion	—	—	• Annual capital stress tests under home country regime, broadly consistent with U.S. requirements • US risk committee (if FBO is publicly traded) ("***Basic Requirements***")
$50 billion or more	less than $50 billion	less than $10 billion	Basic Requirements, *plus*— • Home country capital standards consistent with Basel standards • Single-counterparty credit limits • Annual internal liquidity stress tests • §166 early remediation (triggered on discretionary basis) (together with Basic Requirements, "***Transitional Requirements***")
		$10 billion or more	Transitional Requirements, *plus*— • Intermediate holding company for all U.S. operations other than branch and agency network • IHC subject to: – US bank holding company capital requirements – Single-counterparty credit limits – §165(i) annual "company-run" capital stress tests
	$50 billion or more	less than $10 billion	Transitional Requirements, *plus*— • US risk committee (whether or not FBO is publicly traded) • US chief risk officer • Information requirements on results of annual capital stress tests under home country regime • §166 early remediation (triggered automatically) • US branch and agency network and IHC, if any, subject to: – monthly liquidity stress tests – local liquidity buffer requirement – contingency funding plan (together with Transitional Requirements, "***Full Requirements***")
		$10 billion or more	Full Requirements, *plus*— • Intermediate holding company for all U.S. operations other than branch and agency network • IHC subject to: – US bank holding company capital requirements – Single-counterparty credit limits – §165(i) annual "company-run" capital stress tests • If IHC total consolidated assets = $50 billion or more, IHC also subject to: – Regulation Y "capital plan" rule – §165(i) annual supervisory and semi-annual "company-run" capital stress tests

The IHC Requirement

The most significant feature of the Federal Reserve proposals is the IHC requirement. Each non-US bank with US banking operations that has both $50 billion or more in global consolidated assets and $10 billion or more in US non-branch assets will need to establish an IHC. It is primarily through the IHC that the Federal Reserve will impose enhanced capital, liquidity and risk management requirements on non-US banks because the IHC will be subject to the same requirements as any US bank holding company.

Any controlling investment by the non-US bank in a US entity would have to be held by the IHC. Investments in certain non-US domiciled commercial companies under the authority of Section 2(h)(2) of the Bank Holding Company Act would be excluded, but all other controlling investments in the United States are covered, including those made under merchant banking authority.

Non-US banks that meet the threshold before July 1, 2014 will be required to establish an IHC by July 1, 2015. Non-US banks that meet the threshold after July 1, 2014 will generally have one year to set up their IHC from the time they meet the threshold. The proposal provides a fairly simple 30-day, after-the-fact notice requirement for establishing the IHC.

US Branch And Agency Liquidity Requirements

The Federal Reserve continues to recognize that US branches and agencies are not distinct from their parent banks, but will nonetheless impose for the first time a specific branch and agency local liquidity buffer requirement. The standard will generally require that the branch or agency maintain in the United States a buffer of high quality assets to cover the first 14 days of stressed cash flow needs for a 30-day period. The remainder of the liquidity buffer for the 30-day period can be satisfied by the head office of the bank.

Single-Counterparty Credit Limits

This aspect of the proposal will likely give rise to many comments because the similar proposal for US banks has been controversial. A non-US bank with US banking operations will be subject to this rule if it has US-only consolidated assets of at least $50 billion. The combined US operations of that organization would then be subject to a limit of 25 percent of the non-US bank's total regulatory capital to a single-counterparty. The US IHC of that non-US bank would also be subject to a limit of 25 percent of its regulatory capital to a single-counterparty. The proposal states that a more stringent limit will apply to non-US banks that have consolidated assets of $500 billion or more.

Other Aspects Of The Proposal

The 305-page release from the Federal Reserve contains considerable technical detail on how other aspects of the enhanced prudential requirements will apply to the US operations of non-US banks. The pattern for the Federal Reserve approach in regard to risk management requirements, early remediation and stress testing is generally the same. The Federal Reserve will apply to the IHC all of the requirements that otherwise apply to a US bank holding company. The Federal Reserve will continue to look to a large extent to home-country requirements for the branches and agencies. For example, while stress testing requirements will apply to any non-US bank with $50 billion or more in global consolidated assets, the requirements for a US branch or agency will be considered to be satisfied "if it is subject to a consolidated capital testing regime that is broadly consistent with the stress test requirements in the United States." If the non-US bank has US assets of $50 billion or more, the Federal Reserve will require that it be given the results of the stress tests that were conducted under the non-US bank's home-country regime.

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