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Global Regulatory Network Executive Briefing

Global Regulatory Network

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Comments reflect substantial concerns about Federal Reserve's proposed foreign banking regulation

The public comment period for the Federal Reserve's December 2012 notice of proposed rulemaking (NPR) to establish enhanced prudential and early remediation standards for inbound foreign banking organizations (FBOs) pursuant to Sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act closed on 30 April 2013. As expected, the controversial rulemaking has generated extensive comment from the industry and the foreign regulatory and public sector community, much of which is directed at the fundamental nature of the proposal — to prescribe for many inbound foreign banks a US "intermediate" holding company (IHC) structure for all US subsidiaries, and attendant US-centric capital, liquidity and risk governance requirements.

Key concerns raised about the proposal include:

- The overall territorial nature of the proposal and its implications for global banks and markets
- Its intended scope of coverage, extending to more than 100 foreign banking institutions operating in the US
- The potential for trapping substantial capital and liquidity in the US
- The competitive implications for foreign banks, since US-domiciled bank holding companies (BHCs) would continue to be prudentially supervised and regulated on a consolidated basis and would not have to establish intermediate holding companies
- The proposal's inherent lack of confidence in both home-country supervision and regulation, as well as the prospects for international regulatory coordination and cooperation, particularly in dealing with large, cross-border institutions under significant stress

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Background and key drivers of proposal

The December NPR would, generally speaking, require all inbound foreign banks with US$10 billion or more in US assets outside of the bank's US branch and agency network to establish a holding company in the US that would hold the stock of its US subsidiaries. That "intermediate" holding company would in many respects be subject to consolidated capital, liquidity and regulatory reporting requirements as if it were a US bank holding company, even if none of its US subsidiaries is an insured depository. Further, there are specific risk governance requirements for both the IHC and the combined US operations. Those foreign banks with US$50 billion or more in US assets would be subject to very detailed and exacting liquidity and capital stress-testing and reporting requirements and to the Fed's capital planning regime. On the liquidity front the proposal discourages these banks from raising funds in the US, other than to support the US businesses of the IHC and the US branches, and it discourages intercompany funding between the US branch network and the IHC.

The Fed's motivations for the proposal are explained in the preamble to the NPR, in the discussion at the public Federal Reserve Board of Governors meeting at which the Board voted to publish the NPR for comment, and in speeches given before and after the proposal's publication last December. Among the concerns cited is what the Fed describes as the changing profile of foreign banking operations, generally in the US, leading into the financial crisis — the increasing use of US-sourced funding to support foreign operations, increasing reliance on short-term wholesale funding, and a shift in emphasis from commercial and industrial lending conducted out of banking offices to capital markets activities conducted in securities broker-dealers and other nonbanking entities in the US. In addition, US branches of foreign banks used the Fed's discount window at a "substantial" level during the crisis, and foreign bank-owned broker-dealers tapped the Fed's Primary Dealer Credit Facility. Further, it has been noted that home-country initiatives (for example, those in Europe directed at ensuring that the domestic activities of internationally active banks can be insulated from risks associated with capital markets and cross-border activities) raise questions about the extent of head-office and home-country support that may be forthcoming to the US operations of a foreign bank during times of stress. Finally, the Fed has noted that ongoing practical challenges remain to establishing mechanisms for the resolution of banking organizations on a cross-border basis and that these will take some time to address.

Overview of comments

The comments submitted on the NPR raise concerns about the fundamental nature of the proposal —arguing that it does not comply with the statutory mandate in Section 165 that, in prescribing enhanced prudential standards for foreign banks, the Fed shall "give due regard to the principle of national treatment and equality of competitive opportunity; and ...take into account the extent to which [the foreign bank] is subject on a consolidated basis to home country standards that are comparable to those applied … in the United States." The term "national treatment" reflects the principle that US-based and inbound foreign banking organizations face the same treatment. However, commenters have underscored that the US has interpreted "national treatment" to mean that an IHC, not the foreign banking organization as a whole, faces the same standards as a US BHC. This focus on national treatment at the intermediate holding company level of the foreign banking organization (and not at the level of the global operations) results in a number of additional requirements for FBOs that US BHCs do not face.

In short, these comments argue that the NPR is more legislative in nature than regulatory, as it reflects fundamental changes in the supervision and regulation of foreign banks in the US, and that it is inconsistent with the principle of national treatment and the long-established practice of relying on consolidated, home-country supervision and prudential standards as supporting US operations.

A large number of more specific, technical concerns are also raised across the structural, capital, liquidity and governance requirements in the NPR, reflecting, among other things, the unduly binding nature of some of the proposed requirements on established business models. For instance, the comments include an Institute of International Bankers-sponsored study that suggests that the contemplated leverage ratio requirements on IHCs could reduce liquidity in the US Government securities repo market by approximately US$330 billion.[1] The very detailed and prescriptive liquidity requirements in the NPR and the single counterparty credit limit and how they would apply separately to the IHC and to the branch network have also generated extensive comment and concern.

(See the box below for additional information on the comments covering each of the proposal's components.)

[1] "Enhanced Prudential Standards for Foreign Banking Organizations: An Impact Assessment," Oliver Wyman, www.oliverwyman.com/Enhanced_Prudential_Standards_for_Foreign_Banking_Organizations.htm#.UYv5B-Tkvj4, 30 April 2013.

Next steps

So, what's next? The comments argue strongly for delayed and phased implementation, at a minimum, and for aligning the timetable with that for related international efforts, such as the Basel Committee's Liquidity Coverage Ratio, to maximize global consistency. In addition, several commenters have recommended that the Fed conduct quantitative impact studies before setting requirements that could have unintended consequences.

The NPR contemplated a 1 July 2015 compliance date. With the expectation that it will take at least several months for the comments to be evaluated and a final rule to be implemented, the "worst-case scenario" for foreign banks covered by the proposal would be for no significant changes in the final rule from the NPR and roughly only 18 months to have to come into compliance (assuming a final rule perhaps around year-end 2013). Many of these requirements represent large-scale, multiyear implementation efforts (e.g., the Fed's Comprehensive Capital Analysis and Review, or CCAR program). Absent clear signals to the contrary from the Fed regarding both substance and timing, this suggests that detailed planning needs to begin right away to assess options and associated resource requirements from a business, operational, structural, infrastructure and tax perspective to allow for an effective implementation assuming the core elements of the proposal survive. Alternatively, to count on major changes in the final rule and delays in implementation while waiting for clarity could complicate considerably what will be a difficult implementation even in the best of circumstances.

Summary of comments by major NPR topic

Intermediate Holding Company requirements:

- The NPR threshold for formation of the IHC is too low. The US$10 billion threshold brings into scope financial institutions that are not currently designated as systemically important by the Financial Stability Oversight Council.
- The "one size fits all" approach is not mandated by Section 165/166 of the Dodd-Frank Act and does not take into account various forms of doing business in the US, ultimately discriminating against FBOs.
- The scope of entities that would have to be consolidated under the IHC is too broad, resulting in adverse tax consequences and fundamentally shifting the way that FBOs operate in the US markets.

Capital and leverage limits:

- The requirements will hamper the ability of FBOs to manage capital centrally and could increase overall funding costs for FBOs, as compared with BHCs, creating an "unlevel playing field." The IHC would be denied the benefit of its parent's global capital and liquidity support in a way that is not comparable to how US-headquartered banking organizations are regulated.
- The proposed rule goes beyond the Basel III capital requirements, as an FBO's US IHC would have to maintain its own capital, in addition to the capital required to be held by the US bank subsidiary, US broker-dealer and foreign parent, resulting in significant additional costs and operational risks.
- The comments stressed the importance for the Federal Reserve to ensure the requirements are consistent with the capital and leverage limits and timeline already agreed to by BCBS (Basel III) and the G20.

Liquidity:

- Many letters highlighted that the assumption that the parent would not provide funding to US subsidiaries is over-simplified and in many cases inconsistent with the FBOs' legal obligations to support their foreign operations. Trapping liquidity in particular jurisdictions makes systemically important financial institutions less resilient at a time of crisis and could result in contagion.
- The NPR would place significant limits on the ability of an FBO to take into account intra-group funding flows, both across borders and within the US.
- Many noted that foreign sovereign debt would not be permitted automatically as a high-quality liquidity asset for buffer calculations, putting FBOs at a disadvantage relative to their US counterparts.
- The comments highlighted the misalignment with Basel III rules and the higher standards FBOs will be subject to.

Stress tests and early remediation:

- The comments stressed that the Federal Reserve needs to develop a detailed understanding of the FBO's home-country stress-testing requirements to ensure they do not require duplicative or contradictory processes/measures.
- Stress-testing US subsidiaries in isolation does not account for the way the subsidiaries interact with the parent organization (e.g., transferability of capital between the parent and the US subsidiaries, parent-level guarantees).
- The bank-centric early remediation framework was viewed as inappropriate and too inflexible for all institutions. There were concerns that this would result in the application of inappropriate and potentially counterproductive remediation measures if an FBO trips a remediation trigger (e.g., capital, stress tests, risk management, liquidity risk management or market indicators).

Single-counterparty credit limits (SCCLs):

- The proposal should give FBOs the option to provide reporting of compliance with comparable consolidated exposure limits imposed by home country regulators, instead of applying SCCL to the IHC.
- FBOs and their IHCs should continue to be able to use home-country "sovereign entities" as eligible protection providers. High-quality sovereign debt and "major host country" sovereign debt should be exempt.
- Restrictions on "central counterparties" (e.g., clearing entities) will create constraints as DFA Title VII requires clearing through central counterparties selected by customers.

Risk management:

- FBOs need to be able to implement a comprehensive risk strategy that addresses the risks posed by the entire enterprise. FBOs already have management and governance structures that define risk appetite at the group level, and the allocation of that risk appetite needs to be a group-wide decision that considers local regulations where appropriate.
- A US independent director is not necessary to achieve the goals of the US risk committee. The Board should defer to home-country supervisors for judgments regarding appropriate independence standards.
- Banks should be given discretion in appointing a US chief risk officer. Many highlighted that the specific minimum qualifications requirements are too prescriptive.

Timing:

- July 2015 was viewed as too aggressive a compliance date to allow orderly implementation of such a broad suite of regulatory requirements.

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Global Regulatory Network

Ernst & Young's Global Regulatory Network is an integral part of our Financial Services Office and enables Ernst & Young to offer banks deep experience, leadership and insights on financial regulation.

Our global regulatory services are led by an executive team of former senior regulators, including former Basel Committee Secretary General Stefan Walter. This team, supported by more than 100 other former regulators, drives Ernst & Young's strategic outlook on global regulatory themes impacting global banks, including capital, liquidity, resolution and recovery planning, risk governance and other emerging topics in banking regulation.

Stefan Walter was secretary general of the Basel Committee on Banking Supervision from 2006 to 2011. During this time, he was also a member of the Financial Stability Board. He has more than 20 years of international bank supervisory experience, including 15 years at the Federal Reserve Bank of New York.

Dr Tom Huertas is a former member of the FSA's Executive Committee. He also served as alternate chair of the European Banking Authority, as a member of the Basel Committee on Banking Supervision and as a member of the Resolution Steering Committee at the Financial Stability Board.

Patricia Jackson is the former head of the Bank of England Regulatory Policy. She was the head of the Financial Industry and Regulation Division from 1995 to 2003 and was a member of the Basel Committee from 1995 to 2003. She chaired the global Quantitative Impact Studies to test the effect of Basel II and chaired the Calibration subgroup.

Don Vangel, Regulatory Advisor to the Office of the Chairman, joined Ernst & Young after a 17-year career at the Federal Reserve Bank of New York where he ultimately served as a Senior Vice President for Bank Supervision.

Urs Bischof is the former head of Risk Management of the Extended Executive Board of Switzerland's FINMA. His responsibilities included risk management supervision and oversight and prudential regulations, along with leadership roles with respect to Basel III, SIFI regulation, payments and clearing.

Marie-Helene Fortesa has extensive regulatory experience. Her posts have included leadership roles at the Autorité de Contrôle Prudentiel (French Prudential Supervisory Authority), the Association Française des Banques (French Banking Association) and INSEE (French National Institute for Statistics and Economic Studies), as well as senior roles at a leading investment bank.

John Liver's experience includes a number of regulatory roles with leading investment banks as well as the UK FSA and its predecessors. His roles include head of thematic supervision in the Investment Firms Division, head of Personal Investment Authority Supervision, overseeing the sales regulation of the life and pensions industry, and management roles in Investment Management Regulatory Organization's Enforcement and Supervision Departments.

Phil Rodd and **Keith Pogson** have extensive experience working with regulators across the Asia-Pacific region. **Hidekatsu Koishihara** is a former chief inspector and Inspection administrator for the Japan Financial Services Agency. He also worked at the Ministry of Finance of Japan (MOF), Japan's former financial regulator, serving as the financial inspector at the Bank Bureau of MOF and Financial Inspection Division, and Minister's Secretariat of MOF.