

# ***FS Regulatory Brief***

## ***Fed to raise requirements for foreign banks*** **Not waiting for home country regulators**

November 2012

### ***Federal Reserve to propose that large foreign bank SIFIs would be required to establish a top-tier Fed-regulated US intermediate holding company over all US bank and US nonbank subsidiaries***

Federal Reserve Governor Daniel K. Tarullo – who has become the Fed’s chief spokesman and architect of financial regulatory reform – used the occasion of a speech before the Yale School of Management Leaders Forum on November 28, 2012 to outline a new “modified” regulatory approach which substantially narrows the structural flexibility that has been afforded to Foreign Banking Organizations (FBOs) operating in the US. This new approach (hereinafter referred to as the “Tarullo proposal”) would require all US subsidiary operations of an FBO to roll up under a top-tier US holding company. However, it stops short of a complete subsidiarization model which would require roll-up of branches as well. Governor Tarullo said that the approach will be formally unveiled “in the coming weeks” by the Fed’s issuance of a Notice of Proposed Rulemaking (NPR), with “all-important details” currently under discussion at the Fed Board of Governors (Board). We understand that this speech was to be given nearly a month ago, but was delayed by Hurricane Sandy, so don’t assume the usual delays here, the NPR will likely be out very soon.

### ***The Tarullo proposal***

The crux of the proposal will be to require large Systemically Important Foreign Banking Organizations (SI-FBOs) which operate a network of subsidiaries (bank and nonbank) to form a top-tier US intermediate holding company (IHC). US branches and agencies of foreign banks however would not be included in the IHC because they are part of the parent foreign bank.

The formation of these IHCs would allow US regulators to supervise these institutions similarly to US Systemically Important Bank Holding Companies (SIFI BHCs) meaning that they would be subject to US SIFI BHC capital rules including capital and liquidity buffers and surcharges. Moreover, these IHCs would be subject to the same enhanced prudential standards as US SIFI BHCs – including stress-testing, risk management and governance requirements, single counterparty credit exposure limits and early remediation requirements. While many of these US subsidiaries are already regulated on a legal entity basis, no specific requirement exists today to mandate that all FBO subsidiary operations in the US fall under a top tier US consolidating entity. Consequently, FBOs which recently made organizational moves to streamline capital requirements would once again be caught in the “net” unless the operations are moved to a branch. Even more significantly, FBOs that only have US branches and US nonbank subsidiaries would for the first time be required to establish a US holding company structure that must comply with US SIFI BHC capital and other requirements.

Despite the fact that US branches and agencies of foreign banks would not be required to be part of the IHC, the Fed is clearly concerned about the “dollar funding model” of many of FBO branch operations which will be subject to new liquidity standards.

Governor Tarullo noted that the Fed would work to ensure that the proposed new regime is “minimally disruptive through transition periods and other means.” Despite the comfort offered, this proposal is a significant departure from the traditional US approach of allowing foreign banks to choose among structures that they believe promote maximum efficiency at the consolidated parent level. Instead, the largest FBOs would be required to have a uniform IHC structure. In defending the proposal, the Governor specifically rejected the traditional case-by-case approach to structure and regulation as involving, in his judgment, the “worst of both worlds” – an ongoing intrusiveness into how FBOs are regulated in their home country without the ability to evaluate the FBO comprehensively or direct changes at the parent level to mitigate risks in the US.

### ***Which foreign banks would likely be affected?***

Under the Tarullo proposal, an FBO would only be required to establish an IHC if it operates through US subsidiary operations and the foreign bank is “large,” meaning an SI-FBO. This proposal is directly aimed at SI-FBOs which operate sizeable broker dealer and asset management activities in the US. Many of these firms also operate a number of unregulated subsidiaries which assist in US and global operations but are not subject to capital and other BHC regulations.

Governor Tarullo noted in his speech that 23 foreign banks have at least \$50 billion in US assets (both bank and nonbank), compared with 25 US BHCs that meet the \$50 billion threshold, which triggers enhanced prudential standards for US BHCs. He also noted that whether foreign banks with relatively small operations in the US “should be subject to the same prudential requirements as those with

US operations in excess of \$50 billion is an open question.”

Subject to the “all-important details” to be determined by the Fed’s Board, the implication is fairly clear that the Tarullo proposal is likely to apply IHC requirements to SI-FBOs that have US subsidiary operations and that have US assets of \$50 billion or more. However, it would not be surprising for the Fed to also preserve its right to require other FBOs to establish IHCs for specific supervisory reasons.

### ***Why require an IHC structure for large US operations of foreign banks?***

Governor Tarullo cited a number of factors in his speech to support the need for a “rebalanced approach” to foreign bank regulation in the US, including:

- A shift of foreign banks away from commercial lending to capital markets activities that are more complex and create more interdependencies with other large US and non-US financial institutions that could impact US financial stability – broker-dealer assets at the 10 largest foreign banks went from 13% of all foreign bank third party assets in 1995 to 50% in 2011.
- A greater concentration of third-party assets at fewer, larger FBOs in the US whose systemic importance rivals that of the largest US BHCs in many areas – five of the ten largest US broker-dealers are owned by FBOs and ten FBOs now account for more than two-thirds of foreign bank third-party assets held in the US, up 40% from 1998.
- Less confidence that in all cases a parent foreign bank will act as a source of strength to its US operations – citing in part “constraints” that have been placed on the ability of some large international banks to support their foreign operations – which places more emphasis on capital and liquidity supporting local subsidiary operations.

- The fact that several national authorities have already introduced their own policies to fortify the resources of internationally-active banks within their borders – citing UK requirements for liquidity to cover local operations of domestic and foreign banks and Swiss authorities explicitly prioritizing the domestic systemically important operations of their large active firms – which suggests a modified territorial approach is prudent in light of these types of developments.
- While a foreign bank regulatory regime designed to accommodate centralized management of capital and liquidity can provide efficiency in good times, it can increase the chances of ring-fencing by home and host jurisdictions at the moment of a crisis – citing capital and liquidity trapped at the home entity of Lehman Brothers during the crisis.
- Dodd-Frank provisions requiring the Fed to develop enhanced prudential standards for foreign banks, requiring FHCs to be well-capitalized and rescinding SR 01-01 in 2015 – SR 01-01 is the Fed's guidance that exempts BHCs owned by FBO FHCs from having to comply with US BHC capital requirements – collectively provide political and legal support for requiring IHCs as a prudential requirement.
- Despite continued work by the Financial Stability Board, challenges to cross-border resolution is likely to remain significant –an IHC would help mitigate resolution difficulties by providing US regulators with one consolidated legal entity to put into receivership under the Orderly Liquidation Authority of title II of Dodd-Frank.
- As with the likelihood of cross-border resolution, Governor Tarullo appears to take a *pragmatic* approach as well to harmonization, as he states that it is “not clear that we should aim toward extensive harmonization of national regulatory practices related to foreign banks” – citing substantial differences in FBO

operations among national markets and emphasizing that due to the importance of the US dollar in international transactions, foreign banks may be motivated in their US operations to raise dollar funding that can be used for their international operations “potentially creating vulnerabilities.”

### ***What would likely be the greatest impacts of this major shift in policy?***

- SI-FBOs that already have a US BHC Structure because they own a US bank will have to move US nonbank subsidiaries currently outside the BHC into the BHC (which becomes an IHC) and/or establish a top-tier IHC structure that includes all US bank and nonbank subsidiaries within the same chain of ownership.
- SI-FBOs that do not have a current BHC structure in the US will have to create an IHC structure that includes all US nonbank subsidiaries and presumably meets US BHC enterprise risk management and compliance requirements and expectations.
- In either of the preceding situations, there will be a significant expansion of US nonbank subsidiary assets covered by consolidated US BHC SIFI capital requirements. Will the Collins Amendment minimums apply across the board to these new SI-FBO capital requirements? Will the Fed propose a transition period for adjusting to the new BHC capital requirements based on Basel or other timing?
- Aside from the capital and financial costs of having to comply with such IHC requirements there are the additional associated costs as well of bringing more US nonbank subsidiaries under the FR Y-9C regulatory reporting requirements for affected FBOs.

- Because the Tarullo model questions the availability of home country support in difficult times and acknowledges the risks of ring-fencing during such periods, credit limits under an IHC structure will have to be managed on a legal entity or perhaps country basis.
- The Governor describes at length the shift from a “lending branch” to a “funding branch” model at US branches of FBOs and notes that large intra-firm cross-border flows grew rapidly during the years leading up to the crisis. This created a degree of cross-currency funding risk and heavy reliance on swap markets that proved destabilizing and, in some cases, resulted in substantial discount window access for FBO branches. Given this emphasis on US branch activities, it is reasonable to expect that to meet new liquidity standards for branches that SI-FBOs may need a full treasury operation within the US to manage liquidity.
- The potential for legal entity alignment that may be prompted by additional capital and liquidity requirements for the US footprint could also have implications for reorganization tax consequences.

## ***What should affected FBOs be doing now?***

Based on the policy/structural outline in the Tarullo proposal, there are at least some basic assessments that can be started absent the language of a formal NPR and the “all-important details.”

- Assess US operations
  - Are there operations that can be efficiently relocated offshore?
  - Are there activities that can be done more efficiently in a branch?
- Assess impact of new capital, liquidity and governance requirements as proposed for US BHC SIFIs.
- Assess reorganization and other tax impacts that may be triggered by aspects of the proposal.
- Assess opportunities for collaborating with other FBOs and relevant US and non-US trade groups in analyzing the proposal in terms of broader G-20, Basel and other principles.
- Alert home country regulatory and finance officials to the possible implications.
- Begin developing a list of key issues for a dialogue with the Fed prior to the NPR (if possible).

# Additional information

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