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Evolving Perspectives on Regulation of Foreign Banking Organizations – Remarks of Fed Governor Tarullo

Executive Summary

In a speech by Federal Reserve Board ("Fed") Governor Daniel K. Tarullo before the Yale School of Management Leaders Forum on November 28th, Governor Tarullo described and promoted an evolving regulatory regime for foreign banking organizations ("FBOs") that would be more reflective of the post-crisis economic environment and the presence and significant role these firms have in current U.S economic development and stability.

As currently envisioned by Governor Tarullo, the enhanced supervisory approach to foreign banks would incorporate the following aspects:

- A more uniform structure for the largest U.S. operations of foreign banks, specifically, that these firms establish a top-tier U.S. intermediate holding company ("IHC") over all U.S. bank and nonbank subsidiary activities;
- Application of the same capital rules that currently apply to U.S. bank holding companies ("BHCs") would also apply to any existing and newly-formed U.S. IHCs; and
- Enhanced liquidity standards for the U.S. operations of large foreign banks.

The impetus for change in the supervision and regulation of foreign banking activities in the U.S was mandated by the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "Dodd-Frank Act"). Congress included in the Dodd-Frank Act a number of changes directed at the financial stability risk posed by foreign banks. Among these are Sections 165 and 166, which instruct the Fed to implement enhanced prudential standards for large foreign banks as well as for large domestic BHCs and nonbank systemically important financial institutions. The Dodd-Frank Act also bolstered capital requirements for financial holding companies ("FHCs"); including foreign FHCs, by extending the well-capitalized and well-managed requirements beyond U.S. bank subsidiaries to the top-tier holding company.

The details of how these changes will be put into practice are under consideration at the Fed Board of Governors ("Board") and will likely take some time to develop, given the input that will necessarily be forthcoming from the other regulatory agencies. This Regulatory Practice Letter ("RPL") captures excerpts and themes from Governor Tarullo's speech and provides comments on KPMG's view of how these changes may impact FBOs.

Background

In the aftermath of the financial crisis, the U.S. regulatory agencies and regulators around the world continue to implement reforms designed to limit the severity of future crises. One area that is still in flux is the large foreign banking organizations operating within the U.S.

Any new approach to the supervision of foreign banking entities' U.S. operations will almost certainly address the significant market presence, systemic considerations and related vulnerabilities that have been created by the growth of FBOs in recent years.

Regulating the U.S. operations of foreign banks presents unique challenges. Although U.S. supervisors have full authority over the local operations of foreign banks, they see only a portion of a foreign bank's worldwide activities, and regular access to information on its global activities is often limited. Foreign banks operate under a wide variety of business models and structures that reflect the legal, regulatory, and business climates in the home and host jurisdictions in which they operate.

In his comments, Governor Tarullo noted that any modification or expansion of the U.S. regulatory oversight of these firms must maintain the principle of national treatment and allow foreign banks to continue to operate here on an equal competitive footing, to the overall benefit of the U.S. banking system and the U.S. economy.

The large intra-firm, cross-border flows that grew rapidly in the years leading up to the crisis created specific vulnerabilities and risks. The ability to move liquidity freely throughout a global banking group provided flexibility and some financial stability benefits during the crisis by enabling banks to respond to localized balance-sheet shocks, but this model also created a degree of cross-currency funding risk and reliance on swap markets that at times proved destabilizing. Other risks were created by the foreign banks that relied on short-term U.S. funding which were then forced to reduce lending rapidly when that funding source evaporated during the crisis, thereby compounding risks to U.S. financial stability.

Although the United States did not suffer a destabilizing failure of foreign banks, many rode out the crisis only with the help and support from home and host country regulators. Following national treatment practice, the Fed provided substantial discount window access to U.S. branches and the opportunity to participate in the Primary Dealer Credit Facility to U.S. primary-dealer subsidiaries of foreign banks.

The Collins Amendment in the Dodd-Frank Act (Section 171) removed the exemption from BHC capital requirements granted by the Fed's Supervision and Regulation ("SR") Letter 01-01. The required phase-out of SR 01-01 was intended to strengthen the capital regime applied to the U.S. operations of foreign banks; however, the organizational flexibility that the amendment gave to foreign banks in the United States has allowed some large foreign banks to restructure their U.S. operations to minimize the impact of this regulatory change. As a result, in the absence of additional structural requirements for foreign banks in the United States (i.e., an IHC), the effectiveness of the regulatory capital regime for large foreign banks with both bank and nonbank operations in the United States depends on the foreign bank's own organizational choices.

Description

Since the crisis, important changes have been made to strengthen international regulatory standards. The Basel III capital and liquidity frameworks are significant, and the proposed capital surcharges for systemically important firms are designed to further strengthen the financial system as a whole. But these reforms are primarily directed at the consolidated level, with less attention directed to specific risk factors and vulnerabilities posed by internationally active banks within the U.S.

Within this context, the Fed identified the need to adjust the regulatory requirements for foreign banks in response to changes in the nature of their activities in the United States, the risks attendant to those changes, and instructions from Congress in new statutory provisions. The modified supervisory approach lends transparency to and helps counteract the risks posed to U.S. financial stability by the activities of FBOs, as manifested in the years leading up to, and through, the financial crisis. Further changes will direct special attention to liquidity risks associated with significant reliance on short-term funding. Additionally, an enhanced supervisory regime should reduce the difficulties in the resolution of cross-border firms during any future crisis.

In modifying the existing regulatory regime for FBOs, Governor Tarullo noted that the Fed remains cognizant of the benefits that foreign banks bring to our economic recovery and of the important policies of national treatment and comparable competitive opportunity. As such, the Fed does not appear to be moving toward a fully territorial model of foreign bank regulation, but instead is making targeted adjustments and refinements to its supervisory activities and programs to address the funding, capital adequacy, cross-border exposures and other risks that are present in the current economic environment.

To supervise the foreign entities in a more efficient and effective manner, the Fed is considering the following changes in its approach to foreign bank supervision:

- First, a more uniform structure should be required for the largest U.S. operations of foreign banks--specifically, that these firms establish a top-tier U.S. intermediate holding company ("IHC") over all U.S. bank and nonbank subsidiaries.
  - An IHC would facilitate the Fed's application of enhanced prudential supervision through increased transparency and provide for consistent treatment across foreign banks while reducing the ability of foreign banks to avoid U.S. consolidated-capital regulations. *It is important to note that as currently under consideration, U.S. branches and agencies would not be included in the IHC because they are an extension of the foreign parent bank.* This is reflective of the existing regulatory treatment of branches and agencies. However, they would be subject to the activity restrictions applicable to branches and agencies today as well as to certain additional measures under consideration.
- Second, the same capital rules applicable to U.S. BHCs should also apply to U.S. IHCs.
  - These rules have been reshaped to counteract the risks to the U.S. financial system revealed by the crisis and Governor Tarullo suggests they should be implemented consistently across all firms that engage in similar activities. Similarly, other enhanced prudential standards required by the Dodd-Frank Act (including stress testing requirements, risk management requirements,

single counterparty credit limits, and early remediation requirements) should be applied to the U.S. operations of large foreign banks in a manner consistent with the Board's domestic proposal.

- Third, there should be liquidity standards for large U.S. operations of foreign banks.
  - The Fed is considering standards to increase the liquidity resiliency for the U.S. operations of foreign banks during times of stress. For IHCs, the standards would be broadly consistent with the standards the Fed has proposed for large domestic BHCs, pending final adoption and phase-in of quantitative liquidity requirements by the Basel Committee on Banking Supervision. They would be designed to ensure that, in stressed circumstances, the U.S. operations have enough high-quality liquid assets to meet expected net outflows in the short term. There is further consideration being given to liquidity standards for foreign bank branch and agency networks in the United States, although they will likely be less stringent in recognition of the integration of branches and agencies into the global bank as a whole.

The principle behind all of the regulatory efforts directed at FBOs is the expectation and reliance on the foreign bank to act as a source of strength to its U.S. operations. The Fed's view is that the likelihood that some home-country governments of significant international firms will backstop their banks' foreign operations in a crisis appears to have diminished over time. It also appears that constraints have been placed on the ability of the home offices of some large international banks to provide support to their foreign operations. As Governor Tarullo noted, the motivations behind these actions are not hard to understand and appreciate but they do affect supervisory considerations for host countries such as the United States.

Commentary

Although the development of the formal proposal and the details around the implementation of this change in the supervision of FBOs is still under consideration at the Board, this portends a very significant development for foreign banks currently operating both banking (wholesale and retail) and non-banking subsidiaries in the U.S. in an unconsolidated manner.

It is not uncommon for the Fed to introduce proposed supervisory changes in this manner to gauge the reaction of effected firms before finalizing proposed changes through the rulemaking process and seeking public comment. Governor Tarullo is promoting the Fed's view that an evolved regulatory regime for FBOs should include an IHC structure. This is a significant departure from the prior Fed acceptance of a "virtual BHC" structure in the U.S. whereby all U.S. operations of a foreign bank can be managed and governed on a holistic basis without the formality – and regulatory oversight and reporting requirements – that are associated with a tiered legal entity structure. The Fed has heretofore accepted a "virtual" BHC in the absence of a formal BHC if a formal U.S. governance framework inclusive of U.S. CEO, CRO and Risk and Compliance Committees had been established. Those tiered positions and structures will likely be requisites of an IHC.

It is apparent that the informal "virtual" holding company approach taken by many large foreign entities has proven to be less than ideal from the regulatory standpoint. Requiring the formalization of these governance structures, along with the requisite reporting to the regulatory agencies, will increase the transparency into the U.S. operations of foreign banks and provide the Fed and other regulators with the data and information to carry-out their prudential supervisory oversight. While this facilitates the Fed's efforts, there will undoubtedly be a cost associated with the establishment of these new IHCs and may further complicate the internal managerial and reporting lines within foreign banks. Further, there may be unintended consequences and additional costs associated with these changes. The potential tax implications and the potential that other jurisdictions may take a similar "localization" approach like the Fed's by requiring the consolidation of legal entities may increase the cost of doing business significantly with little or no benefit to the firms.

By imposing a more standardized regulatory structure, the Fed will be better positioned to apply the enhanced prudential standards (Refer to RPL 12-04) consistently across foreign banks and in comparable ways between U.S. banking organizations and FBOs. As with domestic banking entities subject to enhanced prudential standards, Governor Tarullo indicated that the Fed will work to ensure that the new foreign bank supervisory regime is minimally disruptive, through transition periods and other means.

Whether this will impact the desire of foreign banking institutions to maintain or make further investments in their operations within the U.S. has yet to be determined, though it is unlikely we will see a major strategic shift away from the U.S. market even if these regulatory changes are established. As Governor Tarullo noted, this reconsideration of the regulatory approach to FBOs reflects the important role the foreign banks play within the U.S. financial system and the recognition that these firms provide unique competitive and countercyclical benefits.

This proposed shift in regulatory focus to a more formalized IHC structure is by no means a surprise. We have thought for some time that the Fed would move toward this approach, especially once the agency took on new authority under the Dodd-Frank Act with respect to macro-prudential supervision and oversight of systemic risks presented by the largest and most complex foreign and domestic firms operating within the U.S. Affected entities should evaluate the potential impact of any forthcoming proposals, giving consideration to their efforts to address U.S. organizational and governance structures brought about by the Fed's new authority.

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