



New Regulatory Framework for Foreign Banks with U.S. Operations

Federal Reserve Unveils Proposal to More Stringently Regulate and Supervise Foreign Banking Organizations Operating in the United States

December 19, 2012

On December 14, 2012, the Federal Reserve Board issued a notice of proposed rulemaking to apply enhanced prudential standards and an early remediation framework to foreign banking organizations (“FBOs”) with \$50 billion or more in total global consolidated assets.¹ The proposed rules implement Sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and, together with other rulemakings, would result in the most dramatic regulatory change in more than a decade for foreign banks having a U.S. presence. Comments on the 304-page proposal, which also includes more than 100 questions for public comment, are due in March 2013.

The proposal is “broadly consistent” with the proposal that was issued by the Federal Reserve in December 2011 with respect to U.S. bank holding companies.² The Federal Reserve is in the process of considering comments with regard to that prior U.S. bank holding company proposal, and any changes will impact the final rule applicable to FBOs.

The proposal includes a number of important new provisions, including:

- *A U.S. Intermediate Holding Company Requirement:* An FBO with both \$50 billion or more in total global consolidated assets and U.S. assets (excluding the total assets of each U.S. branch and agency) of \$10 billion or more would be required to establish a U.S. top-tier intermediate holding company (“IHC”) over all U.S. bank and nonbank subsidiaries. This holding company would be the focus of the enhanced prudential requirements under the proposal. Minority interests in U.S. companies and U.S. joint ventures would generally be included if the FBO owns a 25% or greater voting interest. U.S. branches and agencies of FBOs, however, would not be included within the holding company, as they are not separate legal entities from the FBO parent.
- *Risk-Based Capital and Leverage Requirements:* An FBO’s intermediate holding company, regardless of whether it controls a bank, would be subject to the same capital adequacy standards, including minimum risk-based capital and leverage requirements, as those applicable to U.S. bank holding companies. This may require significant capital adjustments for

FBOs that operate U.S. nonbanking businesses with lower capital requirements.

Current U.S. capital requirements will increase as the Federal Reserve implements Basel III. The proposal notes that the Federal Reserve may consider in a future rulemaking adopting a domestic surcharge on the largest foreign bank holding companies. Branches and agencies (which are not included in the U.S. intermediate holding company structure) will continue to be subject to home country capital standards, but with enhanced reporting requirements to the Federal Reserve.

- Liquidity Requirements: An FBO with U.S. assets of \$50 billion or more would be required to have its U.S. operations satisfy certain liquidity risk management standards, conduct liquidity stress tests, and maintain a 30-day buffer of highly liquid assets, enumerated examples of which include cash and obligations of the U.S. government. An FBO with U.S. assets of less than \$50 billion would be required to conduct an internal liquidity stress test and report the results to the Federal Reserve on an annual basis. Failure to report such results would result in intragroup funding restrictions for the FBO's U.S. branch and agency network.
- Capital Plans and Stress Testing: The largest FBOs with the most significant U.S. operations (*i.e.*, those FBOs with \$50 billion or more in total global consolidated assets and \$50 billion or more in combined U.S. assets, excluding the assets of their U.S. branch and agency networks) would have heightened compliance obligations with respect to capital plans and stress testing. These organizations' U.S. IHCs would be subject to the Federal Reserve's Comprehensive Capital Analysis and Review ("CCAR"), as conducted under the Federal Reserve's capital plan rule, and would be required to submit annually to the Federal Reserve the results of supervisory and company-run stress tests.

The proposal also includes requirements relating to single-counterparty credit limits, overall risk management, debt-to-equity limits, and early remediation for the U.S. operations of FBOs.

FBOs with total global consolidated assets of \$50 billion or more as of July 1, 2014 will be subject to the proposed rules starting on July 1, 2015. FBOs that cross the \$50 billion threshold later would generally be required to comply with the enhanced prudential standards beginning 12 months thereafter. Stress test requirements and the capital plan rule would be applied in October of the year after that in which an FBO is required to establish a U.S. intermediate holding company. The Federal Reserve has discretion to accelerate or extend the date by which an FBO or U.S. intermediate holding company must comply with any of the requirements under the proposal.

A. Scope of Application

The proposal is structured with tiered levels of regulation depending upon the size of an FBO's global and U.S. consolidated assets, with the most comprehensive U.S. regulation applied to those FBOs with U.S. consolidated assets of more than \$50 billion. Some aspects of the proposal apply to FBOs with \$10 billion or more in total global consolidated assets; additional aspects apply to FBOs with total global consolidated assets of more than \$50 billion; and the most stringent aspects apply to FBOs with U.S. consolidated assets of more than \$50 billion, as detailed in the table below.³

Scope of Application for FBOs

Global Assets	U.S. Assets	Requirements
> \$10 billion and < \$50 billion	n/a	<p>Must:</p> <ul style="list-style-type: none"> • Have a U.S. risk committee • Meet home country stress test requirements that are broadly consistent with U.S. requirements
> \$50 billion	< \$50 billion	<p>All of the above, plus:</p> <ul style="list-style-type: none"> • Meet home country capital standards that are broadly consistent with Basel standards • Single-counterparty credit limits • Subject to an annual liquidity stress test requirement • Subject to early remediation requirements • Subject to U.S. intermediate holding company (IHC) requirements: <ul style="list-style-type: none"> ○ Required to form U.S. IHC if non-branch U.S. assets exceed \$10 billion. All U.S. IHCs are subject to U.S. BHC capital requirements ○ U.S. IHC with assets between \$10 and \$50 billion subject to stress testing (company-run stress test)
> \$50 billion	> \$50 billion	<p>All of the above, plus:</p> <ul style="list-style-type: none"> • U.S. IHC with assets >\$50 billion subject to capital plan rule and all stress test requirements (CCAR) • U.S. IHC and branch/agency network subject to monthly liquidity stress tests and in-country liquidity requirements • Must have a U.S. risk committee and U.S. chief risk officer • Subject to nondiscretionary early remediation requirements

B. Requirement to Establish a Top-Tier U.S. Intermediate Holding Company

A key feature of the proposal is the requirement that an FBO establish a U.S. IHC if it has both (i) \$50 billion or more in total global consolidated assets *and* (b) \$10 billion or more in combined U.S. assets (excluding assets of its U.S. branches and agencies).⁴ FBOs meeting these thresholds—according to the Federal Reserve, there are currently at least 23 such banks—as of July 1, 2014 must comply with the IHC requirement starting on July 1, 2015.

Structurally, the IHC requirement is significant because it will require FBOs—many for the first time—to have a single top-tier U.S. entity over their U.S. bank and nonbank subsidiaries. An FBO must hold its interests in any U.S. subsidiary exclusively through the U.S. IHC, although U.S. branches and agencies, as well as so-called “Section 2(h)(2)” companies, are not required to be placed under this structure.⁵ Importantly, for purposes of the IHC requirement, the term “subsidiary” is defined by reference to the traditional and broad concept of “control” under the Bank Holding Company Act of 1956, as amended (the “BHC Act”). That is, a subsidiary includes any company (or similar entity) for which the FBO directly or indirectly: (i) owns, controls, or has the power to vote 25% or more of any class of voting securities; (ii) controls in any manner the election of a majority of its directors; or (iii) exercises a controlling influence over its management or policies. The proposal also indicates that FBOs will be required to transfer to the U.S. IHC any controlling interests in U.S. companies held as merchant banking investments.

The Federal Reserve retains discretion to allow an FBO to hold its interests in U.S. subsidiaries within alternative structures (including through multiple U.S. IHCs) if, for example, applicable law restricted it from owning or controlling a particular subsidiary through a single U.S. IHC or if other circumstances (on an “exceptional basis”) warrant an exception based on the FBO’s activities, scope of operations, or structure.

Substantively, the IHC requirement is significant because it will serve, in the words of the proposal, as a “platform” and “focal point” for the Federal Reserve to supervise and regulate the U.S. operations of FBOs on a “consistent, comprehensive, and consolidated basis.” Accordingly, each U.S. IHC will be subject to the panoply of capital, leverage, liquidity, risk management, and other requirements set forth in the proposal. Under the risk management requirements under the proposal, U.S. IHCs must have a board of directors to ensure strong, centralized corporate governance. U.S. IHCs will also be required to furnish reports to the Federal Reserve in the same manner and to the same extent as bank holding companies. In addition, they and their subsidiaries may be subject to examination and inspection by the Federal Reserve.

FBOs subject to the IHC requirement would need to provide after-the-fact notice to the Federal Reserve within 30 days of establishing a U.S. IHC. A U.S. IHC must be organized under U.S. federal or state law, although the proposal does not require any particular corporate form (*e.g.*, corporation, limited liability company, partnership).

There is no requirement that a U.S. IHC be wholly-owned by its FBO parent, and the preamble to the proposal states that a U.S. IHC could have minority investors.

C. Risk-Based Capital and Leverage Requirements

When an FBO has sought to establish a branch, agency, or bank in the United States, the Federal Reserve has traditionally relied on an FBO's satisfaction—on a consolidated basis—of capital requirements imposed by its home country banking supervisor, provided that such requirements are equivalent to those required of a U.S. banking organization.⁶ In addition, since 2001, the Federal Reserve has permitted the top-tier U.S. bank holding company subsidiaries of FBOs that qualify as financial holding companies to have little or even negative capital in reliance on Supervision and Regulation Letter 01-01. Under the proposal, and consistent with other provisions of Dodd-Frank, including the Collins Amendment (which requires the U.S. bank holding company of FBOs that relied on SR Letter 01-01 to meet the minimum capital requirements established for other U.S. bank holding companies by July 21, 2015), risk-based and leverage capital requirements applicable to U.S. holding companies will now apply to top-tier U.S. holding companies of FBOs.

1. Capital and Leverage Standards for U.S. IHCs and a Potential Capital Surcharge for U.S. IHCs Deemed to Be "Systemically Important"

Every U.S. IHC established by an FBO pursuant to the proposal, regardless of whether it controls a bank, will need to satisfy all applicable capital adequacy standards, including minimum risk-based capital and leverage standards, and comply with all restrictions associated with applicable capital buffers, in the same manner and to the same extent as those applicable to U.S. bank holding companies. However, the U.S. branch and agency networks of FBOs would continue to be evaluated based on the FBO's satisfaction of its home country's capital requirements on a consolidated basis.

The proposal contemplates that some U.S. IHCs will be determined to be domestically systemically important banks, which are referred to as "D-SIBs," consistent with the framework recently established by the Basel Committee on Banking Supervision or some other framework.⁷ As a result, these institutions could be subject to a quantitative risk-based capital charge, in addition to all other capital requirements and buffers that they would be subject to under the revised capital requirements to be implemented by the Federal Reserve and the other U.S. federal banking agencies pursuant to the Basel III Accord. If the Federal Reserve elects to apply such a surcharge, it would be done through a separate rulemaking, but there is no indication in the proposal as to timing.

2. Capital Planning for Very Large U.S. IHCs

For U.S. IHCs with total consolidated assets of \$50 billion or more, the Federal Reserve will require such companies to comply with the capital plan rule under Section 225.8 of Regulation Y. This rule, which currently applies to large U.S. bank holding companies (except those relying on SR 01-01 that have been exempted until July 21, 2015), requires the submission of annual capital plans to the Federal Reserve detailing how minimum risk-based capital ratios are satisfied—under both baseline and stressed scenarios—over a minimum nine-quarter, forward-looking planning horizon. Dividends and share repurchases are permitted only to the extent reflected in an approved capital plan. Failure to submit a satisfactory capital plan would result

in restrictions on the U.S. IHC's ability to make capital distributions (including redemptions or repurchases of any debt or equity capital instrument and payment of dividends on common or preferred stock).

3. Certification and Reporting Requirements for Very Large FBOs

All FBOs with total global consolidated assets of \$50 billion or more (including those with less than \$10 billion in combined U.S. assets that are not required to establish a U.S. IHC) would be required to certify to the Federal Reserve that they meet capital adequacy standards at the consolidated level that are consistent with the regulatory capital framework established by the Basel Committee, as amended from time to time. FBOs would generally be permitted to rely on the standards established by their home country banking supervisor. The proposal notes that this would apply only risk-weighted capital calculations, and not the U.S. minimum leverage ratio requirements, to FBOs (at least until international leverage requirements are implemented under the Basel III Accord in 2018). The certification would be made concurrently with the organization's FR Y-7Q filing (which is made on a quarterly basis for FBOs that have elected to become financial holding companies and on an annual basis for all other FBOs), and the Federal Reserve may impose conditions or restrictions on the U.S. activities or business operations of an FBO that fails to comply.

D. Risk Management and Risk Committee Requirements

The proposed rules also implement risk management provisions of Dodd-Frank applicable to U.S. operations of FBOs. Section 165(b) of Dodd-Frank requires the Federal Reserve to establish overall risk management requirements, while Section 165(h) requires the Federal Reserve to issue regulations requiring certain publicly traded companies to establish risk committees.

Any FBO with \$10 billion or more in total consolidated assets that has publicly traded stock and any FBO with total consolidated assets of \$50 billion or more (regardless of whether its stock is publicly traded) would be required to establish and maintain a U.S. risk committee at the board level, and to certify to the Federal Reserve annually that its risk committee (i) oversees the U.S. risk management practices of the company and (ii) has at least one member with appropriate risk management expertise. The degree of expertise required of the committee would depend upon the capital structure, risk profile, complexity, activities, and size of the FBO's combined U.S. operations. Generally, the risk committee may be either a committee of the FBO's global board of directors or a committee of the board of the U.S. IHC. An FBO with total U.S. assets of \$50 billion or more must maintain the committee at the U.S. IHC level if it conducts its U.S. business solely through a U.S. IHC (and does not have any U.S. branches or agencies). The risk committee of any FBO with \$50 billion or more in U.S. assets must include at least one independent member who is not an officer or employee of the company.

FBOs with \$50 billion or more in U.S. assets would be required to employ a U.S. chief risk officer with appropriate expertise to oversee the risk management framework of the U.S. operations. The U.S. chief risk officer would report directly to the U.S. risk committee and the company's global chief risk officer and must be employed by a U.S. subsidiary or U.S. office of the FBO.

If an FBO were to fail to satisfy these risk management or risk committee requirements, the Federal Reserve may impose conditions or restrictions on the activities or business operations of the FBO's combined U.S. operations.

E. Liquidity Requirements

The proposal also seeks to improve the overall liquidity resiliency of the U.S. operations of FBOs and to reduce the need for parent and government support during periods of stress. In general, the liquidity requirements largely track those set forth in the domestic proposal and would apply only to those FBOs with combined U.S. assets of \$50 billion or more. For FBOs with total global consolidated assets of \$50 billion or more but less than \$50 billion in combined U.S. assets, the only specific requirement contained in the proposal is that they annually report to the Federal Reserve the results of their internal liquidity stress tests for either their consolidated operations or their combined U.S. operations. Failure to do so would subject an FBO's U.S. branch and agency network to intragroup funding restrictions (on a daily basis, the net aggregate amount owed by an FBO's head office and its non-U.S. affiliates to the combined U.S. operations could not exceed 25% of the third party liabilities of an FBO's combined U.S. operations).

The liquidity requirements are divided into three broad categories: (i) requirements related to the management of liquidity risk, (ii) liquidity stress testing requirements, and (iii) a requirement that an FBO establish a 30-day buffer of highly liquid assets that could be sold or pledged to withstand liquidity stress under adverse conditions.

1. Enhanced Liquidity Risk Management Standards

The proposed rules would require an FBO to take a number of prudential steps to manage liquidity risk, including the following:

- the "liquidity risk tolerance" of the combined U.S. operations of an FBO would be subject to annual review and approval by its U.S. risk committee (described above), with the concurrence of the FBO's board of directors or its enterprise-wide risk committee;
- the U.S. chief risk officer of an FBO would be required to review and approve, in advance, the liquidity costs, benefits, and risks of each significant new business line and each significant new product offered, managed, or sold through the organization's combined U.S. operations, and for existing significant business lines and products there must be a review for unanticipated liquidity risks and to determine whether the liquidity risk of each line or product continues to be within the established risk tolerance for the U.S. operations;
- comprehensive cash flow projections for an FBO's combined U.S. operations would need to be "tailored to, and provide sufficient detail to reflect, the capital structure, risk profile, complexity, activities, size, and other relevant factors" of the FBO and its combined U.S. business operations, including by business line or legal entity where appropriate,

and “identify and quantify discrete and cumulative cash flow mismatches” over short-term and long-term periods; and

- an independent review function would need to be established and maintained to evaluate the liquidity risk management of an FBO’s combined U.S. operations at least annually.

FBOs would also be required to establish and maintain a contingency funding plan that outlines their strategies for addressing liquidity needs in circumstances where normal sources of funding may not be available. In particular, each contingency funding plan would require:

- a quantitative assessment of future liquidity needs and funding sources;
- an event management process that sets out the procedures for managing liquidity during identified liquidity stress events;
- procedures for monitoring emerging liquidity stress events; and
- periodic testing of the components of the contingency funding plan to assess its reliability during liquidity stress events.

To enhance management of liquidity risk, the proposed rules also would require FBOs to establish and maintain specific limits on potential sources of liquidity risk, including three specified sources of liquidity risk:

- concentrations of funding by instrument type, single-counterparty, counterparty type, secured and unsecured funding, and other liquidity risk identifiers;
- the amount of specified liabilities that mature within various time horizons; and
- off-balance sheet exposures and other exposures that could create funding needs during liquidity stress events.

The proposal also requires the monitoring of liquidity risk and collateral positions, as well as intraday liquidity positions, for an FBO’s combined U.S. operations. To promote effective monitoring across the enterprise, FBOs would be required to, among other things, establish and maintain procedures for monitoring and controlling liquidity risk exposures and funding needs within and across significant legal entities, currencies, and business lines.

2. Liquidity Stress Testing

An FBO would be required to conduct monthly liquidity stress tests separately with respect to its U.S. IHC and its U.S. branch and agency network. In addition, the U.S. operations of FBOs may be subject to “ad hoc” stress tests at the request of the Federal Reserve.

At a minimum, the required stress tests must account for, among other things, adverse conditions due to market stress and idiosyncratic stress (and combinations of both) and the potential actions of other market participants experiencing liquidity stresses under market disruptions that would adversely affect the FBO or its combined U.S. operations. Stress tests must also use a variety of time horizons (including, at a minimum, overnight, 30-day, 90-day,

and one-year time horizons) and comprehensively address the activities, exposures, and risks of an FBO's combined U.S. operations.

Consistent with the domestic proposal, an FBO's stress test must incorporate the following assumptions:

- for the first 30 days of a liquidity stress scenario, only highly liquid assets that are unencumbered may be used as cash flow sources to offset projected cash flow needs;
- for time periods beyond the first 30 days of a liquidity stress scenario, highly liquid assets that are unencumbered and other appropriate funding sources may be used as cash flow sources to offset projected cash flow needs;
- if an asset is used as a cash flow source, the fair market value of the asset must be discounted to reflect any credit risk and market price volatility of the asset; and
- throughout each stress test time horizon, assets used as funding sources must be diversified by collateral, counterparty, or borrowing capacity, or other factors associated with the liquidity risk of the assets.

The proposal would also require that an FBO provide to the Federal Reserve, within 14 days, the results of any liquidity stress test and liquidity buffers established by the FBO's home country banking supervisor.

3. Liquidity Buffers

An FBO would need to maintain separate 30-day liquidity buffers for its U.S. IHC and for its U.S. branch and agency network. Each buffer must consist of "highly liquid assets that are unencumbered and that are sufficient to meet the net stressed cash flow need over the first 30 days of its stress test horizon." Highly liquid assets would include (i) cash; (ii) securities issued by the U.S. government, a U.S. government agency, or a U.S. government-sponsored entity; or (iii) any other asset that the FBO demonstrates to the satisfaction of the Federal Reserve as having low credit and market risk, an active two-way market, and is a type of asset that investors historically have purchased in periods of financial market distress during which market liquidity is impaired. An asset would be regarded as "unencumbered" if it is not subject to any pledge or lien, not designated as a hedge on a trading position, and not subject to any other legal or contractual restriction on liquidation or transfer.

Under the proposal, an FBO would be required to keep the highly liquid assets comprising the buffer for its U.S. IHC in the United States. For an FBO's U.S. branch and agency network, the first 14 days of the buffer would need to be maintained in the United States, but the remainder could be outside the United States (*e.g.*, at the parent consolidated level), provided that the FBO demonstrate to the satisfaction of the Federal Reserve that it or an affiliate could provide the residual liquid assets to the U.S. branch and agency network if circumstances warranted.

F. Single-Counterparty Credit Limits

Section 165(e) of Dodd-Frank authorizes the Federal Reserve to prescribe, by regulation, standards that prohibit certain companies from having credit exposure to any unaffiliated company that exceeds 25% of their capital stock and surplus (or such lower threshold if necessary to mitigate risks to U.S. financial stability). As explained in the preamble to the proposal, the recent financial crisis highlighted how “existing regulatory requirements generally failed to meaningfully limit the interconnectedness among large U.S. and foreign financial institutions in the United States and globally.” For example, existing single-borrower and investment limits have been applied at the bank level, but not at the holding company level. In addition, prior to Dodd-Frank, lending limits had excluded credit exposures generated by derivatives and certain securities financing transactions.

Consistent with the domestic proposal, the proposal introduces a two-tier single-counterparty credit limit for FBOs with \$50 billion or more in total global consolidated assets: (i) a general limit on the aggregate net credit exposure to any single unaffiliated counterparty by a U.S. IHC or the combined U.S. operations of an FBO, and (ii) a more stringent limit applicable to aggregate net credit exposures of the largest U.S. IHCs and FBOs. Both limits would be measured based on the U.S. IHC’s or FBO’s capital stock and surplus, respectively, although the preamble to the proposal queries whether common equity would be a better measure and expressly seeks public comment on this point.⁸

1. General 25% Limit on Aggregate Net Credit Exposure

A U.S. IHC, together with its subsidiaries, would be prohibited from having an aggregate net credit exposure to any unaffiliated counterparty, together with its subsidiaries, that exceeds 25% of the IHC’s consolidated capital stock and surplus. In addition, an FBO with \$50 billion or more in consolidated assets would not be allowed to permit its combined U.S. operations, together with any subsidiary of an entity within the combined U.S. operations, to have an aggregate net credit exposure to any unaffiliated counterparty, including subsidiaries of the counterparty, in excess of 25% of the consolidated capital stock and surplus of the FBO. For this purpose, an FBO’s combined U.S. operations include any U.S. IHC and its branch and agency network.

2. A More Stringent Limit on Aggregate Net Credit Exposures Applicable to “Major” U.S. IHCs and FBOs and Their “Major” Unaffiliated Counterparties

The proposed rules impose a more stringent limit for credit exposures between “major” U.S. IHCs and FBOs with total consolidated assets of \$500 billion or more and “major” unaffiliated counterparties of similar size. A major counterparty would include not only other bank holding companies and FBOs with total consolidated assets of \$500 billion or more but also their respective subsidiaries and any nonbank financial company that is supervised by the Federal Reserve. For now, the proposal does not set a specific limit, but it is expected to be at least 10% or whatever limit is ultimately imposed under the domestic proposal.

3. Key Terms and Calculations

(i) *Subsidiaries*

The credit exposure limits under the proposed rules apply to both the U.S. IHC and the U.S. operations of an FBO (referred to at times as “Covered Entities”) and their respective subsidiaries, on the one hand, and to an unaffiliated counterparty and its subsidiaries, on the other hand. A “subsidiary” is a company that is directly or indirectly controlled by another company. For this purpose, a company controls another company if it (i) owns or controls 25% or more of a class of a company’s voting securities, (ii) owns or controls 25% or more of a company’s total equity, or (iii) consolidates the company for financial reporting purposes. Significantly, this standard of control would exclude the more subjective “controlling influence” test contained in the BHC Act and the Federal Reserve’s Regulation Y.

Under the proposal, a fund or vehicle that is sponsored or advised by a U.S. IHC or any part of the combined U.S. operations of an FBO would not be considered a subsidiary (and, thus, exposures to such fund or vehicle would not be aggregated for purposes of the credit limits) unless it falls within the voting/equity ownership or financial reporting “control” tests above. However, the proposal indicates that the Federal Reserve could ultimately use its “reservation of authority to look through a special purpose vehicle either to the issuer of the underlying assets in the vehicle or to the sponsor.”

(ii) *Counterparties*

The proposed rules establish limits on the credit exposure to a single unaffiliated “counterparty,” which is defined to include:

- with respect to a natural person, the person and members of the person’s immediate family, collectively;
- with respect to a company, the company and all of its subsidiaries, collectively;
- with respect to the United States, the United States and all of its agencies and instrumentalities (excluding states and their political subdivisions), collectively;
- with respect a U.S. state, the state and all of its agencies, instrumentalities, and political subdivisions (including any municipalities), collectively; and
- with respect to a foreign sovereign entity, the foreign sovereign entity and all of its agencies, instrumentalities, and political subdivisions, collectively.

Significantly, the Federal Reserve included foreign sovereign entities in the counterparty definition because it believes that credit exposures to such governmental entities create risks that are comparable to those created by large exposures to other types of entities, such as financial firms. However, as discussed below, with regard to the U.S. government and to an FBO’s home country sovereign entity, the proposed rules specifically exempt certain exposures to these entities from the limits.

(iii) *Credit Transactions*

Consistent with the domestic proposal, the proposed rules apply broadly to the following “credit transactions” with a counterparty:

- any extension of credit, including loans, deposits and lines of credit, but excluding advised or other uncommitted lines of credit;
- any repurchase or reverse purchase agreement;
- any securities lending or securities borrowing transaction;
- any guarantee, acceptance or letter of credit (including any confirmed letter of credit or standby letter of credit) issued on behalf of the counterparty;
- any purchase of, or investment in, securities issued by the counterparty;
- any credit exposure to the counterparty in connection with a derivative transaction with the counterparty;
- any credit exposure to the counterparty in connection with a credit derivative or equity derivative transaction with a third party where the reference asset is an obligation or equity security of the counterparty; and
- any transaction that is the functional equivalent of the transactions listed above or any similar transaction that the Federal Reserve determines to be a credit transaction.

(iv) *Calculation of Credit Exposures*

Generally, a Covered Entity will first calculate its “gross credit exposure” and then calculate its “net credit exposure” after taking into account and adjusting for certain credit risk mitigants, such as netting agreements for securities financing transactions; eligible collateral (which would not include any debt or equity securities, including convertible bonds, issued by an affiliate of a U.S. IHC or by any part of the combined U.S. operations of an FBO), subject to haircuts; eligible guarantees; and other forms of credit protection.

(A) *Calculation of Gross Credit Exposure*

The proposal outlines outline how the gross credit exposure of a Covered Entity to a counterparty would be calculated with respect to the following types of credit transactions:

Type of Credit Transaction	Gross Credit Exposure
Loans and leases to a counterparty	The amount owed by the counterparty to the Covered Entity.
Debt securities issued by the counterparty	The greater of the amortized purchase price or market value, for trading and available for sale securities, and the amortized purchase price, for securities held to maturity.
Equity securities issued by the counterparty	The greater of the purchase price or market value.
Repurchase agreements	The market value of the securities transferred by the Covered Entity to the counterparty plus such market value amount multiplied by the

Type of Credit Transaction	Gross Credit Exposure
	applicable collateral haircut to the securities transferred by the Covered Entity to the counterparty.
Reverse repurchase agreements	The amount of cash transferred by the Covered Entity to the counterparty.
Securities borrowing transactions	The amount of cash collateral plus the market value of securities collateral transferred by the Covered Entity to the counterparty.
Securities lending transactions	The market value of securities lent by the Covered Entity to the counterparty plus such market value amount multiplied by the applicable collateral haircut to the securities lent by the Covered Entity to the counterparty.
Committed credit lines to a counterparty	The face amount of the credit line.
Guarantees and letters of credit issued on behalf of a counterparty	The lesser of the face amount or the maximum potential loss to the Covered Entity on the transaction.
Derivative transactions that are not subject to a qualifying master netting agreement	The sum of (i) the current exposure of the derivatives contract equal to the greater of the mark-to-market value of the derivative contract or zero; and (ii) the potential future exposure of the derivatives contract, calculated by multiplying the notional principal amount of the derivative contract by the appropriate conversion factor.
Derivative transactions that are subject to a qualifying master netting agreement	The exposure at default amount calculated under the Basel II-based exposure at default calculation set forth in the Federal Reserve's existing methodology (<i>see</i> 12 C.F.R. Part 225, App. G, § 32(c)(6)); however, with regard to derivatives exposures of U.S. branches and agencies, an FBO could choose either the forgoing calculation or the gross valuation methodology for derivatives not subject to qualified master netting agreements.
Credit or equity derivative transactions with a third party where the Covered Entity is the protection provider and the reference assets is an obligation or equity security of the counterparty	The lesser of the face amount of the transaction or the maximum potential loss to the Covered Entity on the transaction.

With respect to derivative transactions, a “qualifying master netting agreement” is defined in the proposal as a legally enforceable bilateral agreement such that: (i) the agreement creates a legal obligation for all individual transactions covered by the agreement upon an event of default (including bankruptcy, insolvency, or similar proceeding of the counterparty); (ii) the agreement provides the Covered Entity with the right to accelerate, terminate and close-out on a net basis all transactions under the agreement and to liquidate or set off collateral promptly upon an event of default, and that, in such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdiction; and (iii) the agreement does not contain a walk-away clause (*i.e.*, a clause that permits a non-defaulting counterparty to make lower payments than it would make otherwise under the agreement, or

no payment at all, to a defaulter or the estate of a defaulter, even if the defaulter is a net creditor under the agreement).

(B) Calculation of Net Credit Exposure

In calculating net credit exposure, the proposed rules would permit exposures from repurchase and reverse repurchase transactions and securities lending and borrowing transactions that are subject to a bilateral netting agreement (as defined above) with the relevant counterparty to be calculated on a net basis under such agreement.

Importantly, the proposed rules provide that gross credit exposure amounts can be converted into net credit exposure amounts by taking into account eligible collateral, unused credit lines, eligible guarantees, eligible credit and equity derivatives and other eligible hedges. If a Covered Entity has eligible collateral, then it would have the choice to reduce its gross credit exposure to a counterparty by the adjusted market value of that collateral, subject to the applicable regulatory haircut for that type of collateral and to other limitations. If a Covered Entity chooses to reduce its gross credit exposure by the adjusted market value of eligible collateral, however, it would be required to include the adjusted market value of the eligible collateral when calculating its gross credit exposure to the issuer of the collateral (in effect, the Covered Entity would shift its credit exposure from the original counterparty to the issuer of the eligible collateral). The term “eligible collateral” means collateral in which the Covered Entity has a perfected, first priority security interest (or the legal equivalent, if outside the United States), with the exception of cash on deposit and notwithstanding the prior security interest of any custodial agent, and which is in the form of (i) cash on deposit with the Covered Entity (including cash held for the Covered Entity by a third party custodian or trustee); (ii) debt securities (other than mortgage- or asset-backed securities) that are bank eligible investments; or (iii) equity securities that are publicly traded (including convertible bonds); Debt or equity securities (including convertible bonds) issued by an affiliate of the U.S. IHC or by any part of the combined U.S. operations would not be an eligible form of collateral.

Covered Entities would also be able, but not required, to reduce their gross credit exposure by the amount of certain unused extensions of credit, provided generally that the Covered Entities does not have a legal obligation to advance additional funds under the relevant extension of credit and that the relevant credit contract specifies that any unused portion of the credit extension be fully secured by certain high quality collateral, such as cash and U.S. government obligations.

In contrast to eligible collateral and unused credit lines, Covered Entities that have “eligible guarantees,” “eligible credit and equity derivatives” or “other eligible hedges,” each as defined in the proposed rules, would be required to reduce their gross credit exposures to the relevant counterparties by the amount of the eligible guarantees, the notional amount of such eligible credit and equity derivatives, or the face amount of a short sale of the counterparty’s debt or equity securities, as applicable.

4. Attribution Rule

Consistent with Section 165(e)(4) of Dodd-Frank and the domestic proposal, the proposed rules provide that a Covered Entity must treat a transaction with any person as a credit exposure to a counterparty to the extent the proceeds of the transaction are used for the benefit of, or transferred to, that counterparty. In order to minimize administrative burden on FBOs, the Federal Reserve will adopt a “minimal scope of application” of this attribution rule.

5. Compliance

The compliance burden of the single-counterparty credit limits under the proposal lies with each FBO, which must ensure that its U.S. IHC and combined U.S. operations comply on a daily basis at the end of each business day. FBOs must submit monthly reports to the Federal Reserve demonstrating such daily compliance. Subject to limited exceptions, if *either* the U.S. IHC or the FBO is not in compliance with single-counterparty credit limits, then *both* of the U.S. IHC and the combined U.S. operations of the FBO would be prohibited from engaging in any additional credit transactions with respect to a particular counterparty.

6. Exemptions

Certain categories of credit transactions are exempt from the credit exposure limits, including claims that are directly and fully guaranteed as to principal and interest by the United States and its agencies, Fannie Mae and Freddie Mac (only while operating under U.S. conservatorship), or by the FBO’s home country sovereign entity (exposures to other sovereigns, however, are not exempted). In addition, intraday credit exposures to a counterparty would be exempted.

G. Stress Testing Requirements

Section 165(i)(1) of Dodd-Frank directs the Federal Reserve to conduct annual supervisory stress tests of supervised organizations with total consolidated assets of \$50 billion or more, including FBOs and nonbank financial companies supervised by the Federal Reserve, and to make publicly available a summary of those results. In addition, Section 165(i)(2) Dodd-Frank requires each supervised organization, including FBOs and foreign savings and loan holding companies, with total consolidated assets of more than \$10 billion, to conduct company-run stress tests and publish a summary of the results of the company-run stress tests.

On October 9, 2012, the Federal Reserve issued a final rule implementing the supervisory and company-run testing requirements for U.S. bank holding companies. The proposed rules would implement stress test requirements for a U.S. IHC consistently with those required of a U.S. bank holding company. Specifically, U.S. IHCs with total consolidated assets of more than \$10 billion but less than \$50 billion would be required to conduct annual company-run stress tests; and U.S. IHCs with assets of \$50 billion or more would be required to conduct each year both company-run stress tests, as well as supervisory stress tests. The proposal would tailor the stress testing requirements based on the size of the U.S. operations of the FBO.

Assets of \$50 Billion or More. A U.S. IHC that meets the \$50 billion asset threshold as of July 1, 2015 (or an FBO with U.S. assets that meet the threshold as of July 1, 2014) would be required to comply beginning with the stress test cycle that commences on October 1, 2015. Under the proposed rules, such a holding company would conduct two stress tests each year, one using scenarios provided by the Federal Reserve (the “annual test”) and one using scenarios developed by the company (the “mid-year test”). The annual test would occur in the fall and would be reported to the Federal Reserve by January 5, with results made public in March, each year. Results of the mid-year test would be provided to the Federal Reserve by July 5, with results made public in September.

An FBO with total consolidated assets of \$50 billion or more that maintains a U.S. branch or agency that is subject to a home country stress testing regime may satisfy U.S. requirements by providing information to the Federal Reserve regarding the results of its consolidated, home country stress tests.⁹ Regardless of whether home country stress tests are used to satisfy U.S. stress testing, FBOs with combined U.S. assets of \$50 billion or more would be required to submit by January 5 each year to the Federal Reserve information regarding the results of their home country stress tests. When a U.S. branch and agency network is in a “net due from” position to its foreign bank parent or affiliates, the FBO also would be required to report additional information to the Federal Reserve, including any information that the Federal Reserve deems necessary to evaluate the ability of the FBO to absorb losses under stressed conditions.

If an FBO with \$50 billion or more of U.S. assets does not meet the stress test requirements of its home country or the Federal Reserve, then:

- the Federal Reserve would require its U.S. branch and agency network to maintain eligible assets equal to 108% of third-party liabilities;¹⁰
- the FBO would be required to conduct an annual stress test of any U.S. subsidiary not held under a U.S. IHC (other than a Section 2(h)(2) company), to determine whether that subsidiary has the capital necessary to absorb losses; and
- the Federal Reserve may impose intragroup funding restrictions on the FBO’s U.S. operations.

Assets Between \$10 Billion and \$50 Billion. A U.S. IHC with more than \$10 billion but less than \$50 billion in assets as of July 1, 2015 would be required to comply with the stress test cycle that begins October 1, 2015. Such a holding company would conduct one company-run stress test per year, using scenarios provided by the Federal Reserve. The company would report results to the Federal Reserve by March 31 of each year and publicly disclose a summary of the results in June each year.

The proposal also would apply stress testing to FBOs with total consolidated assets of more than \$10 billion, but combined U.S. assets of less than \$50 billion, and foreign savings and loan holding companies with total consolidated assets of more than \$10 billion. These companies

could satisfy these requirements through stress tests conducted by their home country supervisor, as described above. They would not be subject to separate information requirements of the Federal Reserve related to the results of their home country stress tests. However, if they failed to meet their stress tests, these companies would be subject to a U.S. asset maintenance requirement of 105%, and annual stress tests of any U.S. subsidiary not held under a U.S. IHC.

H. Debt-to-Equity Limit for Certain FBOs

Under Section 165(j) of Dodd-Frank, if the FSOC determines that an FBO with total consolidated assets of \$50 billion or more (i) poses a “grave threat” to U.S. financial stability and (ii) the imposition of a leverage limitation is “necessary to mitigate” that threat, then the Federal Reserve must require the company to maintain a debt-to-equity ratio of no more than 15-to-1. The proposed rules would implement this limitation at the U.S. IHC level and for any subsidiary not organized under such structure, as well as imposing a 108% U.S. asset maintenance requirement on its U.S. branch and agency network. This portion of the rule would be effective on the effective date of the final rule.

The proposed rules define “debt” and “equity” as having the same meaning as “total liabilities” and “total equity capital,” respectively, as calculated in a company’s reports of financial condition. The 15-to-1 debt-to-equity ratio would be calculated as the ratio of total liabilities to total equity capital minus goodwill.

An FBO that is subject to a “grave threat” determination by the FSOC will receive written notice from the FSOC. After receiving such notice, the FBO will have 180 calendar days to come into compliance with the prescribed debt-to-equity ratio requirement, although it may seek up to two extensions of 90 days each. The debt-to-equity ratio requirement would remain in effect until the FSOC determines that a particular FBO no longer poses a grave threat to U.S. financial stability and that the imposition of the leverage limitation is no longer necessary.

I. Early Remediation Requirements

To minimize the risk that the insolvency of an FBO with U.S. operations would harm U.S. financial stability, Section 166 of Dodd-Frank requires the Federal Reserve to issue regulations providing for the early remediation of financial distress of the U.S. operations of FBOs. The proposed rules establish this early remediation framework, setting forth a matrix of five remedial triggering events, including several forward-looking triggers, and four levels of remediation actions that FBOs are required to take when the relevant triggering event occurs.

1. Early Remediation Requirements

The proposed rules would implement early remediation requirements for FBOs with total consolidated assets in the U.S. of \$50 billion or more in a manner generally consistent with the domestic proposal. They lay out four levels of remediation requirements and several forward-looking triggers designed to identify emerging or potential issues before they develop into larger problems. The proposed triggers would be based on capital (of both the intermediate U.S. holding company and the FBO), stress tests, risk management, and liquidity standards, as

set forth elsewhere in the proposal, as well as market indicators. These triggers are summarized in a chart accompanying the proposal and are included for reference in Annex A to this memorandum.

All FBOs with U.S. operations subject to Federal Reserve supervision would be subject to the triggers;¹¹ however, only FBOs with combined U.S. assets of \$50 billion or more would be subject to non-discretionary remediation measures once a triggering event occurs, as follows:

(i) *Level 1 – Heightened Supervisory Review*

Under Level 1 remediation, the Federal Reserve would conduct a targeted supervisory review of the U.S. operations of the FBO to determine whether the U.S. operations of the FBO are experiencing financial distress or material risk management weaknesses, including with respect to exposures that the combined U.S. operations have to the FBO, such that further decline of the U.S. operations is probable. If this supervisory review concludes that further decline of the U.S. operations is probable, then Level 2 remediation is implemented.

(ii) *Level 2 – Initial Remediation*

Under Level 2 remediation, the U.S. operations of an FBO would be subject to, among other things: restrictions on capital distributions; asset growth limitations; and restrictions on certain U.S. acquisitions, establishing any U.S. office, engaging in any new business line, or acquiring a controlling interest in any company that would be a subsidiary of the U.S. IHC. An FBO at Level 2 would be required to enter into a non-public memorandum of understanding or other acceptable enforcement action, which may further limit the conduct or activities of the FBO (or any of its affiliates) in the U.S. These limitations would be imposed on the FBO's U.S. IHC, its U.S. branch and agency network, and its combined U.S. operations. While in Level 2 remediation, the U.S. branch and agency network also would be required to remain in a "net due to" position to the FBO, and would be required to maintain a liquid asset buffer in the U.S. sufficient to cover 30 days of stressed outflows.

(iii) *Level 3 – Recovery*

Under Level 3 remediation, an FBO and its U.S. IHC would be required to enter into a written agreement or other formal enforcement action with the Federal Reserve that requires the U.S. IHC to restore its capital. In addition, the U.S. IHC would be subject to, among other things: prohibitions on capital distributions, U.S. asset growth, U.S. acquisitions, establishing any U.S. office, engaging in any new business line, or acquiring a controlling interest in any company that would be a subsidiary of the U.S. IHC. In addition, compensation to executive officers in the U.S. operations could not be increased. While in Level 3 remediation, the U.S. branch and agency network also would be required to remain in a "net due to" position to the FBO and maintain a U.S. asset maintenance ratio of 108%, although it would not be subject to the liquid asset buffer required under Level 2 remediation. In addition, the Federal Reserve has discretion to impose limitations or conditions on the FBO with regard to the conduct of other activities in the U.S.

(iv) *Level 4 – Resolution Assessment*

Under Level 4 remediation, the Federal Reserve must consider whether the combined U.S. operations of the FBO warrant termination or resolution. If the Federal Reserve determines that action is necessary, based on the financial decline of the FBO or its U.S. operations and the risk posed to U.S. financial stability, the Federal Reserve will take action that includes recommending to the appropriate financial regulatory agencies that an entity within the U.S. branch and agency network be terminated or that a U.S. subsidiary be resolved.

2. Early Remediation Triggering Events

A number of triggering events will determine whether the U.S. operations of an FBO fall within one of the four levels of remediation. These events would be based on the Federal Reserve's existing definitions of minimum risk-based capital and leverage ratios, the results of supervisory stress tests under the proposed rules, and weaknesses in complying with enhanced risk management and liquidity standards, as set forth in other parts of the proposal and described above.

The Federal Reserve also proposes to use various market indicators designed to capture both emerging idiosyncratic and systemic risk across all supervised organizations. Rather than setting forth such indicators in the proposal, the Federal Reserve proposes to publish for comment annually (or less frequently as deemed appropriate) the market-based triggers and thresholds. For now, Level 1 remediation would be required if the Federal Reserve determines that any single market indicator has exceeded the market indicator threshold with respect to the U.S. operations of an FBO during the applicable breach period.

The Federal Reserve has proposed an initial list of market-based indicators, including various equity-based and debt-based indicators.

- Equity-Based Indicators—The proposed equity-based indicators include: (i) an “expected default frequency,” which measures the expected probability of default in the next 365 days based on a model developed by Moody's; (ii) a “marginal expected shortfall,” which would look at the expected loss in a company's equity based on its stock price and volatility; (iii) a “market equity ratio,” which is the ratio of market value of equity to market value of equity plus book value of debt; and (iv) “option-implied volatility,” which would use a standard option pricing model.
- Debt-Based Indicators—The proposed debt-based indicators would be based on credit default swaps (CDS) and subordinated debt (bond) spreads.

* * *

The proposal represents a fundamental change to existing U.S. regulation of foreign banks with operations in the United States. For more information regarding the proposal, the issues it raises for your organization, or how comments may be submitted to the Federal Reserve, please contact a member of Simpson Thacher's Financial Institutions Group.

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¹ The proposal also applies to foreign nonbank financial companies designated by the Financial Stability Oversight Council (the "FSOC") as "systemically important" due to the nature, scope, size, scale, concentration, interconnectedness, or mix of their activities and the threat that their material financial distress could pose to the financial stability of the United States. However, because the FSOC has yet to designate any nonbank financial company (foreign or domestic) as systemically important and because the Federal Reserve has stated that it expects to clarify, by order, how the enhanced prudential standards would apply to any individual foreign nonbank financial company operating in the United States, this memorandum only summarizes the proposal with respect to FBOs.

² For a summary of the enhanced prudential requirements and early remediation framework applicable to large bank holding companies with \$50 billion or more in total consolidated assets, please see our memorandum titled, "Regulating Systemically

Important Financial Companies,” dated January 10, 2012, *available at* <http://stblaw.com/content/Publications/pub1356.pdf>. The proposed rules discussed in that memorandum remain pending, although the comment period has closed.

Where there are differences between the proposal and the domestic proposal, Federal Reserve staff, in a memorandum to the Federal Reserve Governors, dated December 7, 2012 and made available in connection with the release of the proposal, have explained that such differences are in recognition of the different regulatory framework and structure under which U.S. and non-U.S. banks operate and, importantly, have cautioned that these differences “do not reflect potential modifications” that may be made to the domestic proposal.

- 3 An FBO’s total consolidated assets will generally be measured on the basis of its average total consolidated assets for the four most recent consecutive quarters as reported on its FR Y-7Q filing (Capital and Asset Report for Foreign Banking Organizations). Similarly, an FBO’s combined U.S. assets (excluding the assets of U.S. branches and agencies and excluding the assets of any so-called “Section 2(h)(2)” company of a U.S. subsidiary) and an intermediate holding company’s total consolidated assets will generally be measured on the basis of such institution’s average total consolidated assets for the four most recent consecutive quarters as reported on its FR Y-9C filing (Consolidated Financial Statements for Bank Holding Companies). If FR Y-7Q or FR Y-9C filings have not been made, then the particular calculation would be made under applicable accounting methods.
- 4 This new structural requirement is not among the prudential standards listed in Section 165 of Dodd-Frank. However, Section 165(b)(1)(B) of Dodd-Frank provides the Federal Reserve with considerable authority to establish any other prudential standard it determines is appropriate on its own or pursuant to a recommendation made by the FSOC. *See* U.S.C. § 5365(b)(1)(B).
- 5 Section 2(h)(2) of the BHC Act allows qualifying FBOs under Regulation K to retain their interests in non-U.S. commercial firms that conduct some business in the United States. The Federal Reserve believes it would be inappropriate to include such “Section 2(h)(2)” companies under the IHC structure because these companies have not been subject to Federal Reserve supervision, are not included in the U.S. financial operations of FBOs, and FBOs face significant practical limitations in restructuring such commercial investments.
- 6 U.S. insured depository institutions controlled by FBOs have always been subject to the same risk-based capital and leverage requirements as other U.S. insured depository institutions. The difference has been in the treatment of holding companies.
- 7 *See* Basel Committee on Banking Supervision, “A Framework for Dealing with Domestic Systemically Important Banks,” issued for comment Aug. 1, 2012, *available at* <http://www.bis.org/publ/bcbs224.pdf>.

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- ⁸ Under the proposed rules, the capital stock and surplus of a U.S. IHC would generally be defined to include both its total regulatory capital and the balance of its allowance for loan and lease losses not included in Tier 2 capital. However, for an FBO, capital stock and surplus would be defined only by reference to its total regulatory capital on a consolidated basis.
- ⁹ The FBO must be subject to a consolidated capital stress testing regime that includes either an annual supervisory capital stress test conducted by the FBO's home country supervisor or an annual self-test that is reviewed and evaluated by the home country supervisor.
- ¹⁰ This is intended to be comparable to the 8% minimum risk-based capital standard that currently applies to U.S. bank holding companies and to align with asset maintenance requirements that apply to U.S. branches and agencies under existing federal or state rules. *See, e.g.,* New York Superintendent's Regulations, 3 NYCRR Section 322.2-322.4.
- ¹¹ FBOs with total consolidated assets of \$50 billion or more and combined U.S. assets of less than \$50 billion would be subject to the same triggers and notification requirements, but the Federal Reserve has discretion to tailor the application of the proposed early remediation steps.