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CLIENT MEMORANDUM

# Governor Tarullo Foreshadows Proposal to Ring-Fence Large U.S. Operations of Foreign Banks

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In an unprecedented and provocative **speech**, Federal Reserve Governor Daniel K. Tarullo foreshadowed a proposal from the Federal Reserve Board that could fundamentally change the way foreign banks are regulated in the United States. As previewed, the proposal would require foreign banks with large operations in the U.S. to create a separately capitalized top-tier U.S. intermediate holding company ("**IHC**") that would sit on top of *all* U.S. bank and nonbank subsidiaries. The IHC would be required independently to meet all U.S. capital and liquidity requirements as well as other enhanced prudential standards required by the Dodd-Frank Act. While the U.S. branches and agencies of a foreign bank would *not* be part of the IHC, they would be subject to "certain additional measures," especially regarding liquidity. Governor Tarullo noted that the "all-important details" of the proposal are still under discussion and anticipated the release of a notice of proposed rulemaking "in the coming weeks."

If the Federal Reserve actually adopts a proposal along the lines outlined in Governor Tarullo's speech, it could have profound negative implications not only for the operations of foreign banks in the United States, but also for U.S. banking organizations doing business outside the United States. It would likely contribute and add fuel to the growing trend towards regionalization of global banking, thereby complicating and increasing the cost of providing cross-border banking services.

- **Increasing the Costs of U.S. Operations by Trapping Capital and Liquidity.** For foreign banks with large operations in the U.S., the proposal would almost certainly require significant restructuring, capital injections, business and operational changes, and compliance burdens. The IHC model, by requiring separate capital and liquidity at the IHC level, will lead to further fragmentation of foreign banks' capital and liquidity structures and thus further increase the cost of doing business in the United States. Given that Basel III will require internationally active banks to increase their levels of capital and liquidity substantially on a consolidated basis, any increased capital or liquidity trapped in the United States could cause foreign banks to reevaluate the costs and benefits of at least some of their U.S. operations.

- **Blurring the Line Between Branch Banking and Full Subsidiarization.** U.S. branches and agencies of foreign banks would not be included within the IHC model. They would, however, be subject to liquidity standards and "certain additional measures" that could, depending on what the missing "all-important details" turn out to be, result in increased capital and liquidity requirements in a manner approaching subsidiarization. At a minimum, the proposal would apparently require U.S. branches and agencies of foreign banks to meet a U.S. version of the Basel III Liquidity Coverage Ratio, which would effectively force foreign banks to decentralize their liquidity and possibly their capital management. This could well create additional liquidity and capital risk compared to current centralized liquidity and capital management operations, which have the benefit of taking into account the liquidity and capital demands of the consolidated group. It would certainly reduce the capital and liquidity efficiency of branch banking, thereby blurring the line between branch banking and full subsidiarization.

- **Possible Retaliatory Impact on U.S. Banking Organizations.** The proposal could prompt foreign policymakers to introduce similar requirements for U.S. and other international banks that operate in their jurisdictions. Thus, the proposal would both become part of and function as a catalyst for additional proposals for the regionalization of global banking, most recently exemplified by the UK

FSA's subsidiarization proposal in the depositor preference context and the uncertainty surrounding the treatment of UK and EU branches of international banks in a post-Vickers and post-Liikanen world. It remains to be seen what longer-term implications the proposal, if adopted, would have on the composition and competitiveness of the U.S. financial system.

- **Negative Impact on International Regulatory Coordination.** Since at least part of the stated justification for the proposal is to address "vulnerabilities posed by internationally active banks in host markets," and Governor Tarullo cites the UK and Switzerland as examples of national authorities that "have already introduced their own policies to fortify the resources of internationally active banks within their geographic boundaries," the proposal represents a decisive step away from efforts to coordinate and harmonize the regulation of internationally active banks and heightens the risk of subsidiarization and other forms of national ring-fencing around the world.

  Indeed, the proposal could signal the start of a global circling of the wagons around the domestic operations of global banks, the beginning of the end of any real deference by the U.S. to home country standards or supervision, and a retreat if not a surrender – led by the United States – in the global quest for common standards and cross-border regulatory cooperation. Examples include the Basel capital standards, derivatives and other market reforms and regulatory deference and cooperation based on the comprehensive consolidated supervision (CCS) standard. It could provide an excuse for similar retaliatory actions around the world, not unlike the tariff war spawned by the Smoot-Hawley Act. Instead of continuing to lead the quest toward an internationally coordinated regulatory system designed to accommodate an efficient global banking system, a retreat by the U.S. would provide an excuse for other countries' regulators, in reforming their cross-border regulatory systems, to erect costly walls to insulate host interests from the risk of a global bank's failure.

- **Harm to the Real Economy.** Such a reversal in the quest for a global regulatory system will hurt not only internationally headquartered banks with operations in the United States and U.S.-headquartered banks with global operations, but it could also impose deadweight costs on the global financial system, as capital and liquidity become inefficiently trapped in local jurisdictions. These deadweight costs, in turn, could result in harm to the real economy in terms of a further contraction in the supply of credit, higher unemployment, lower output, and more political instability.

- **Making Global Banks Less Resolvable.** Ironically, by further contributing to the trend towards subsidiarization and other forms of national ring-fencing in other jurisdictions, the proposal outlined by Governor Tarullo could actually make it more difficult to resolve banks with cross-border operations. Increasing the number of material legal entities within a global banking group necessarily increases the number of insolvency regimes implicated by the failure of any substantial portion of the group. Instead of having a single global resolution led by the home country resolution authority of a global bank and governed by a single home country resolution law, the resolution will be fragmented among a multiplicity of administrative and judicial authorities under a multiplicity of insolvency laws. If the risk of local ring-fencing is one of the most serious impediments to the successful cross-border resolution of a global bank, this proposal and the subsidiarization it may provoke around the globe will multiply the impediments by making ring-fencing part of the permanent structure of banking groups. Subsidiarization will also increase the contractual, financial, and operational connections among the various material legal entities. If a majority of the Federal Reserve Board shares Governor Tarullo's view that "it is not clear that we should aim toward extensive harmonization of national regulatory practices related to foreign banking organizations," this does not bode well for the clear need for international regulatory cooperation in planning for the resolution of internationally active banks.

In short, the proposal described in Governor Tarullo's speech raises some very serious policy issues. The remainder of this memorandum summarizes the basic elements of the proposal, as well as certain key issues and questions that remain open.

## Requirements that Would Apply to IHCs

The IHC housing *all* U.S. banking and non-banking subsidiaries of a large foreign bank would be subject to U.S. capital and liquidity requirements as well as other Dodd-Frank enhanced prudential standards, including stress testing, risk management standards, single counterparty credit limits, and early remediation requirements. Governor Tarullo stressed that "the same capital rules applicable to U.S. BHCs should also apply to U.S. IHCs."[1] Moreover, the liquidity standards applicable to IHCs "should be broadly consistent with the standards the Federal Reserve has proposed for large domestic BHCs, pending final adoption and phase-in of quantitative liquidity requirements by the Basel Committee."[2] He also stated that other Dodd-Frank enhanced prudential standards "should be applied to the U.S. operations of large foreign banks in a manner consistent with the [Federal Reserve's proposal for large domestic firms]."[3]

## Key Open Issues and Questions

- **Which Foreign Banks Will Be Required to Establish an IHC?** Governor Tarullo's speech does not specify the test or threshold for determining which foreign banks would be required to establish an IHC. However, he stated that "Sections 165 and 166 [of the Dodd-Frank Act] apply to all foreign banks with $50 billion or more in global consolidated assets and a U.S. banking presence of any size," and that currently more than 100 foreign banks would meet this threshold. He also observed that "there are 23 foreign banks with at least $50 billion in assets in the United States." On the other hand, Governor Tarullo specifically noted that whether a foreign bank "with relatively small U.S. operations should be subject to the same prudential requirements as those with U.S. operations in excess of $50 billion is an open question." This implies that the proposal would not pursue a "one size fits all" approach to the IHC model, but it is clearly a point that requires clarification.
- **Complying with U.S. *and* Home Country Capital and Liquidity Requirements.** Under the IHC model, a foreign bank would be subject to U.S. capital and liquidity regulations with respect to its U.S. operations, other than the U.S. branches and agencies of a foreign bank itself (depending on what the missing "all-important details" of the proposal turn out to be), and would be subject to home country capital and liquidity regulations on a consolidated group level. Governor Tarullo's speech does not address the practical implications of subjecting foreign banks to multiple sets of capital requirements, especially in light of material differences between the U.S. and home country capital frameworks. Among other things, the permanent capital floor imposed by the Collins Amendment and the prohibition on reliance on external credit ratings has resulted in significant U.S. departures from the international Basel capital framework and the capital regulations in other major jurisdictions.
- **Intra-group Funding.** Governor Tarullo noted that the approach outlined in his speech "would not impose a cap on intra-group flows, thereby allowing foreign banks in sound financial condition to continue to obtain U.S. dollar funding for their global operations through their U.S. entities." He did not elaborate on the meaning of "sound financial condition." Nor is it clear how the liquidity and

[1] A Davis Polk memorandum on the U.S. banking agencies' proposals to implement Basel III in the United States is available **here**.

[2] The Secretary General of the Basel Committee recently signaled that the Basel Committee is working towards issuing the final version of Basel III's Liquidity Coverage Ratio in the first part of 2013, but that the final calibration of the Net Stable Funding Ratio will take longer. The Federal Reserve has stated that it intends to propose "quantitative liquidity requirements that are derived from, or consistent with, the international liquidity standards incorporated into Basel III."

[3] A Davis Polk memorandum on the Federal Reserve's proposed enhanced prudential standards for large domestic firms is available **here**.

perhaps capital standards imposed on IHCs and foreign banks' U.S. branches and agencies could fail to complicate or hinder foreign banks' liquidity and capital management operations.

- **Resolvability.** Governor Tarullo generally stated that the IHC model would "help mitigate resolution difficulties by providing U.S. regulators with one consolidated U.S. legal entity to place into receivership under Title II of the Dodd-Frank Act if the failure of the foreign bank would threaten U.S. financial stability." This rationale presumes that such IHCs would be designated under Title II and become subject to the FDIC's orderly liquidation authority. It is not clear, however, why the imposition of a single holding company structure would necessarily aid resolvability, especially when the overall effect of the IHC model may be to reduce incentives for international cooperation on the resolution of an internationally active bank. Indeed, there is some irony, given Governor Tarullo's view that ring-fencing at the moment of crisis impeded orderly resolution during the Financial Crisis, in his effective imposition of *ex ante* ring-fencing through the IHC model.
- **Transitional Arrangements.** Governor Tarullo stated that "the Federal Reserve would work to ensure that the new regime [for foreign banks] is minimally disruptive, through transition periods and other means." It remains to be seen whether these arrangements would take into account the difficulties of raising capital in a challenging global economic climate as well as the enormous time and resources needed to establish and bring an IHC into compliance with U.S. enhanced prudential standards.
- **Consultation with Home Country Regulators.** Governor Tarullo's speech does not disclose the extent to which the IHC model he described reflects discussions with home country regulators of large foreign banks. In fact, Governor Tarullo stated that "it is not clear that we should aim toward extensive harmonization of national regulatory practices related to foreign banking organizations." He specifically cited regulatory developments in the UK and Switzerland as evidence of national authorities taking action "to fortify the resources of internationally active banks within their geographic boundaries." It remains to be seen what implications adopting a national approach to the regulation of international financial institutions would have on ongoing multilateral and international efforts to address important prudential issues such as capital and liquidity standards and cross-border resolution.
- **Statutory Requirement to Take Into Account Comparable Home Country Standards.** Section 165 of the Dodd-Frank Act requires that the Federal Reserve, in developing enhanced prudential standards for a foreign bank, 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 to financial companies in the United States." Governor Tarullo's speech not only does not address this important statutory requirement, but also appears to treat it as no longer desirable or relevant.
- **U.S. Branches and Agencies of Foreign Banks.** Governor Tarullo stated that because "U.S. branches and agencies are part of the foreign parent bank, they would not be included in the IHC." He also described the IHC model as "chart[ing] a middle course" that avoids a "fully territorial model of foreign bank regulation." In other words, the proposal would not require full "subsidiarization" of U.S. branches and agencies of foreign banks. However, in addition to activity restrictions currently applicable to such branches and agencies, Governor Tarullo noted that they will be subject to "certain additional measures." He did not elaborate on what these additional measures would be, except to note that liquidity standards will apply to "foreign bank branch and agency networks in the United States," which "may be less stringent" than those imposed on IHCs, in recognition of the integration of branches and agencies into the foreign bank as a whole.

  Significantly, although Governor Tarullo stated that the proposal would allow foreign banks to continue to operate branches in the United States, he also said that it would "generally" allow branches to meet comparable home country capital requirements at a consolidated level. It is unclear whether Governor Tarullo meant to suggest that, in certain circumstances, U.S. branches or agencies would *not* be able to rely on home country capital requirements applicable to the foreign bank as a whole. Given the importance of this issue, any proposal that follows from this speech needs to be crystal-clear on this point. Overall, it remains unclear whether the other "additional measures" that would apply to U.S. branches and agencies of foreign banks would be tantamount to *de facto* subsidiarization.

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