

The Federal Reserve's Proposed Framework for Regulation of Foreign Banks: Issues for Comment and Consideration

The Federal Reserve Board's proposed implementation of Sections 165 and 166 of the Dodd-Frank Act, which require enhanced prudential standards and an early remediation regime for certain large foreign banking organizations, represents a dramatic shift in the Federal Reserve's approach to supervising and regulating foreign banks.¹ If adopted as proposed, the new regulations could have profound implications for internationally active banks, both foreign and domestic, and could result in fundamental changes in how banks allocate capital and liquidity across jurisdictions.

As internationally active banks continue to review the Federal Reserve's proposal and assess its potential impact on their U.S. and global operations, we have prepared this memorandum as a follow-up to our December 14 summary to highlight what we see as key implications and questions created by the proposal, with an emphasis on issues that banking organizations should consider addressing in comments on the proposal.²

Introduction

The Federal Reserve's proposal contains a number of significant departures from previous approaches to the supervision of foreign banking organizations ("FBOs") in the United States. While the proposal has been under consideration for some time, and to some degree has been informed by developments after Dodd-Frank (including the European financial crisis), it reflects a distinct reassessment of U.S. policy that few would have anticipated when the Dodd-Frank Act was passed in 2010.

In many respects, the Federal Reserve's proposal has an almost legislative character to it—for example, creating a new class of U.S. regulated entity, the "intermediate holding company" or "IHC". Other provisions of Dodd-Frank expressly authorized IHCs for certain nonbank financial companies and savings and loan holding companies as a means

¹ See Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77 Fed. Reg. 76,628 (Dec. 28, 2012) (the "Proposed Rule" or the "proposal"). Comments are due March 31, 2013.

² Our earlier condensed summary of the proposal's requirements is attached to this memorandum.

of separating those companies' financial and commercial activities, but no such IHC option or requirement was included for FBOs or bank holding companies (“BHCs”) under Sections 165 and 166. And when Governor Tarullo explained in his Yale speech that the approach the Federal Reserve would be taking was not unprecedented, he pointed to the International Banking Act of 1978 and the Foreign Bank Supervision Enhancement Act of 1991, two pieces of landmark legislation that Congress adopted specifically to change U.S. regulation of foreign banks. It is fair to say that the Federal Reserve's proposal is no less momentous than those developments, but noteworthy that it is being developed as a regulatory action under generally worded Congressional authority.³

The proposal is premised on a decidedly dim view of the prospects for cross-border supervisory coordination, information sharing and ultimately resolution of major financial institutions in a time of stress. The Federal Reserve makes several fundamental assumptions about the likely behavior of FBOs and other supervisors and regulators (both inside and outside the United States) that drive its preference for ex ante legal and practical ring-fencing of U.S. operations. The Federal Reserve explicitly assumes that other governments may create obstacles to preserving a foreign bank's U.S. operations and that the foreign banks themselves will not, in times of stress, support their U.S. operations. These assumptions suggest a significant shift away from the Federal Reserve's former reliance on a foreign bank's consolidated capital and management position to support and strengthen the U.S. operations when necessary.

The ripple effects of the Federal Reserve's proposal, including for U.S.-headquartered institutions, will depend in part on whether other countries pursue a similar course. Even if other countries do not respond in the form of direct retaliation, the proposal could push the international regulatory community further toward ring-fencing, subsidiarization or other domestic self-help solutions at the expense of international cooperation.

In particular, the Federal Reserve's calling out of what it perceives as persistent impediments to cross-border resolution, combined with the actual and virtual ring-fencing of capital and liquidity created by the proposal, does little to promote progress on cooperative solutions to cross-border insolvencies.⁴ The proposal also conflicts with the

³ Several aspects of the proposal have generated questions about whether the proposal (as currently drafted and explained) is adequately supported by the Federal Reserve's authority under the Dodd-Frank Act. We highlight some of these questions in the outline that follows.

⁴ Compare FDIC and Bank of England, “Resolving Globally Active, Systemically Important, Financial Institutions” (Dec. 10, 2012), available at <http://www.bankofengland.co.uk/publications/Documents/news/2012/nr156.pdf>. At the December 10, 2012 meeting of the Systemic Resolution Advisory Committee, Paul Tucker, Deputy Governor of the Bank of England, stated that “United Kingdom authorities are prepared in principle to stand back and let you execute a resolution of the massive US groups which have massive operations in the UK and to leave it to you to do it, without our stepping in and interfering and grabbing the subsidiaries or the branches or the assets of the businesses that are domiciled in the UK. This is a

developing concept, espoused by the FDIC, of “single point of entry” as an international resolution mechanism. Indeed, the proposal specifically contemplates the possibility of “entry” at the IHC level as a means to facilitate the resolution or restructuring of an FBO’s U.S. subsidiary operations by providing one top-tier U.S. legal entity to be resolved or restructured, apparently assuming that an effective single-point-of-entry resolution conducted through the FBO’s top-tier foreign parent would not occur.

Serious critique of the proposal is likely to come not only from industry but also from home country governments and supervisors, which may perceive that the Federal Reserve has abandoned the high road of cooperation in exchange for an “every nation for itself” policy. More broadly, the potentially costly effects on international capital flows, enterprise-wide risk and operational management, and market liquidity will no doubt be a focus of commenters. The Federal Reserve has made the judgment that the costs of its proposal would be outweighed by the perceived benefits for U.S. financial stability; commenters opposed to the proposal will need to explain clearly why the proposal has not struck the appropriate balance between these two goals and how the proposal could be revised.

Top Ten Issues for FBOs—Key Implications and Issues for Comment

Below are ten of the most significant issues that we expect to be raised by FBOs in comment letters. Each of these issues is discussed in the relevant section of the outline that follows:

- The proposal does not adequately tailor Section 165’s requirements to minimize burdens on those FBOs whose U.S. operations do not pose a significant threat to U.S. financial stability.
- The \$10 billion threshold for the IHC requirement is not justified in light of the minimal systemic significance of FBOs with between \$10 billion and \$50 billion in U.S. non-branch assets.
- The Federal Reserve has failed to adhere to the Dodd-Frank Act’s statutory mandate to take into account how FBOs are regulated on a consolidated basis under home country regulation, and generally to consider whether home country regulation is comparable to enhanced standards that the Federal Reserve would otherwise apply.
- The geographic compartmentalization of risk, liquidity, and capital management in the Proposed Rule runs counter to historical Federal Reserve

journey that involves trust. The trust that is based on the standards and foundations which we will continue to need to build. And I say that because we are going to need to build those foundations with countries around the world and where it's important therefore, that we together set an example.”

guidance and will create inefficiencies that may harm the safety and soundness of FBOs, increase the likelihood that regulatory ring-fencing could accelerate the failure of a troubled FBO, and create incentives for FBOs to reduce their U.S. assets and activities.

- If the IHC requirement is retained, many FBOs will require significant flexibility to address particular structures and investments, including “controlled” minority owned subsidiaries and joint-ventures, and to mitigate potential legal, tax or other burdens in relation to the required restructuring. The Federal Reserve should be flexible in accommodating specific situations by permitting FBOs to use alternative structures as appropriate.
- There is not sufficient justification for applying the IHC requirement in situations where an FBO has only nonbank subsidiaries in the United States (*i.e.*, does not control a U.S. insured depository institution). A more appropriately tailored application of the requirements should be applied to the combined U.S. operations (including branches) without the use of an IHC.
- The Proposed Rule’s enhanced remediation regime would create de facto minimum risk-based capital and leverage requirements beyond Basel III capital minimums for both the IHC and the FBO at the consolidated global level.
- The Proposed Rule’s liquidity buffer requirements will harm enterprise-wide liquidity management by imposing a separation between intragroup and external funding flows specifically designed to wall off U.S. operations from home country liquidity and discourage the use of short-term U.S. funding.
- Application of the proposal’s single-counterparty credit limits to U.S. branches is unnecessary and redundant, because branches are already subject to federal and/or state lending limits.
- An IHC’s single-counterparty credit limit should not result in restrictions on the ability of a branch to take on additional exposures. Linking the single-counterparty credit limits on IHCs and on an FBO’s combined U.S. operations is unjustified and vastly more restrictive than existing lending limits.

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APPENDIX A: Applicability of Key Provisions of FBO 165/166 Proposal by Asset Size

I. Overarching Areas of Concern About the Proposal

Most of this outline is devoted to specific implications and areas for potential industry comment related to individual requirements in the Proposed Rule. However, there are a number of overarching, fundamental issues that many commenters are likely to address in the rulemaking process.⁵

A. *Overbroad Scope and Lack of Tailoring*

1. Section 165 gives the Federal Reserve authority to tailor application of heightened prudential standards in order to differentiate among companies individually or by category. Although the proposal contains some degree of tailoring, it would still impose a variety of new supervisory and regulatory requirements on many FBOs that have small U.S. footprints and are effectively irrelevant to U.S. financial stability.
2. This is partly due to the Federal Reserve's interpretation of Section 165 as applying to all FBOs with global consolidated assets of \$50 billion or more ("Large FBOs"), with a global asset threshold of only \$10 billion or more in the case of stress test and risk management requirements. While this was not the only possible interpretation of Section 165, especially in light of Congress's explicit intent to address U.S. financial stability, it is the interpretation that the Federal Reserve has adopted throughout its regulatory implementation of Section 165.⁶
3. The overbreadth of the Proposed Rule also stems, however, from a decision to provide only minimal tailoring of Section 165's requirements, rather than attempting to minimize burdens on FBOs with no U.S. systemic significance.
4. In addition, the proposal does not give full effect to the Federal Reserve's legal authority to tailor heightened prudential standards to individual institutions (in addition to classes of institutions). Even those institutions that could arguably be relevant to U.S. financial stability are likely to

⁵ This outline is not intended to reiterate comments and concerns regarding the Federal Reserve's proposed implementation of on the various proposed enhanced prudential standards under Sections 165 and 166 of the Dodd-Frank Act generally. Significant industry and other comments have already been aired in relation to the proposal for enhanced prudential standards for domestic BHCs and nonbank systemically important financial institutions. Rather, the focus of this outline is to address those issues of particular significance to FBOs.

⁶ See, e.g., 12 C.F.R. § 243.2(f) (Federal Reserve rule implementing Section 165's resolution planning requirements).

argue that the proposal does not sufficiently tailor its heightened prudential standards to the actual risks that they present.

B. Across-the-Board Imposition of an IHC Requirement on Large FBOs with \$10 Billion or More in U.S. Non-Branch Assets, and Potential Questions Regarding the Legal Basis for the Federal Reserve's Proposal

1. The intermediate holding company (“IHC”) requirement is arguably the most radical feature of the Federal Reserve’s proposal, and the one with potentially the most serious adverse effects on Large FBOs’ cross-border operations in the United States.
2. Questions have arisen regarding the Federal Reserve’s legal authority to impose this requirement as it is explained in the proposal.
 - a. Congress specifically directed the Federal Reserve to “take into account the extent to which [an FBO] is subject on a consolidated basis to home country standards that are comparable to those applied to financial companies in the United States.”⁷ In the preamble to the Proposed Rule, it appears that the Federal Reserve has read into this standard the flexibility to “balance” this mandate against financial stability and other considerations. As a result, however, the Federal Reserve’s stated concerns seem to overshadow any consideration of home country standards, and, with limited exceptions, the Federal Reserve’s analysis generally skips over any determination of whether home country standards are comparable. The Federal Reserve’s proposal also appears at odds with the clear thrust of the mandate, which was to start with an evaluation of consolidated standards, and only in the absence of comparable consolidated requirements (such as consolidated capital standards) impose new standards.
 - b. More complex questions have arisen regarding the Federal Reserve’s legal authority to impose a broadly applicable IHC requirement on Large FBOs in light of the fact that the proposal appears at least in part to have been targeted at large SEC-regulated broker-dealer subsidiaries of FBOs and concerns about their capital adequacy.
 - c. It is also noteworthy that Congress specifically contemplated the creation of intermediate holding companies in other areas of

⁷ Dodd-Frank Act §165(b)(2)(B).

Dodd-Frank, such as for savings and loan holding companies and systemically important nonbank financial companies, but did not contemplate an across-the-board IHC requirement for FBOs in Sections 165 and 166.⁸

C. *Macroeconomic and Financial Stability Implications and Impact Analysis*

1. The Proposed Rule's U.S.-based capital requirements, and the limits on dividends and other distributions that could result from the application of the Federal Reserve's capital planning rule and early remediation regime to IHCs, would effectively trap capital and liquidity in the United States. The consequences would be particularly pronounced when an FBO's non-U.S. operations come under distress or display significant weaknesses under regulatory scrutiny, which could create pro-cyclical negative impacts on the parent organization during a crisis. Indeed, the result would be to create in reverse the type of scenario the Federal Reserve cites as justification for the Proposed Rule—regulatory limitations on cross-border, intragroup capital flows—illustrating that the downward spiral for a stressed institution can be created by home and host country responses of this kind.
2. The proposal reflects the Federal Reserve's conclusion that the macroeconomic effects of fragmenting FBOs' U.S. capital and liquidity, including direct effects on the availability of credit and liquidity in U.S. financial markets if FBOs were to shrink their U.S. operations (or even "de-bank"), as well as broader effects on global financial stability that could indirectly impact the United States, are justified by the benefits to U.S. financial stability that the proposal is meant to achieve.
3. Industry commenters will want to consider how to challenge this conclusion, including through the use of data and impact analysis. Especially in view of the broad international commitment to promoting global economic recovery, data-driven comments could persuade the Federal Reserve to reconsider the potential macroeconomic implications of the Proposed Rule before finalizing a new FBO supervisory framework.
4. In addition, as the Proposed Rule contains explicit and implicit incentives to reduce FBO assets and activity in the United States, more direct questions will arise as to whether the proposal could lead to greater concentration in U.S. wholesale banking markets—a development that

⁸ See, e.g., Dodd-Frank Act §§ 167 and 626.

would arguably reduce, rather than promote, financial stability in the long term.

D. The Federal Reserve's Empirical Data and Supervisory Experience

1. The Federal Reserve cites empirical data and its own supervisory experience during the financial crisis to justify the prophylactic approach outlined in its proposal. The Federal Reserve also points to trends in FBO's funding practices and financial activities to support its proposed approach.
2. While the Federal Reserve of course has unique access to information across the industry, the validity of the Federal Reserve's conclusions is a fair and important topic for industry comment. The Federal Reserve's description of FBO practices and industry trends is meant to build an administrative record to support a controversial proposal. Well-supported comments challenging the Federal Reserve's characterizations will therefore be especially important.
3. Similarly, individual FBOs whose own experience or practices diverge from the descriptions in the proposal may want to use that difference as a further rationale for greater tailoring of enhanced prudential standards.

II. Issues Related to the IHC Requirement

The Proposed Rule's requirement that any Large FBO with combined U.S. non-branch assets of at least \$10 billion establish a single U.S. IHC to hold virtually all of its U.S. bank and nonbank subsidiaries has quickly become the most controversial element of the proposal. It is the primary vehicle for the new framework's imposition of U.S. territorial capital and liquidity requirements on the nonbank affiliates of FBOs, and several aspects of the new IHC structure should be considered for potential comment.⁹

A. Threshold for the IHC Requirement

1. The preamble suggests that the Federal Reserve chose the \$10 billion IHC threshold because it aligned with the \$10 billion asset threshold established by Section 165 for stress test and risk management requirements. The logic of this connection is not entirely clear, since the Proposed Rule's IHC threshold is based on U.S. non-branch assets, while

⁹ For ease of reference, this memorandum refers to any U.S. branch or agency of a foreign bank as a "U.S. branch", and refers to all the U.S. branches and agencies of a foreign bank collectively as its "U.S. branches" or "U.S. branch network."

the proposal's stress testing and risk management thresholds are based on global assets (and the stress testing and risk management requirements would apply to FBOs without an IHC). It is apparent, however, that the \$10 billion combined U.S. asset test reflects an attempt to tailor the requirement to some degree.

2. Many banks are likely to argue that the \$10 billion threshold is too low, and that most of the Large FBOs with between \$10 billion and \$50 billion in U.S. non-branch assets do not present systemic risks in the United States that justify compelling them to restructure their U.S. affiliates into an IHC. In other contexts, the Federal Reserve has indicated that institutions with significantly more than \$10 billion in assets should not present financial stability risks.¹⁰
3. At the Board of Governors meeting approving the proposal, Federal Reserve staff highlighted the size of the thresholds set in the proposal as an issue on which they are particularly interested in public comment.

B. Potential Complications in the Calculation of Combined U.S. Assets

1. The Proposed Rule has a variety of asset thresholds that trigger different regulatory requirements, including thresholds based on the total consolidated assets of an FBO, an FBO's combined U.S. assets excluding U.S. branch assets, an FBO's combined U.S. assets including U.S. branch assets and an IHC's total consolidated assets. In general, these would be calculated based on the average of the four most recent quarters as reported on various Federal Reserve reporting forms (or, if the FBO or IHC did not previously file the relevant forms, based on applicable accounting standards).¹¹ A chart setting forth the various thresholds is attached as Appendix A.
2. In calculating whether a Large FBO has more than \$10 billion in combined U.S. assets (excluding branch assets), thus triggering the IHC requirement, the Proposed Rule helpfully allows for the exclusion of intercompany balances and transactions between U.S. subsidiaries that would be eliminated in consolidation if the IHC were already formed. (Section 2(h)(2) subsidiaries would also be excluded.) Intercompany

¹⁰ For example, in approving the Capital One-ING acquisition in February 2012, the Federal Reserve stated that acquisitions that lead to the creation of an institution with less than \$25 billion in assets "likely would have only a de minimis impact on an institution's systemic footprint and, therefore, are not likely to raise concerns about financial stability." Capital One Financial Corporation, 98 Fed. Res. Bull. 7, 24 (2012).

¹¹ E.g., FFIEC 002 (U.S. branches); FR Y-9C (BHCs and, eventually, IHCs); and FR Y-7Q (FBOs).

balances and transactions with non-U.S. affiliates would not, however, be excluded in the calculations. Institutions near the \$10 billion threshold will want to consider whether the Federal Reserve’s proposed calculation method (and any other factors) create distortions that should be addressed in comments on the proposal.¹²

3. Given the difficulties encountered by the Treasury Department’s Office of Financial Research (“OFR”) earlier this year in attempting to calculate correctly the combined U.S. assets of FBOs (for purposes of OFR assessments), it seems likely that similar complications could arise in calculating combined assets for purposes of the proposal.

C. Issues Regarding What Must be Put Under the IHC

1. Tiered FBOs, Joint Ventures and Minority “Controlling” Interests

- a. Many institutions have one or more significant investments that either could not, as a practical matter, be transferred to an IHC, or would present unusual burdens or complications if required to be transferred.
- b. The most common examples are tiered FBO structures, where an FBO holds a “controlling” (for purposes of the Bank Holding Company Act (the “BHCA”)) investment in another FBO with U.S. operations, investments in other types of foreign financial companies with U.S. subsidiaries, and joint ventures in U.S. financial companies. In each of these cases, the proposal would appear to require the FBO’s indirect interests in U.S. “subsidiaries” to be transferred to the IHC. In some cases, however, because BHCA “control” and “subsidiary” status can be triggered with ownership of 25% (or potentially less) of a class of voting securities of the investee company, the FBO may not have operational control over the entity and may be unable to force the transfer of the subsidiary, and in other cases, such a forced transfer may be inappropriate.¹³

¹² Other calculations of combined U.S. assets (either excluding or including branches) under the Proposed Rule also permit the exclusion of intercompany balances and transactions between U.S. subsidiaries (and between U.S. subsidiaries and U.S. branches, if U.S. branches are included in the total). However, these calculations do not permit the exclusion of transactions between U.S. subsidiaries or U.S. branches and foreign affiliates or foreign branches of the FBO (including the FBO itself).

¹³ “Subsidiaries” are defined by reference to the BHCA definition of control.

2. Flexibility for Multiple IHCs or Other Alternative Structures

- a. The Proposed Rule does provide flexibility for the Federal Reserve, in what the preamble describes as “exceptional circumstances”, to permit an FBO to establish multiple IHCs or “use an alternative organizational structure.” The Proposed Rule provides that such flexibility may be appropriate (i) in the case of tiered FBOs; (ii) when, under applicable home country law, the FBO may not control its U.S. subsidiaries through a single IHC; or (iii) when circumstances warrant an exception based on the FBO’s activities, scope of operations, structure, or similar considerations.
- b. If this standard were adopted, it could leave the Federal Reserve significant flexibility to address particular circumstances on a case-by-case basis. It is of course unclear how willing the Federal Reserve would be to provide FBOs flexibility in situations where moving a subsidiary into the structure is not illegal or impossible, but highly burdensome or impractical. In addition, the Proposed Rule is short on detail as to how this case-by-case process would work and the likelihood and/or timing of approval of an alternative structure.
- c. Institutions should focus in their comment letters on the importance of the Federal Reserve providing significant flexibility to address specific situations if they choose to adopt a “one-size-fits-all” baseline approach to IHCs. When asked by Governor Tarullo about areas where comments would be especially helpful, Federal Reserve staff mentioned their understanding that there are “idiosyncratic” differences in how firms operate and the staff’s desire to hear from firms about why their particular circumstances might require tailoring of structural requirements.

3. Tax and Other Potential Impediments

Moving subsidiaries into the IHC could trigger adverse tax consequences, including in foreign jurisdictions. Tax inefficiencies created by the IHC requirement—either in connection with a required restructuring or going forward—would be appropriate topics for comment.

4. Operating Subsidiaries of FBO Branches

- a. The Proposed Rule and preamble do not explicitly address whether operating subsidiaries of Large FBO branches would need to be moved under the IHC. The preamble states that the FBO would not

be required “to transfer any assets associated with a U.S. branch” to the IHC, which supports an argument that subsidiaries of branches should not have to be transferred.

- b. Subsidiaries of federal and New York state branches of FBOs are permitted to perform a wide range of functions, including providing data processing and consulting services to the parent FBO; holding the parent FBO’s investment securities portfolio; buying, selling and servicing loans (including holding assets acquired as a result of a “debt previously contracted”); and acting as an investment advisor. There would be a particularly strong argument that branch subsidiaries that are integrally connected to the activities of the branch should be able to remain under the branch.

D. Potential Movement of Assets and Activities into Branches

1. In the preamble and at the Board of Governors meeting approving the proposal (in response to a question from Chairman Bernanke), the staff noted that they will be monitoring whether FBOs relocate activities into branches in response to the proposal. At the Board of Governors meeting, the staff indicated that if supervisors see a substantial flow of assets and activities into FBO branches and feel it is inconsistent with safety and soundness or poses a risk to U.S. financial stability, the Federal Reserve could use its supervisory tools to stop such transfers and, if necessary, recommend changes to the regulation.
2. FBOs have many bona fide reasons for relocating activities into branches that are entirely separate from the IHC requirements, and many FBOs have been making structure decisions regarding where to conduct new and existing activities, such as securities lending and repo activities, since well before Dodd-Frank. Post-Dodd-Frank structural choices are also now informed by a myriad of regulatory considerations, including swaps push-out, the Volcker Rule, resolution planning, and other Dodd-Frank-related initiatives. Well-documented and transparent business planning should help withstand any enhanced supervisory scrutiny that is applied to movement of activities from subsidiaries into branches.

E. Treatment of FBOs Controlled by Foreign Sovereigns/Sovereign Wealth Funds

The proposal does not address implications for sovereign wealth funds that are treated by the Federal Reserve as FBOs due to a controlling interest in a bank with U.S. operations, or implications for banks in which a sovereign currently holds a controlling interest. Presumably, just as the Federal Reserve has

granted relief to sovereign entities from BHCA restrictions on nonbanking activities, the Federal Reserve will not require sovereign wealth funds or other sovereign-owned entities to move all “controlled” U.S. entities under a single IHC. Separately, as discussed below, banks in which a sovereign entity holds a controlling interest may need to address specific issues in areas such as single-counterparty credit limits (“SCCLs”).

F. Timing Issues, Including for Existing BHC Subsidiaries

1. The proposal provides some significant flexibility in relation to timing of implementation, including for the IHC requirement. As predicted following Governor Tarullo’s speech, the proposed new IHC framework would become effective in July 2015, roughly in line with the effectiveness of the Collins Amendment for most BHCs owned by FBOs.
 - a. For U.S. BHCs with \$50 billion or more in consolidated assets (“Large BHCs”) that are owned by FBOs, the proposed effective date for the IHC requirement would represent a more flexible timetable than the timetable set forth in the Federal Reserve’s earlier proposal regarding enhanced prudential standards for domestic BHCs (the “Domestic Proposal”).¹⁴
 - i. Many FBOs already own BHC subsidiaries that would be required either to become an IHC or become a subsidiary of a newly created IHC. Under the Domestic Proposal, the Federal Reserve would have applied the liquidity and risk management requirements under Section 165’s enhanced prudential standards to top-tier U.S. BHC subsidiaries of Large FBOs on the same timeframe as other U.S. BHCs (the regulatory capital provisions, stress testing, SCCLs, and early remediation regime would have been deferred until July 21, 2015 for BHC subsidiaries that, pursuant to Federal Reserve Supervision and Regulation Letter SR 01-1, rely on their parent’s capital support in lieu of meeting U.S. BHC capital requirements).¹⁵

¹⁴ See Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594 (Jan. 5, 2012).

¹⁵ See Federal Reserve Supervision and Regulation Letter SR 01-1 (Jan. 5, 2001) (Application of the Board’s Capital Adequacy Guidelines to Bank Holding Companies owned by Foreign Banking Organizations) (“SR Letter 01-1”), available at <http://www.federalreserve.gov/boarddocs/srletters/2001/sr0101.htm>.

- ii. In the preamble to the Proposed Rule, however, the Federal Reserve clarified, “[t]he proposal would also provide that a U.S. [IHC] would be subject to the enhanced prudential standards of this proposal, and would not be separately subject to the enhanced prudential standards applicable to U.S. [BHCs], regardless of whether the company would also meet the scope of application of those provisions. In doing so, the proposal intends to minimize uncertainty about the timing or applicability of certain requirements and to ensure that all U.S. [IHCs] of [FBOs] are subject to consistent rules.” Other provisions also confirm that the Proposed Rule, and the timing of its effectiveness, supersedes any intended application of the Domestic Proposal to U.S. BHC subsidiaries of FBOs.
- iii. In particular, this would significantly delay the application of the liquidity risk management and liquidity buffer requirements. Under the Domestic Proposal, top-tier Large BHC subsidiaries of FBOs would have had to establish a liquidity risk management framework and liquidity buffer within one year of finalization of the Domestic Proposal. Given the proposed effective date of the Proposed Rule, such U.S. BHC subsidiaries that become, or become part of, an IHC would not be required by regulation to satisfy these requirements until July 2015. Similarly, top-tier Large BHC subsidiaries of FBOs not relying on SR Letter 01-1 would have had to provide a capital plan and comply with the first supervisory stress test by the end of 2013 under the Federal Reserve’s recently finalized stress testing rules. Given the proposed effective date of the Proposed Rule, an IHC would not be required by regulation to submit a capital plan or conduct a stress test until late 2015. Other provisions of the Domestic Proposal would be similarly extended.
- iv. On the other hand, it is possible that the Federal Reserve could seek to impose some of the heightened prudential standards, such as stress-testing of Large BHCs owned by FBOs, as an informal supervisory matter in advance of the effective date (perhaps to facilitate horizontal reviews with U.S. BHCs or other similar reasons).

III. Issues Related to Capital Requirements

Although the Proposed Rule’s capital requirements are unsurprising in some respects,¹⁶ its treatment of IHCs represents a radical shift in approach. For the first time, the Federal Reserve would impose domestic BHC capital standards on Large FBOs’ entire U.S. operations outside of the branch network—regardless of whether the FBO has a U.S. bank subsidiary.¹⁷ Compliance with these capital regulations at the IHC level—which would include U.S. minimum risk-based capital and leverage standards (as revised to implement the Basel III capital framework), the Federal Reserve’s capital planning rule,¹⁸ capital stress testing, and early remediation triggers based on U.S. and global consolidated capital levels¹⁹—is likely to be challenging and costly. The implications and consequences of applying consolidated capital standards at the IHC level will undoubtedly be the subject of numerous comments.

A. *Loss of Organizational Flexibility*

1. Application of the domestic BHC capital regime to IHCs would dramatically reduce the flexibility of Large FBOs to manage both their U.S. and worldwide operations in a capital-efficient manner.
2. Although the effects on individual FBOs would vary based on their current structures, many would be required to hold significantly more capital within the United States.
3. The Federal Reserve is undoubtedly aware of these inefficiencies, but has made a judgment that the costs of trapping capital and liquidity in the United States are outweighed by the financial stability benefits of keeping a minimum amount of capital. Whether the Federal Reserve has correctly

¹⁶ For example, they generally continue prior Federal Reserve policy regarding expectations that FBOs must satisfy home country consolidated capital standards consistent with currently applicable capital accords. See Basel Committee on Banking Supervision (the “Basel Committee”), *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (Dec. 2010, rev. Jun. 2011) (“Basel III”).

¹⁷ Pursuant to Dodd Frank Act Section 171, commonly known as the Collins Amendment, intermediate U.S. BHCs of FBOs that have successfully elected financial holding company (“FHC”) status, which have generally been exempt from U.S. BHC capital standards pursuant SR Letter 01-1, will lose their ability to rely on their parent’s capital in lieu of holding capital at the U.S. BHC level on July 21, 2015. The combined effect of the Proposed Rule and the Collins Amendment would be to require all top-tier U.S. BHCs and IHCs owned by FBOs to comply with U.S. risk-based capital and leverage standards by July 2015.

¹⁸ See 12 C.F.R. § 225.8.

¹⁹ Stress testing and early remediation under the Proposed Rule are discussed in more detail in Sections VI and VII below.

weighed the costs and benefits of this approach will no doubt be a focus of comments.

B. Application of U.S. Leverage Ratios to IHCs

The effect of applying BHC leverage standards to an FBO's U.S. operations that have not traditionally operated under U.S. capital standards would be significant for Large FBOs required to create an IHC (*i.e.*, those with more than \$10 billion in non-branch U.S. assets).²⁰ Even if an FBO already has an existing BHC, it may not own all of its U.S. subsidiaries under the BHC. The Proposed Rule's IHC requirement would subject all subsidiaries, including nonbank subsidiaries, to the capital requirements of the IHC. In particular, application of a leverage ratio could have significant implications for those FBOs that currently operate large U.S. broker-dealers.

C. Implications for U.S. Broker-Dealer Operations

1. One clear motivating factor in the creation of the IHC requirement was the Federal Reserve's desire to bring the U.S. broker-dealer subsidiaries of Large FBOs under a BHC-like regulatory structure, despite the fundamental differences between banks and broker-dealers and the existence of a separate U.S. capital regime tailored to broker-dealers (the SEC's net capital rule).
2. To the extent that a broker-dealer forms a large portion of the assets of the IHC, it would have a disproportionately large effect on the regulatory capital calculations of the IHC, in contrast to the much smaller effect it would have had under current capital rules applicable to the consolidated top-tier foreign parent. Large FBOs could face substantial operational, compliance and capital costs adapting to this new approach. They may face incentives to curtail certain funding and other activities. The proposal may also encourage FBOs to terminate or relocate abroad certain activities that attract higher capital charges under the federal banking agencies' proposed capital adequacy rules than they would under

²⁰ The Proposed Rule makes clear that an IHC can be subject to the advanced approaches capital rules if the IHC meets the thresholds for application of those rules (total consolidated assets greater than or equal to \$250 billion or foreign exposure greater than or equal to \$10 billion). Under the federal banking agencies' proposed capital adequacy rules, 77 Fed. Reg. 52,792 (Aug. 30, 2012), an advanced approaches IHC would be required to comply with both the minimum U.S. leverage ratio (using GAAP assets) of 4% and the supplementary Basel III minimum leverage ratio (using both on- and off-balance sheet exposures) of 3% (beginning January 1, 2018, when the supplementary leverage ratio becomes effective).

the capital regulations applicable in their parent FBO's home country, such as securitization activities.

D. Application of Capital Planning Rule to IHCs Would Effectively Increase Capital Minimums and Potentially Limit Return of Capital to Parent

1. IHCs with \$50 billion or more in assets would be subject to the Federal Reserve's capital planning rule and "CCAR" stress testing (see below), with their first plans due on January 5, 2016. This has the potential to significantly limit the flexibility of an FBO to receive dividends and distributions from its IHC, as all such distributions must be included in the IHC's annual capital plan and receive a non-objection from the Federal Reserve. The Federal Reserve currently requires BHCs subject to the capital planning rule to demonstrate maintenance of a 5% common equity tier 1 ratio under both expected and stressed conditions in order to pay dividends, which would create an effective "minimum stressed common equity tier 1 ratio" beyond what Basel III otherwise requires, even taking into account the capital conservation buffer.
2. The Federal Reserve has also begun requiring capital plans to address long term (beyond two years) capital planning to demonstrate progress toward Basel III targets.
3. Presumably, stress testing and capital plans for IHCs will take into account the role of the IHC's parent FBO as a source of capital (just as capital plans developed by U.S. BHCs owned by FBOs have done so previously). However, industry comment letters are likely to focus on the importance of adapting the capital planning process to U.S. subsidiaries of FBOs in recognition of the fact that they are part of a consolidated banking group and therefore operate under different assumptions regarding likely sources of capital.
4. It is possible that the Federal Reserve's flexible approach to minority ownership of an IHC evidences a recognition that some IHCs may choose to issue additional common stock, preferred stock or convertible instruments to third parties to meet applicable capital ratios.

E. Early Remediation Requirements Would Increase De Facto Capital and Leverage Requirements

1. As described further in Section VII below, the early remediation regime would start applying sanctions, including restrictions on capital distributions and on funding flows from U.S. operations to home office and non-U.S. affiliates, if an IHC's capital ratios were to fall below a

ratio that is set above the minimum U.S. capital ratios. As proposed, “Level 2” remediation could be triggered if an IHC were to fall below a risk-based capital ratio 200-250 basis points above the relevant minimum, or a leverage ratio 75-125 basis points above the relevant minimum. An IHC’s need to maintain a minimum buffer of 75-125 basis points over the minimum U.S. leverage ratio of 4% would create a de facto minimum leverage ratio of 4.75% to 5.25% for IHCs to remain free from regulatory constraints on the activities of the IHC and the Large FBO’s U.S. branches.²¹

2. Similarly, the Proposed Rule would apply sanctions if an FBO’s consolidated global capital ratios were to fall below targets that are set above the minimum Basel III capital ratios. Thus, large FBOs effectively would be required to maintain a leverage ratio of 3.75% to 4.25% at a consolidated level once the Basel III 3% leverage ratio comes into effect in 2018.
3. Any G-SIB surcharge for relevant FBOs, or potentially a “D-SIB” surcharge for some IHCs (as discussed immediately below), would generally apply to the risk-based capital ratios of an organization. The early remediation triggers are, in effect, a method of also applying a “surcharge” to the non-risk-based leverage capital measures applicable to FBOs or IHCs.

F. Possible Application of a Capital Surcharge to IHCs Deemed “D-SIBs”

1. The proposal indicates that the Federal Reserve may apply a quantitative risk-based capital surcharge on IHCs that it deems to be systemically important banking organizations in the United States (“D-SIBs”). The Proposed Rule notes that any such a surcharge would be aligned with the Basel Committee’s D-SIB regime and would be proposed in a separate, future rulemaking.
2. It is unclear whether the application of such a surcharge would “reset” the minimum risk-based capital thresholds in early remediation triggers in the Proposed Rules and/or the definition of “well capitalized” as applicable to subject IHCs.

²¹ Although the Domestic Proposal stated that it would put a Large BHC into Level 2 remediation if its holding company leverage ratio fell below 5%, the appearance of a range of possible trigger points in the Proposed Rule may signify a change in thinking in relation to the Domestic Proposal as well.

G. Increased Capital Costs of U.S. Operations May Cause Some FBOs to Reevaluate U.S. Operations

1. FBOs that have significant nonbanking operations in the United States and manage their capital (and liquidity) in a centralized manner would face particularly challenging strategic questions regarding which, if any, of their U.S. operations could become uneconomic in light of the new capital requirements.
2. Local capital and liquidity requirements may also affect judgments about the level of acceptable risk at an FBO's U.S. operations. Capital or liquidity losses at the U.S. operations would have a significantly greater effect on the overall organization than before because the parent bank would need to address losses through contributions of new capital or liquidity, rather than absorbing losses at the larger consolidated level. Thus, changes to strategy would almost certainly include structural and product mix changes well beyond the insertion of an IHC into the FBO's U.S. organizational structure.

H. Consistency Determinations

1. The Proposed Rule would require Large FBOs to certify compliance with home country capital requirements that are "consistent with" Basel Committee standards. We expect that the Federal Reserve will remain largely deferential to home country regulators in making these determinations, consistent with past practice, although complications could arise as home country regulators implement their versions of Basel III (including, *e.g.*, the Basel III capital buffer for globally systemically important banks (also referred to as "G-SIBs") and the Basel III leverage requirement due to be implemented in 2018).²²
2. Under the Proposed Rule, consistency with the Collins Amendment capital "floor" and with separate U.S. leverage requirements would not be required at the level of the consolidated foreign parent, although the preamble asks whether a leverage ratio requirement should be applied to the global consolidated operations of Large FBOs prior to the phase-in of the Basel III leverage ratio.

²²

In the event that the Federal Reserve were to determine that home country capital requirements were not consistent with Basel accords, the Large FBO would be required to demonstrate to the Federal Reserve that its institution otherwise meets consolidated capital adequacy standards consistent with Basel. Large FBOs that are not able to certify or demonstrate compliance with capital standards consistent with Basel accords would face potential conditions or restrictions on their U.S. activities and business operations.

- a. Despite the lack of an explicit leverage ratio requirement for an FBO's global operations, the Federal Reserve clearly remains interested in the leverage of FBOs. Notably, the Proposed Rule would require Large FBOs to report their total assets (in addition to risk-weighted assets, capital levels and risk-based capital ratios) to the Federal Reserve, providing a readily available denominator for a leverage ratio calculation.
- b. In the federal banking agencies' rulemaking implementing the Collins Amendment, the Federal Reserve raised the question of how the Collins Amendment should be taken into account for purposes of making capital equivalency determinations in the context of applications by FBOs, ultimately concluding that it would evaluate equivalency issues on a "case-by-case basis."²³

I. Implications for Financial Holding Company Status

1. The Proposed Rule and preamble do not address separate requirements in the BHCA that an FBO must satisfy to acquire and maintain FHC status. Under current law, most FBOs that wish to be treated as FHCs are required to maintain well-capitalized status at their subsidiary U.S. depository institutions (if any) and at the parent bank level.²⁴
2. With the introduction of the IHC requirement, several FHC compliance questions arise. However, at least until the Federal Reserve engages in separate rulemaking to revise its FHC regulations, we assume that the Federal Reserve will continue to apply the well-capitalized requirement only at the parent bank (as well as at any depository institution subsidiary).

J. Coordination of Multiple, Duplicative Capital Regimes

1. The Federal Reserve's traditional approach to FBO supervision and regulation permitted most FBOs to operate in the United States without having to make separate capital calculations under U.S. and home country regimes (with the exception, of course, of their U.S. bank subsidiaries).

²³ See 76 Fed. Reg. 37,620, 37,624 (June 28, 2011).

²⁴ See 12 C.F.R. § 225.90. Likewise, a BHC that wishes to qualify for FHC status must ensure that it and each of its subsidiary U.S. depository institutions is well-capitalized. Dodd-Frank Act Section 606 changed the requirements for BHCs to maintain FHC status, so that now both the BHC and its depository institution subsidiaries must be well-capitalized. Although the Federal Reserve has not issued any guidance or rules regarding Section 606, it began applying Section 606 to BHCs and FBOs on its effective date in July 2011.

Large FBOs subject to the IHC requirement likely would have to develop systems to conduct both calculations in parallel for all of their U.S. operations (other than their U.S. branches).

2. In addition to the added burden of conducting multiple capital calculations based on materially different standards, this could in some cases lead to different capital charges associated with the same subsidiary or activities, depending on the capital regime applied.
3. The ultimate effect on overall consolidated capital levels and intragroup allocation of capital would depend in part on the extent of divergence between the U.S. and home country capital standards, which will be especially hard to assess for purposes of comments when neither the U.S. nor EU Basel III capital proposal is final. Certain requirements, such as the application of U.S. leverage ratios and the Collins Amendment capital floor to IHCs but not their foreign parents, would be clear sources of differences. Timing and effective implementation of the Basel III leverage ratio is another likely area of divergence. Calculations would be further complicated by the differences between the federal banking agencies' proposal to implement the standardized approach to determining a banking organization's total risk weighted assets (which, if adopted as proposed, would apply to all IHCs) and the home country capital guidelines applicable to their parents. For example, the federal banking agencies have proposed approaches for determining the risk weights applicable to securitization and residential mortgage exposures that differ markedly from the Basel capital framework.

IV. Issues Related to Liquidity Requirements

The liquidity buffer requirements in the Proposed Rule have the potential to significantly restrict the ability of Large FBOs to rely on their U.S. operations as a source of U.S.-dollar funding (in particular short-term funding) for their global funding needs. We expect that the details of these proposals will be a key area of focus in industry comments. In preparing comments on the liquidity buffer and other aspects of the proposed liquidity requirements, attention should be given to the Federal Reserve's expressed concerns that shaped the proposal. In particular, the Federal Reserve cited concerns regarding (i) the quality of liquidity risk management; (ii) overreliance on short-term funding in the lead-up to the financial crisis; (iii) the increasing number of FBOs that rely on their U.S. operations as a source of U.S.-dollar funding; and (iv) the use of short-term debt financing raised in U.S. markets to support longer-term assets outside of the United States, which could lead to potentially destabilizing cross-border maturity mismatches.

A. *Limited Significance for Large FBOs with Less than \$50 Billion in U.S. Assets*

1. The vast majority of the Proposed Rule's liquidity requirements apply only to Large FBOs with \$50 billion or more in combined U.S. assets.²⁵ Large FBOs with less than \$50 billion in U.S. combined assets are required only to make annual reports to the Federal Reserve on the results of internal liquidity stress tests consistent with Basel Committee principles for liquidity risk management.²⁶
2. Failure to comply with this requirement would limit the net "due from" position of a Large FBO's combined U.S. operations with respect to its non-U.S. operations to no more than 25% of the third-party liabilities of the combined U.S. operations as measured on a daily basis.

B. *Liquidity Management Requirements Apply Across a Large FBO's Combined U.S. Operations*

1. As with the overall risk management requirements discussed below, most of the liquidity management requirements in the Proposed Rule would apply across a Large FBO's combined U.S. operations, including the Large FBO's IHC and its U.S. branch network.²⁷
2. The Proposed Rule's liquidity risk framework for Large FBOs is broadly consistent with the requirements of the Domestic Proposal and with previously expressed guidance and supervisory expectations about funding and liquidity risk management.²⁸ As a result, many Large FBOs are already engaged in substantially similar activities covering all or portions of their U.S. operations and subsidiaries.
3. For Large FBOs that already have a robust liquidity management infrastructure at their U.S. operations and subsidiaries, the main compliance challenge may be in consolidating this infrastructure at the level of an IHC and creating a coordinated liquidity management function

²⁵ Nevertheless, the liquidity buffer and the liquidity governance provisions of the Proposed Rule could apply to an IHC with between \$10 billion and \$50 billion of consolidated assets if the FBO has other assets in the U.S. (e.g., in the FBO's U.S. branches) that make the combined U.S. asset total greater than \$50 billion.

²⁶ See Basel Committee, *Principles for Sound Liquidity Risk Management and Supervision* (Sept. 2008).

²⁷ The liquidity stress test and liquidity buffer requirements would apply separately to each of the IHC and the branch network.

²⁸ See, e.g., Federal Reserve Supervision and Regulation Letter SR 10-6 (Mar. 17, 2010) (Interagency Policy Statement on Funding and Liquidity Risk Management), available at <http://www.federalreserve.gov/boarddocs/srletters/2010/sr1006.htm>.

covering both the IHC and the U.S. branch network, rather than building entirely new systems and operational capacities. Other Large FBOs may face a distinct but related challenge of “spinning off” a U.S.-specific liquidity management unit from their centralized global liquidity management function.

C. Calculation of Liquidity Buffer and Alternatives

1. The liquidity buffer calculations in the Proposed Rule are designed to minimize the use of intragroup cash flow sources to meet external cash flow needs (in other words, the U.S. operations, including branches, of an FBO are meant to find funding sources independent from their parent and affiliates to meet their obligations) and to discourage maturity mismatches between U.S. and non-U.S. operations. To accomplish this, the Proposed Rule would:
 - a. Calculate net external and internal stressed cash flow needs (e.g., the net cash flow needed by the branch network or IHC over a 30-day period) separately and then sum the totals, so that, for example, internal positive cash flow from the home office cannot offset current obligations to be paid to non-affiliated parties; and
 - b. Calculate internal cash flows in a manner that prevents internal cash flow sources (such as maturing loans to parent and non-U.S. affiliates) maturing later in the stress period from offsetting earlier maturing obligations to the parent FBO or non-U.S. affiliates.
2. The details and implications of the liquidity buffer calculations are areas ripe for comment, and the Federal Reserve has invited commenters to address not just its current proposal, but also several alternative or additional approaches to the internal cash flow models in particular.²⁹ Commenters will want to analyze how these calculations might affect their current operations and provide detailed, data-driven comments addressing any concerns.

²⁹ One additional approach would assume that all funding from head office or non-U.S. affiliates would arrive the day after its scheduled maturity date (to prevent intraday arbitrage of maturity matching); a second would do away with the attempt to match maturities within the 30-day period and instead apply a 50% haircut to all incoming internal cash flows from home office or non-U.S. affiliates; a third would adopt an approach similar to the current proposed approach for a liquidity coverage ratio (“LCR”) under Basel III by assuming that all maturing intracompany cash flow obligations over the 30-day horizon mature and roll off at 100% of par, while none of the maturing incoming cash flow sources are received (and therefore cannot be used to offset any maturing intracompany obligations).

- a. Of particular concern might be the inability to use projected intracompany funding sources to meet external funding obligations.

D. Branch Network Liquidity Buffer

1. While IHCs would be required to hold all 30 days of their liquidity buffer in accounts in the United States (which could not be at a U.S. branch or agency of the parent bank or another affiliate), only the first 14 days of the liquidity buffer for a Large FBO's U.S. branch network would always be required to be held in accounts in the United States (which could not be at the affiliated IHC or other affiliate). The remaining buffer for days 15 to 30 could be held instead at the head office or at non-U.S. affiliates, but only so long as the FBO could demonstrate that the parent (or non-U.S. affiliate) has and is prepared to provide highly liquid assets sufficient to meet the remaining liquidity buffer requirement. The buffer for days 15 to 30 also needs only to address the branch network's external cash flow needs.
2. Given the concerns expressed by the Federal Reserve regarding the ability and willingness of FBOs to support their U.S. operations in times of stress (and regarding the willingness of foreign regulators to permit such support), we expect commenters will seek additional clarity regarding what the Federal Reserve expects as evidence that the FBO stands ready and able to provide the remaining liquidity buffer to support its U.S. branch network.
3. Many states and the OCC impose some form of asset pledge or capital equivalency deposit ("CED") requirement on the U.S. branches of FBOs. For example, a federally licensed branch must maintain deposits generally equivalent to 5% of the branch's total third-party liabilities in one or more accounts with unaffiliated banks in the state where the branch is located.³⁰ In New York, a state-licensed branch must maintain an asset pledge in a segregated deposit account with a third-party New York depository institution generally equal to 1% of the branch's total third-party liabilities.³¹ It does not appear that the Federal Reserve considered whether these assets could be counted as part of an FBO's liquidity buffer, and comments may wish to address the intersection of asset pledge/CED requirements and the proposal's liquidity buffer.

³⁰ See 12 C.F.R. § 28.15.

³¹ See New York Comp. Codes R. & Regs., tit. 3, §§ 51.2, 322.1. Branches of "well rated" FBOs have reduced asset pledge requirements under New York law, with a maximum pledge of \$100 million.

E. The Definition of and Potential Expansion of Highly Liquid Assets

1. The required 30-day liquidity buffers can only be met with “highly liquid assets”, defined as cash, U.S. government and agency securities, securities of U.S. government-sponsored agencies (e.g., Freddie Mac and Fannie Mae), and other assets that the Federal Reserve specifically approves.³²
2. This definition tracks the definition in the Domestic Proposal, which was the subject of extensive industry comment due to its narrow scope.
3. Although there is no apparent requirement that cash be U.S. dollars, the Federal Reserve asks for comment on whether “the cash portion of the liquidity buffer [should] be permitted to be held in a currency other than U.S. dollars”. To the extent this question reflects an assumption that the liquidity buffer would need to be held in U.S. dollars, it is unclear why a currency restriction would be necessary or appropriate. There should be no reason why, if the currency is otherwise highly liquid, it could not be exchanged for U.S. dollars (or for another currency that matches the liability that needs to be paid).
4. Notably, there is also no specific requirement that non-cash assets be U.S.-dollar denominated, which may mean that the Federal Reserve would be willing to accept, for example, foreign sovereign bonds that it views as sufficiently stable and high quality.

F. Availability of the Liquidity Buffer During Funding Stress

1. One question the Proposed Rule does not answer clearly is under what circumstances the liquidity buffer could be used to cover periods where funding becomes stressed, although the Federal Reserve specifically contemplates that the liquidity buffer would be used as an FBO’s condition deteriorates.
 - a. The early remediation regime contains no specific triggers based on the level of an IHC or branch’s liquidity buffer (in order to avoid exacerbating runs, according to the Federal Reserve), suggesting that

³² To receive approval, an FBO would have to demonstrate to the Federal Reserve that the asset in question (i) has low market and credit risk, (ii) is traded in an active secondary two-way market where prices can be determined within one day and settled at that price within a reasonable period of time, and (iii) is the type of asset that investors have historically purchased in periods of financial market distress. The phrasing of these criteria suggests that other liquid securities, such as large-cap corporate equities, would be candidates for inclusion.

the Federal Reserve may prefer to take a case-by-case approach to determining when a IHC or branch network is justified in dipping into its liquidity buffer. The early remediation regime, however, does note that during “Level 2” remediation, the branch network is required to hold the full 30-day liquidity buffer in the United States (in contrast to permitting the buffer for days 15 to 30 to be held outside the United States), but that during “Level 3” remediation, there is no longer a requirement that the branch network hold a full 30-day buffer, in order to permit the FBO to use the liquidity buffer to mitigate liquidity stress.

- b. Governor Tarullo has frequently stated that he would like the Basel Committee specifically to allow the LCR to be used in times of stress. The proposal invites comments on whether the Federal Reserve should provide more clarity on when the liquidity buffer could be used and what standards should apply.
2. The Federal Reserve has further observed that it believes that enhancing local liquidity would reduce the need to cut off intragroup funding flows in times of stress, although it should be noted that under the Proposed Rule, if a Large FBO enters “Level 2” or “Level 3” remediation for any reason, its ability to obtain U.S.-dollar funding from its U.S. branches would be severely limited because the branches would need to remain in a net “due to” position in relation to head office and non-U.S. affiliates.

G. Negative Impacts on Intragroup Cash Flows

1. Notwithstanding Governor Tarullo’s statement that the proposed approach “would not impose a cap on intragroup flows” and similar statements in the preamble to the Proposed Rule,³³ the proposal appears designed to do just that. Separate capital and liquidity requirements at the IHC, and separate liquidity requirements for the branch network, are specifically designed to insulate the U.S. operations not only from needing cash and capital from the remainder of the organization, but also from supplying cash and capital to the organization.
2. This result is starkly evident in the liquidity requirements, which, in addition to separating the branch network from the IHC, specifically isolate all internal cash flow among affiliates from external net funding requirements. This restriction on parent foreign bank assistance in paying

³³ See Speech by Governor Daniel K. Tarullo at the Yale School of Management Leaders Forum (Nov. 28, 2012), available at <http://www.federalreserve.gov/newsevents/speech/tarullo20121128a.htm>.

off third-party liabilities could hinder liquidity planning at its U.S. operations.

H. Implications of Liquidity Buffer for U.S.-Dollar Funding of Global Operations

One of the Federal Reserve’s stated goals was to address maturity mismatches between external liabilities and intragroup “due from” positions, as well as between intragroup funding needs and funding sources. This push towards longer-term funding is likely to increase the cost of U.S.-dollar funding obtained in the United States, which may indirectly reduce the amount of funding flowing out of the United States. Some commentators have suggested these increased costs could reduce the U.S. dollar’s role as the global reserve currency.³⁴

I. Potential for Future Liquidity Requirements and Limits on Short-Term Debt

1. The Federal Reserve indicates that the liquidity requirements in the Proposed Rule are only an initial set of enhanced liquidity requirements for Large FBOs subject to Dodd-Frank Section 165, and that it intends to implement the Basel III quantitative liquidity standards in future rulemakings consistent with the Basel III international timeline. Notably, the Federal Reserve indicates that Basel III liquidity requirements might only be applied to a subset of the Large FBOs subject to the Proposed Rule.
2. As proposed in the original Basel III liquidity release, the Basel III liquidity risk framework would require banking organizations to comply with two measures of liquidity risk exposure: (i) the LCR, which is similar to the liquidity buffer in the Proposed Rule, and (ii) the “net stable funding ratio” (the “NSFR”), which is a long-term measure, and as proposed would require that a banking organization’s “available amount of stable funding” be at least 100% of its “required amount of stable funding”.³⁵
3. Both the LCR and NSFR formulas have been controversial and are expected to be revised significantly prior to implementation. The LCR will not be introduced as a requirement until January 1, 2015, and the

³⁴ The preamble to the Proposed Rule also raises the question of whether the Federal Reserve should require Large FBOs with more than \$50 billion in U.S. assets to report on all of their global consolidated cash flows in U.S. dollars, to assist the Federal Reserve in understanding the extent of U.S.-dollar activity and the potential need for U.S.-dollar funding by the global institution.

³⁵ Basel Committee, *Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring* (Dec. 2010).

Basel Committee is expected to make additional revisions to the LCR by mid-2013. The NSFR has an even longer implementation horizon; it will not be introduced as a requirement until January 1, 2018, with expected additional revisions in 2016.

4. Governor Tarullo has stated on a number of occasions that the LCR could be improved by:
 - a. Broadening the definition of eligible instruments, through a greater focus on market liquidity rather than credit risk of the instruments;
 - b. Making more flexible the assumptions used for liquidity analyses, in particular making more realistic the assumptions related to how much credit will be drawn from a banking organization in times of stress, how much credit a banking organization will be able to draw off of its own funding lines and how much deposit run-off there will be;
 - c. Clearly permitting use of the liquidity buffer during stressed times (i.e., it can go below 100% coverage); and
 - d. Focusing more on short-term/long-term funding distinctions and maturity mismatches, particularly given concerns about short-term repo funding used for trading activities.
5. Some of these issues are addressed in the Proposed Rule, which features several proposed approaches to the assumptions applied to cash flows in liquidity analyses, an increased focus on maturity mismatches, and at least a potential avenue for qualifying additional financial instruments as highly liquid assets. These might be some indication of the changes the Federal Reserve hopes to accomplish in the revisions to the Basel III LCR. However, as noted above, the Proposed Rule contains no explicit statement about when a liquidity buffer may be used.
6. Governor Tarullo has also stated that the NSFR requires significant additional consideration by the Basel Committee.

V. Issues Related to the Single-Counterparty Credit Limits

As with many other provisions of the Proposed Rule, the basic framework of the SCCLs for FBOs mirrors the SCCLs for U.S.-headquartered institutions in the Domestic Proposal. Under the Proposed Rule, however, the U.S. operations of many FBOs would be subject to two separate SCCL calculations. Both an IHC and a Large FBO's "combined U.S. operations" would be separately subject to the

Proposed Rule’s SCCLs, thereby limiting their aggregate net credit exposure to any single unaffiliated counterparty to 25% of the consolidated capital stock and surplus of the IHC or Large FBO, respectively. (“Major” IHCs and FBOs would be subject to a stricter limit on credit exposures to major counterparties.)

The SCCL provisions of the Domestic Proposal drew intense scrutiny and detailed criticism from commenters. Many of those same comments are likely to apply to the Proposed Rule’s SCCL provisions. In addition, application of the SCCLs to IHCs and Large FBOs raises additional potential concerns.

A. *No Consideration of Comparable Home Country Standards*

The SCCL provisions in the Proposed Rule fail to take into account whether an FBO is subject to comparable concentration and exposure limits under its home country laws and regulations. Although consistent with the general approach of the Proposed Rule, the omission seems especially glaring in the case of SCCLs, which have long been a core component of banking regulation in jurisdictions worldwide.³⁶

B. *SCCLs Would Apply Regardless of U.S. Asset Size*

1. Unlike other provisions, where the Federal Reserve chose to differentiate compliance requirements for Large FBOs that are above or below the threshold of \$50 billion in total U.S. assets, the SCCLs would apply equally to all Large FBOs. The Federal Reserve did not explain this decision, and it is difficult to reconcile with the purpose of Section 165, which is the reduction of systemic risks to U.S. financial stability. Large FBOs with a small U.S. footprint and no relevance to U.S. financial stability would still be required to calculate their exposure and comply with the SCCL requirement on a daily basis.
 - a. As a practical matter, if a Large FBO conducts relatively small U.S. operations, application of the SCCLs may not impose meaningful constraints because the SCCL for an FBO’s combined U.S. operations is calculated using the parent FBO’s global consolidated capital stock and surplus. However, the compliance burden associated with monitoring against the SCCLs is not insignificant.

³⁶ See Basal Committee, *Core Principles for Effective Banking Supervision* (Sept. 1997) (“supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers”).

C. *SCCLs Would Apply to Both IHC and Combined U.S. Operations*

1. Unlike the SCCL applied to an FBO's combined U.S. operations, the SCCL applied to an IHC is calculated based on the total capital stock and surplus of the IHC, and thus may create significant constraints on IHCs as proposed.³⁷
2. The Proposed Rule would require that, once either the IHC or the combined U.S. operations of a Large FBO exceeds the 25% SCCL with respect to a counterparty, neither the IHC nor the FBO's branch network would be permitted to increase its exposure to that counterparty without specific, case-by-case authorization of the Federal Reserve.
 - a. This result is in stark contrast with the current operation of the lending limits applicable to U.S. banks and U.S. branches of FBOs. For example, if a depository institution subsidiary of an FBO reaches its lending limit vis-à-vis a borrower, the FBO's branch is not prevented from lending to the same borrower.
 - b. This "cross-trigger" aspect of the Proposed Rule creates another incentive for a Large FBO with significant branch operations to move at least some portion of its lending activities outside the United States.
3. In addition, no differentiation was made for IHCs that are below \$50 billion in consolidated assets. This could be particularly constraining because, as noted, (a) the IHC SCCL is calculated based on the smaller capital stock and surplus of the IHC, and (b) under the "cross-trigger," an FBO's entire combined U.S. operations, including branches and agencies, may be restricted from entering into further transactions with certain counterparties if the IHC's SCCL is reached.
4. Even putting aside the "cross-trigger" feature of the SCCLs, it is not clear why a new SCCL specific to a Large FBO's branches would be necessary. U.S. branches are already subject to federal and/or state law lending limits.³⁸ Rather than imposing an SCCL requirement on an FBO's branch network, it should arguably be sufficient to require

³⁷ Curiously, the Federal Reserve reiterated a question raised in the Domestic Proposal as to whether common equity, instead of capital stock and surplus, should be used as the denominator for calculating the SCCLs. No real reason was provided, and the Federal Reserve did not discuss whether, as a result of what would be a smaller denominator, the percentage limits would be raised.

³⁸ See, e.g., 12 U.S.C. §§ 84, 3102(b), 3105(h)(2).

compliance with pre-existing branch lending limit rules paired with the FBO's home country credit exposure rules.

D. "Major" Firm Limit Appears to be in Flux

1. As in the Domestic Proposal, the Proposed Rule would apply stricter exposure limits to Large FBOs and IHCs with more than \$500 billion in total consolidated assets with respect to their credit exposures to major counterparties (*i.e.*, BHCs and FBOs with more than \$500 billion in assets and systemically important nonbank financial companies supervised by the Federal Reserve). Significantly, the Federal Reserve did not propose the 10% limit that appeared in the Domestic Proposal, but rather indicated that the limit would be consistent with the limit ultimately determined for major U.S. banking organizations.
2. The preamble to the Proposed Rule emphasizes that the industry should not infer from this that the Federal Reserve has come to a determination to change the limit, though it would seem likely that the empirical evidence predicting a significant impairment of financial markets submitted by some commenters to the Domestic Proposal has caused the Federal Reserve to reconsider its approach. A staff memorandum released at the same time as the Proposed Rule indicates that the Federal Reserve is conducting its own quantitative impact study in relation to the proposed "major" firm limit.
3. The preamble also suggests that the Federal Reserve might amend the "major" limit at a later date if an international agreement with respect to large exposure limits is reached.

E. Application of the Attribution Rule

1. Although the preamble states that the Proposed Rule "adopts a minimal scope of application" of the attribution rule required under the statutory text of Section 165, no further details are provided and the regulatory language does not include any limitation on the application of this rule.³⁹

³⁹ See Dodd-Frank Act § 165(e)(4). Compare 12 C.F.R. § 223.16 (Federal Reserve attribution rule under Sections 23A and 23B of the Federal Reserve Act); 12 C.F.R. § 32.5 (OCC lending limit combination rules). Under the attribution rule in Sections 23A and 23B of the Federal Reserve Act, a bank must attribute a transaction with a third party to an affiliate of the bank to the extent that the proceeds of the transaction are "used for the benefit of, or transferred to," the bank's affiliate. The same language appears in the statutory text of Section 165 and in both the Proposed Rule and the Domestic Proposal, and therefore it is not clear how the "proposal adopts a minimal scope of application" of the attribution rule.

2. In the Domestic Proposal, the Federal Reserve acknowledged that “an overly broad interpretation” of the attribution rule would lead to “inappropriate results” and “create a daunting tracking exercise”, and that it therefore proposed to “minimize the scope of application” in a manner consistent with preventing evasion of the SCCLs. However, neither the Proposed Rule nor the Domestic Proposal explicitly relies on an anti-evasion provision in lieu of, or to qualify, the attribution rule.
3. Commenters on the Domestic Proposal urged the Federal Reserve to clarify in the text of its final implementing rule that the Section 165 attribution rule should apply only where a company has sought to evade limits on exposure to one party by structuring the transaction with another party.
4. As a result, the scope of the attribution rule remains unclear, creating potentially significant operational challenges. It is helpful that the Federal Reserve has acknowledged the potential pitfalls of a broad reading of the statutory language, but financial institutions should continue to seek clarity on the extent to which they would be expected to track attribution in order to comply with the Proposed Rule.

F. Exemption of Home Country Sovereign Obligations

1. Likely in response to comments on the Domestic Proposal, the Federal Reserve has proposed to exempt from an FBO’s SCCLs exposure to the FBO’s home country sovereign. While helpful, the exemption arguably should be broadened to address several issues.
2. In a number of countries, the political subdivisions of the sovereign are important issuers of government debt. Under the Proposed Rule, exposures to these issuers would not be exempt. FBOs should consider advocating for the expansion of the home country sovereign exemption to cover these issuers.
3. It is unclear how the home-country sovereign exemptions would apply in the case of tiered FBOs where the parent FBO and subsidiary FBO are organized in different jurisdictions. While some of these issues may be addressed if a tiered FBO were to form multiple IHCs (with Federal Reserve approval), it would appear consistent with the policy objectives of the exemption to permit each FBO and its U.S. operations to disregard exposure to the sovereign of the country in which it is organized.
4. The proposed exemption also does not address the Proposed Rule’s potential effect on sovereign debt transactions in major host countries,

such as countries where an FBO may have significant banking operations outside of its home country or countries with major financial centers where financial institutions from many jurisdictions—U.S. and non-U.S.—play a central role in making a market in the local sovereign’s debt and extending credit to sovereign entities.

G. Constraints on Enterprise-Wide Risk Management

1. The Proposed Rule would prohibit a Large FBO or its affiliates from serving as an “eligible protection provider” for the FBO’s U.S. operations or IHC.⁴⁰
2. In the context of enterprise-wide risk management, an IHC or branch would—as the U.S. operations of many Large FBOs currently do—often find it efficient (or even necessary) to engage in certain hedging transactions with its parent FBO or other affiliates. As an example, risks incurred in transactions with customers whose primary operations are located in the home country of the FBO may be managed centrally at the FBO’s head office. In this case, the FBO’s U.S. operations may hedge the credit risk of a transaction with a U.S. subsidiary of such a multinational corporation by obtaining a guarantee, credit protection or equity protection from the home office. The FBO’s head office will likely have ready access to a more liquid, third-party market for protection on the customer because the customer’s primary operations are in such market.
3. Although this policy choice may reflect Federal Reserve concerns about the home country parent’s ability or willingness to provide support to its U.S. operations, it may force Large FBOs to rethink which of their subsidiaries or branches would be their preferred trading or lending entity, since for SCCL purposes the FBO’s U.S. operations would not be permitted to exclude exposure from the SCCL calculation by transferring the risk to the FBO’s head office.

H. Treatment of FBOs Controlled by Sovereign Governments

1. A number of FBOs are controlled (for purposes of the BHCA) by foreign sovereign governments (either due to actions taken to stabilize certain

⁴⁰ In addition, although the Proposed Rule’s definition of “eligible collateral” for the purposes of reducing gross exposure is generally consistent with that in the Domestic Proposal, the Proposed Rule (unlike the Domestic Proposal) “clarifies” that eligible collateral does not include “debt or equity securities (including convertible bonds), issued by an affiliate of the [IHC] or by any part of the combined U.S. operations” of the Large FBO.

foreign banks during the financial crisis or due to strong connections between the government and its banking sector) or sovereign wealth funds. As noted above, we would expect that the Federal Reserve would not seek to impose Section 165 requirements such as compliance with the SCCLs on the U.S. nonbanking activities of sovereigns or sovereign wealth funds that control Large FBOs.

2. However, the aggregation rules for calculating credit exposure to sovereigns under the SCCLs raise another distinct issue. In the case of a foreign sovereign entity, FBOs (and Large BHCs under the Domestic Proposal) must count the sovereign and all of its agencies, instrumentalities and political subdivisions, collectively, as one counterparty, raising the question of whether a Large BHC or Large FBO must aggregate its credit exposure to a foreign sovereign-controlled FBO with the foreign sovereign. (The issue could also arise in the case of an FBO undergoing resolution through a government-controlled bridge bank, which could significantly complicate the resolution process.) Although this issue was raised in several comment letters submitted on the Domestic Proposal, the Federal Reserve did not adjust its approach in the Proposed Rule.

VI. Issues Related to Stress Testing

The Proposed Rule would impose U.S. stress testing requirements on an IHC equivalent to those applicable to a comparably sized U.S. BHC—*i.e.*, annual supervisory stress tests and semi-annual company-run stress tests for IHCs with \$50 billion or more in assets, and annual company-run stress tests for IHCs with \$10 billion or more in assets. It would also require FBOs with \$10 billion or more in global assets to be subject to a consolidated home country capital stress testing regime that includes external or supervised internal annual stress tests.

A. IHC Stress Testing

1. Public Disclosure of Results

- a. The Federal Reserve’s stress testing regime for BHCs requires the public disclosure of certain summary results from company-run stress tests and from the Federal Reserve’s supervisory stress tests. These disclosure requirements are evolving; currently, only results from the “severely adverse” scenario are expected to be disclosed, but the Federal Reserve has suggested additional disclosure may be required in the future. Application of stress test disclosure requirements to an IHC (rather than banks or top-tier BHCs) will present particular challenges.

- i. Without the Proposed Rule's application to the IHC, an FBO would likely disclose information related to the IHC only within its global consolidated results (if at all). An IHC's stress test results could be misleading due to the assumptions of severe stress and potential absence of support from non-U.S. affiliates.
 - ii. The disclosure requirements may also be inconsistent with home-country securities disclosure regimes, particularly regarding the timing of the reporting of information. Notably, the Federal Reserve adjusted its requirements regarding timing of disclosure of stress test results to match better the disclosure obligations of U.S. institutions. We expect that the Federal Reserve is likely to be receptive to comments addressing potential timing conflicts for FBOs.
2. Stress Testing Delayed for FBO-Controlled BHCs Previously Subject to the Domestic Proposal
 - a. Because the Proposed Rule would supplant the Domestic Proposal to the extent it would have applied to U.S. BHCs owned by FBOs, the Proposed Rule would effectively delay the timeline required by regulation for implementation of stress testing.
 - b. Whereas most U.S. BHCs would, under the Domestic Proposal, begin stress testing in October 2013, IHCs (including FBO-controlled Large BHCs not relying on SR Letter 01-1) would not be required to commence testing until October 2015 under the proposal.

B. Stress Testing Requirements for Combined U.S. Operations

1. Requirement for Home Country Stress Testing that is Broadly Consistent with U.S. Stress Tests
 - a. All FBOs with \$10 billion or more in global assets, regardless of the size of their U.S. operations, would need to be subject to (and pass) a consolidated annual home country capital stress testing requirement that is broadly consistent with U.S. stress testing in order to avoid certain restrictions.
 - b. The proposal outlines high-level requirements for the home country stress testing regime. The home country stress test must either be an annual supervisory capital stress test conducted by the FBO's home country supervisor or an annual evaluation by that supervisor

of a company-run test. The regime must include requirements for governance and controls by management and the company's board of directors.

- c. We expect that the stress testing regimes in most major jurisdictions are likely to satisfy these requirements, particularly since stress testing has been a point of emphasis for the Financial Stability Board and has become an important element of the Basel framework and generally accepted supervisory principles.⁴¹

2. Additional Information and Demonstration of Capital Adequacy Required if Branches Operate in Net Due From Position

- a. Large FBOs with combined U.S. assets of \$50 billion or more⁴² would be required to provide specified information regarding home country stress testing activities and results to the Federal Reserve. If the branch network of such an FBO is in a net "due from" position with the foreign bank parent or international affiliates, it is subject to additional informational requirements and must "demonstrate to the Federal Reserve that [the FBO] has adequate capital to withstand stressed conditions".
- b. Neither the preamble nor the Proposed Rule provide any detail about how the Federal Reserve would make such a capital adequacy determination, but the additional information required includes a more detailed description of the stress test methodologies, detailed information about the projected financial and capital position over the planning horizon, and any additional information that the Federal Reserve deems necessary in order to evaluate the ability of the FBO to absorb losses in stressed conditions.
- c. These provisions appear to represent a significant incremental requirement for institutions with a net due from position, and they highlight the fact that, although the proposal purports not to limit intragroup funding flows, net due from positions can trigger

⁴¹ See, e.g., Financial Stability Board, *Intensity and Effectiveness of SIFI Supervision: Recommendations for Enhanced Supervision* at 11 (Nov. 2010); Basel Committee, *Principles for Sound Stress Testing Practices and Supervision* (Jan. 2009).

⁴² The Proposed Rule makes one reference to this requirement applying to all FBOs with \$50 billion or more in total (i.e., global) consolidated assets; however, the Proposed Rule and preamble otherwise consistently refer to the requirement as applying to FBOs with consolidated U.S. assets of \$50 billion or more, so it appears that there is a typographical error in the text of the Proposed Rule. See 77 Fed. Reg. 76,662 (preamble), 76,696 (§ 252.261(a)), 76,698 (§ 225.263(b) and heading).

significant additional scrutiny and restrictions. The preamble discussion notes that the heightened information requirements applied to large institutions with net due from positions “reflects the greater risk to U.S. creditors and U.S. financial stability posed by U.S. branches and agencies that serve as funding sources to their foreign parent.”

VII. Issues Related to the Early Remediation Regime

The framework for early remediation applicable to Large FBOs is largely consistent with the early remediation framework in the Domestic Proposal, including the categories of triggers, the thresholds that would trigger remediation steps, and the remediation measures that would be authorized, with some adaptation for the structure and operations of FBOs.

A. *Potential Concerns Regarding Links Between Early Remediation Triggers for an FBO’s IHC and its Branches*

1. One likely area of concern for FBOs is the “cross-default” nature of the triggers applicable to a Large FBO’s IHC and its U.S. branches.
 - a. Some of the triggers, such as stress test-based triggers, would apply only to an IHC controlled by an FBO. Other triggers, such as capital, liquidity risk management and—when the Federal Reserve adopts them—market-based triggers, would apply separately to the IHC on the one hand and the parent FBO/U.S. branches on the other hand.
 - b. However, remediation measures would be imposed on the combined U.S. operations of the FBO (*i.e.*, both the IHC and the FBO’s U.S. branches), even if triggered by only one part of the FBO’s U.S. operations.
 - c. Consequently, a deficiency in an FBO’s consolidated capital ratio, or in a home country market-based factor, or in home country or U.S. branch liquidity risk management compliance, could lead to the imposition of remedial measures on the IHC, even if the IHC were otherwise sound and in compliance with all applicable heightened prudential standards. Likewise, a deficiency with an IHC’s capital or risk management structure would have consequences for the parent FBO’s U.S. branches.

B. Little Practical Distinction Between Automatic and Discretionary Remediation

1. For FBOs with \$50 billion or more in combined U.S. assets, remediation measures for the combined U.S. operations would be automatic.
2. However, in an apparent attempt to tailor the remediation framework to Large FBOs with less than \$50 billion in combined U.S. assets, the proposal would make the Federal Reserve's imposition of remediation measures discretionary for those institutions (with the implicit ability to apply remedial measures separately to only part of the FBO's U.S. operations)
3. As a practical matter, however, it is likely that institutions in that category (which would include dozens of Large FBOs with a small U.S. footprint and no relevance to U.S. financial stability) would be forced to manage themselves above the early remediation framework's triggers to avoid uncertainty about the imposition of supervisory restrictions. While the preamble to the Proposed Rule suggests that the Federal Reserve expects to take into account the risk to U.S. financial stability that a Large FBO poses before actually imposing remediation measures, (a) this factor is not included in the Proposed Rule, and (b) more importantly, without assurance regarding how the Federal Reserve would analyze this factor, few Large FBOs in this category would take the chance of crossing a remediation trigger.
4. The lack of practical tailoring of the early remediation framework for Large FBOs based on their U.S. footprint is likely to be an area of significant industry comment, especially in light of the fact that the remediation triggers create de facto additional capital requirements.

C. De Facto Heightened Leverage Ratio Requirement for IHCs

1. While not unique to FBOs, one feature of the Federal Reserve's implementation of the early remediation framework that has special implications for FBOs is the nature of the leverage ratio trigger.
2. An IHC would trigger Level 2 remediation for a Large FBO if the IHC's leverage ratio fell below 75-125 basis points above the minimum (i.e., below 4.75-5.25%).⁴³ A similar buffer would apply to an FBO's consolidated leverage ratio when implemented in accordance with

⁴³ This range indicates that the Federal Reserve is continuing to consider the appropriate buffer above the minimum leverage ratio for the early remediation trigger. The Federal Reserve specifically requests comments on where in the range the buffer should fall.

Basel III. Due to the consequences of triggering Level 2 remediation (restrictions on IHC dividends, additional liquidity restrictions on branches and agencies, etc.), it can be expected that the early remediation leverage ratio trigger would become the de facto minimum leverage ratio for most institutions.

3. This phenomenon has particular consequences for Large FBOs because of the novelty of applying a leverage ratio requirement at all on an FBO's U.S. subsidiaries and the fact that the required buffer above the Basel III minimum leverage ratio, when implemented, will be a U.S.-specific requirement.

D. Expected Additional Complexity for Market-Based Triggers for Large FBOs

1. Consistent with the Domestic Proposal, the Federal Reserve indicates in the preamble to the Proposed Rule that it is continuing to consider appropriate market-based triggers, and is not proposing to include specific market indicators among the remediation triggers at this time.
2. Market-based triggers present numerous complexities, not unlike similar issues in the contingent capital context, including the potential to accelerate a downward spiral in stress scenarios, and vulnerability to “false positive” and “false negative” effects.
3. The Federal Reserve solicits comments on a number of questions related to the use of market-based triggers, most of which are generic questions about the development of market indicators. FBOs should consider supplementing any responses to the Federal Reserve's specific questions with views regarding the potential difficulties that would arise in adapting market indicators to FBOs (including the unavailability of some market indicators for U.S. subsidiaries and branches, as well as potential flaws in using head office market indicators).

VIII. Issues Related to the U.S. Risk Committee Requirement

Although in general the Proposed Rule's risk management provisions are among the more straightforward in application, and reflect several adjustments intended to adapt the Domestic Proposal to FBOs, they nonetheless raise several issues for consideration and potential industry comment.

The Federal Reserve poses a number of questions in the preamble acknowledging the issues raised below, in particular regarding the location and structure of mandated risk-management functions. For institutions whose corporate governance structures

would not conform to the models contemplated by the Proposed Rule, this is an area where comments could lead to greater flexibility.

A. Scope of FBOs Covered by U.S. Risk Committee Requirement

1. The Proposed Rule would require Large FBOs and all publicly traded FBOs with \$10 billion or more in global assets to maintain a U.S. risk committee, and would impose additional governance requirements on Large FBOs with \$50 billion or more in U.S. assets.
 - a. It is unclear why a U.S. risk committee requirement is necessary to protect U.S. financial stability for FBOs with more than \$10 billion in global assets, regardless of the size of their U.S. operations. Application of the \$10 billion statutory threshold to an FBO's global assets, although generally consistent with the Federal Reserve's application of other asset thresholds in Section 165, seems particularly overbroad in this circumstance.
 - b. Although the Federal Reserve may have concluded that it is constrained by the statutory language of Section 165, it arguably has significantly more flexibility to interpret Section 165 and calibrate risk management standards (e.g., to defer to a greater degree to home country corporate governance structures) to avoid imposing U.S. risk management requirements on banks that are clearly irrelevant to U.S. financial stability.

B. Risk Committee Location

1. The Proposed Rule would allow most FBOs that are required to have a U.S. risk committee to choose between housing the committee (a) in the FBO's head office board of directors, or (b) in its IHC board of directors. For FBOs that choose to use a head office committee, the U.S. risk committee could be either a standalone committee (an unlikely choice for many FBOs) or part of an enterprise-wide risk committee of the board. However, without explanation, the Proposed Rule would eliminate this flexibility for an FBO with combined U.S. assets of \$50 billion or more that operates solely through an IHC (i.e., with no branches or agencies). FBOs in this structure would be required to house the U.S. risk committee in the board of the IHC.
2. As a practical matter, the vast majority of affected FBOs operate at least one U.S. branch and therefore should be able to house the U.S. risk committee in its head office board of directors.

3. It is not clear, however, why an FBO with only an IHC should have less flexibility to house its U.S. risk committee in its head office board of directors than an FBO whose U.S. operations are otherwise similar but that operates even a small U.S. branch in addition to its IHC. Those FBOs that do operate exclusively through subsidiaries, and therefore would operate exclusively through an IHC, may want to consider commenting on this discrepancy if the flexibility to house the U.S. risk committee in the head office board of directors is important.

* * *

If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under “Banking and Financial Institutions” under the “Practices” section of our website at <http://www.clearygottlieb.com>.

Applicability of Key Provisions of FBO 165/166 Proposal by Asset Size

<u>Standard</u>	<u>Global Assets</u> \$10-50 billion	<u>Global Assets</u> ≥ \$50 billion			
	<u>U.S. Assets</u> N/A	<u>FBO Requirements</u>		<u>IHC Requirements</u>	
		<u>Combined U.S. Assets</u> < \$50 billion in total U.S. operations	<u>Combined U.S. Assets</u> ≥ \$50 billion in total U.S. operations	<u>U.S. Non-Branch Assets</u> ≥ \$10 billion but < \$50 billion (excluding branches)	<u>U.S. Non-Branch Assets</u> ≥ \$50 billion (excluding branches)
Required to Form IHC	N/A	N/A	N/A	Yes	Yes
Risk-Based Capital & Leverage Requirements	N/A	Must meet capital adequacy standards at the parent consolidated level that are consistent with the Basel capital framework, and must provide certain information to the Federal Reserve on a consolidated basis	Same as < \$50 billion	Must comply with U.S. BHC capital requirements	Same as ≥ \$10 billion, <u>and</u> subject to the Federal Reserve’s capital plan rule (12 C.F.R. § 225.8)
Liquidity Risk Management	N/A	Required to report results of annual internal liquidity stress test—either on consolidated basis or for combined U.S. operations	Combined U.S. operations (including branches and IHC) required to meet liquidity risk management and governance standards, conduct liquidity stress tests, make cash flow projections, set liquidity risk limits, establish specific liquidity risk limits, and maintain a contingency funding plan	No IHC-specific requirements	

<u>Standard</u>	<u>Global Assets</u> \$10-50 billion	<u>Global Assets</u> ≥ \$50 billion			
	<u>U.S. Assets</u> N/A	<u>FBO Requirements</u>		<u>IHC Requirements</u>	
		<u>Combined U.S. Assets</u> < \$50 billion in total U.S. operations	<u>Combined U.S. Assets</u> ≥ \$50 billion in total U.S. operations	<u>U.S. Non-Branch Assets</u> ≥ \$10 billion but < \$50 billion (excluding branches)	<u>U.S. Non-Branch Assets</u> ≥ \$50 billion (excluding branches)
Liquidity Buffers	N/A	N/A	<p>Separate liquidity buffer requirements for IHC (see right) and branch network</p> <p>Branch network must maintain separate 30-day liquidity buffer. First 14 days of liquidity buffer required to be held in the United States; remainder may be held at parent with Federal Reserve approval</p>	<p>If combined U.S. assets ≥ \$50 billion, IHC must maintain separate 30-day liquidity buffer of highly liquid assets—all held in the United States</p>	
Single-Counterparty Credit Limit	N/A	<p>Combined U.S. operations (including branches and IHC/bank and nonbank subsidiaries) subject to net credit exposure limit with respect to any single unaffiliated counterparty equal to 25% of parent FBO's consolidated capital stock and surplus</p> <p>If ≥ \$500 billion in assets, subject to stricter limit on exposure to major counterparties</p>		<p>Subject to net credit exposure limit with respect to any single unaffiliated counterparty equal to 25% of IHC's capital stock and surplus</p> <p>If ≥ \$500 billion in assets, subject to stricter limit on exposure to major counterparties</p>	
Risk Management	If publicly traded, FBO must have U.S. risk committee	Must have U.S. risk committee	U.S. risk committee subject to heightened responsibilities with at least one independent member. Must appoint a U.S. chief risk officer	IHCs must be governed by a corporate-style board of managers or directors	

<u>Standard</u>	<u>Global Assets</u> \$10-50 billion	<u>Global Assets</u> ≥ \$50 billion			
	<u>U.S. Assets</u> N/A	<u>FBO Requirements</u>		<u>IHC Requirements</u>	
		<u>Combined U.S. Assets</u> < \$50 billion in total U.S. operations	<u>Combined U.S. Assets</u> ≥ \$50 billion in total U.S. operations	<u>U.S. Non-Branch Assets</u> ≥ \$10 billion but < \$50 billion (excluding branches)	<u>U.S. Non-Branch Assets</u> ≥ \$50 billion (excluding branches)
Stress Testing	FBO must be subject to consolidated home country capital stress testing regime that includes external or supervised internal annual stress test	Same as < \$50 billion, <u>and</u> must submit summary results of home country stress tests to the Federal Reserve. If U.S. branch network operates in a net “due from” position, must demonstrate that the FBO “has adequate capital to withstand stressed conditions”	Subject to annual company-run stress test as if it were a U.S. BHC, with certain results made public	Subject to annual supervisory and semi-annual company-run stress tests as if it were a U.S. BHC, with certain results made public	
Debt-to-Equity Limitations	N/A	<p>Upon a determination by the FSOC that an FBO poses a grave threat to the financial stability of the United States and that such a limit is necessary to mitigate that risk, the FBO’s U.S. operations would be subject to the following limits:</p> <p><u>IHC and other U.S. subsidiaries</u>: Debt-to-equity ratio limit of 15-to-1</p> <p><u>U.S. branch network</u>: 108% asset maintenance requirement</p>			
Early Remediation	N/A	Discretionary	Automatic	Discretionary or automatic, depending on FBO’s combined U.S. assets (see left)	

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