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Federal Reserve Finalizes U.S. and Foreign Bank Prudential Standards

The long-awaited standards establish significant structural, liquidity, risk management, and capital requirements for the largest U.S. and foreign banks operating in the United States, including new intermediate holding company requirements for foreign banks.

The Federal Reserve Board (Federal Reserve) has adopted final rules (Final Rules) implementing the enhanced prudential standards of section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) for U.S. bank holding companies and foreign banking organizations (FBOs) with $50 billion or more in total consolidated assets.[1] The Final Rules, adopted on February 18, are based on the Federal Reserve's previously proposed rules to implement section 165 of the Dodd-Frank Act for domestic bank holding companies (domestic proposal) and FBOs (foreign proposal) (collectively, the Proposed Rules), published in December 2011 and December 2012, respectively.[2]

The Final Rules establish enhanced liquidity and risk management requirements for U.S. top-tier bank holding companies with total consolidated assets of $50 billion or more. In addition, the Final Rules impose a U.S. intermediate holding company requirement for FBOs with $50 billion or more in U.S. non-branch/agency assets, and they impose enhanced risk-based and leverage capital requirements, liquidity requirements, risk management requirements, and stress-testing requirements on FBOs with total consolidated worldwide assets of $50 billion or more. Lastly, the Final Rules establish a risk committee requirement for publicly traded bank holding companies and FBOs with total consolidated assets of $10 billion or more and a stress-testing requirement for FBOs with total consolidated assets of $10 billion or more.

The Final Rules will be effective for covered U.S. top-tier bank holding companies beginning on January 1, 2015 and covered FBOs beginning on July 1, 2016.

Enhanced Prudential Standards for U.S. Bank Holding Companies

Capital Planning and Stress Testing. The Federal Reserve previously adopted enhanced risk-based and leverage capital requirements and stress-testing requirements for large bank holding companies. In 2011, the Federal Reserve issued a capital plan rule requiring capital plans and governing capital distributions for bank holding companies with total consolidated assets of $50 billion or more. Thereafter, in 2012, the Federal Reserve issued final stress-test rules for bank holding companies with total consolidated assets of more than $10 billion. The Final Rules confirm these previously adopted rules and require compliance with the Federal Reserve's regulations regarding capital planning and stress testing.

Liquidity and Risk Management Requirements. The Final Rules impose new liquidity and risk management requirements on large domestic bank holding companies. Under the new liquidity requirements, a bank holding company with total consolidated assets of $50 billion or more must meet liquidity risk management standards,

1. View the Final Rules at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20140218a1.pdf.

2. View the Proposed Rules at http://www.gpo.gov/fdsys/pkg/FR-2012-01-05/pdf/2011-33364.pdf (domestic proposal) and http://www.gpo.gov/fdsys/pkg/FR-2012-12-28/pdf/2012-30734.pdf (foreign proposal).

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conduct internal liquidity stress tests, and maintain a 30-day buffer of highly liquid assets. Liquidity risk management strategies, policies, and procedures must be established by the bank holding company's senior management and approved by its board of directors and must also be subject to annual independent review.

The Final Rules further require a bank holding company with total consolidated assets of $50 billion or more to establish an enterprisewide risk committee chaired by an independent director and to have at least one member with experience in identifying, assessing, and managing risk exposures of large, complex financial firms. A bank holding company with total consolidated assets of $50 billion or more must also appoint a chief risk officer. Publicly traded bank holding companies with total consolidated assets of $10 billion or more but less than $50 billion are also required to establish a risk committee chaired by an independent director that includes at least one member having experience in identifying, assessing, and managing risk exposures of large, complex firms.

Enhanced Prudential Standards for FBOs

The Final Rules establish enhanced prudential standards for FBOs, including new requirements for the establishment of intermediate holding companies, risk-based and leverage capital, liquidity, and risk management.

Intermediate Holding Companies. Under the Final Rules, an FBO with U.S. non-branch/agency assets of $50 billion or more is required to hold its U.S. subsidiaries under an intermediate holding company. The intermediate holding company would be subject to enhanced prudential standards on a consolidated basis. U.S. branches and agencies of an FBO, as well as foreign companies with limited U.S. operations (known as section 2(h)(2) companies), may continue to operate outside of the intermediate holding company.

Capital Requirements. The Final Rules subject an intermediate holding company of an FBO to the standardized risk-based and leverage capital standards applicable to U.S. bank holding companies; the U.S. "advanced approaches" capital rules, however, will not apply unless an FBO specifically opts in to the advanced approaches. The intermediate holding company will also be subject to the Federal Reserve's capital plan rule. In addition, an FBO with total global consolidated assets of $50 billion or more must certify that it meets consolidated capital adequacy standards established by its home country supervisor that are consistent with the Basel Capital Framework.

Liquidity and Risk Management. The Final Rules require the U.S. operations of an FBO with combined U.S. assets of $50 billion or more (in this case, **including** U.S. branch/agency assets) to meet liquidity risk management standards and conduct internal liquidity stress tests. The U.S. branches and agencies of an FBO must maintain a liquidity buffer in the United States for the first 14 days of a 30-day liquidity stress test. The intermediate holding company is required to maintain a liquidity buffer in the United States for a 30-day liquidity stress test. An FBO with total consolidated assets of $50 billion or more, but with combined U.S. assets of less than $50 billion, is not required to perform a separate stress test for its U.S. operations, but instead it may report the results of an internal liquidity stress test (either on a consolidated basis or for its combined U.S. operations) to the Federal Reserve on an annual basis.

Consistent with the requirements for U.S. bank holding companies, an FBO with combined U.S. assets of $50 billion or more is required to establish a U.S. risk committee—at either its intermediate holding company board of directors or its FBO board of directors—that oversees the risk management function for its combined U.S. operations (branch/agency and non-branch/agency activities). The FBO must also appoint a U.S. chief risk officer in the United States. If the risk committee for the FBO's combined U.S. operations is not at the intermediate holding company, the intermediate holding company must have its own risk committee that oversees the risk management function for the intermediate holding company's operations. The FBO's risk committee may also serve as the U.S. risk committee for the combined U.S. operations.

Debt-to-Equity Limits for U.S. Bank Holding Companies and FBOs

Under section 165 of the Dodd-Frank Act, upon a determination by the Financial Stability Oversight Council that a company poses a grave threat to U.S. financial stability and that the imposition of the requirement is necessary to

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mitigate that risk, the Federal Reserve must require a bank holding company and an FBO with $50 billion or more in total consolidated assets, as well as a nonbank financial company supervised by the Federal Reserve, to maintain a debt-to-equity ratio of no more than 15-to-1. Consistent with the Dodd-Frank Act, the Final Rules define the 15-to-1 debt-to-equity limitation and adopt procedures for its implementation.

Differences from the Proposed Rules

The Proposed Rules set forth enhanced prudential standards for (i) bank holding companies with total consolidated assets of $50 billion or more, (ii) FBOs with total consolidated assets of $50 billion or more, and (iii) any domestic and foreign nonbank financial company supervised by the Federal Reserve; although, in the case of nonbank financial companies, they provided little detail as to the specifics of those standards. Furthermore, the foreign proposal required a U.S. intermediate holding company for an FBO with total consolidated assets of $50 billion or more and combined U.S. assets (other than held by a U.S. branch, agency, or section 2(h)(2) company) of $10 billion or more.

In most material respects, the Final Rules are substantively similar to the Proposed Rules, but the following are some differences that warrant separate mention:

- The threshold for the requirement for an FBO to form a U.S. intermediate bank holding company has been raised from $10 billion of U.S. non-branch/agency assets to $50 billion of U.S. non-branch/agency assets. The Federal Reserve said that it believes raising the threshold accomplishes the goal of enhanced prudential regulation of the foreign banks that pose the greatest risk to the U.S. financial markets while, at the same time, not overburdening FBOs that have minimal activities in the United States and do not pose as much of a systemic threat. In addition, the Federal Reserve has postponed the applicability to intermediate holding companies of U.S. leverage capital requirements (previously adopted in July 2013) to January 1, 2018.
- The FBO deadline for forming an intermediate holding company and moving all non-branch/agency subsidiaries under that holding company has been extended from July 1, 2015 to July 1, 2016. The Federal Reserve believes this additional time will better enable foreign banks to reorganize as necessary under the Final Rule and to bring their activities into compliance with the enhanced prudential standards. Similarly, if an FBO not currently subject to the enhanced prudential standards has U.S. non-branch/agency assets that exceed the $50 billion threshold after July 1, 2015, that FBO has two years to come into compliance with the Final Rule, rather than the one-year compliance period set out in the Proposed Rules.
- The Final Rules will not be applicable to nonbank financial companies supervised by the Federal Reserve. Instead, the Federal Reserve proposes to take a more individualized approach to each nonbank financial company it supervises in order to determine how the enhanced prudential standards should apply, and it expects to apply the enhanced prudential standards to nonbank financial companies though order or rule. The Federal Reserve states that it believes that this individually tailored approach better accomplishes the goals of enhanced prudential regulation while, at the same time, not subjecting the nonbank financial companies to bank-like prudential standards that may be more burdensome than required or generally inappropriate for the organization.
- The Federal Reserve has decided to postpone the adoption of the single counterparty credit limits that were contained in the Proposed Rules. Although such limits are required under Dodd-Frank Act section 165, the Federal Reserve intends, at this time, to work with the Basel Committee on Banking Supervision in the development of global single counterparty credit limits and proposes to take these international initiatives into account in developing U.S. counterparty limits in the future.
- The Federal Reserve also is deferring the implementation of the early remediation measures that are required under section 166 of the Dodd-Frank Act, stating simply that it is “continuing to review the comments” on this topic.

Some Observations on the Final Rules

The Final Rules, which are generally required under the Dodd-Frank Act and therefore not unexpected, establish a significant new regime of prudential (risk-based) regulation for both domestic bank holding companies and FBOs that are covered by the rules. The Final Rules demonstrate the Federal Reserve’s continued insistence on

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the importance of strong risk management and accountability for risk management oversight of senior management and the boards of directors of financial institutions.

By and large, the Final Rules do not differ in material respects from the Proposed Rules, although some adjustments around the edges have been made to address various comments on the Proposed Rules. The Final Rules make a notable change in the regulation of large foreign banks operating in the United States by subjecting them to a number of risk management requirements and, in the case of the FBOs with the largest U.S. operations, requiring an organizational structure that would allow them to be regulated in a manner that is substantially similar to the regulation of large U.S. bank holding companies. The most notable—and controversial—element of the Final Rules is the intermediate holding company requirement, which was adopted by the Federal Reserve without material changes in its substance other than to raise the threshold for its application from $10 billion in U.S. assets to $50 billion. Commenters raised concerns about the implications of the intermediate holding company requirement for established U.S. regulatory principles of national treatment, suggesting that the intermediate holding company requirement could disrupt the global operations of covered FBOs and that it is at odds with prevailing principles of international cooperation on financial supervision matters. The Federal Reserve, however, was only modestly swayed by these arguments and agreed only to raise the dollar threshold for the application of the intermediate holding company requirement.

Although the intermediate holding company requirement now will apply only to a small number of FBOs, all of the affected FBOs, by definition, have large U.S. operations, and all also are very large, globally active banks. As a consequence, the impact of the new requirement on aggregate foreign banking operations in the United States may be considerable. Besides requiring affected FBOs to maintain substantial regulatory capital in the United States, the intermediate holding company requirements will affect the corporate governance, risk management, funding, and liquidity management activities of covered FBOs. Also, while the intermediate holding company framework does exclude U.S. branch and agency assets, the movement of large amounts of FBO operations or assets to a branch or agency in order to avoid this requirement is probably not realistic in many cases, given the fact that U.S. branches and agencies of FBOs are significantly more constrained in the activities in which they may engage, in contrast to the materially greater activity flexibility enjoyed by nonbank subsidiaries of these FBOs under U.S. financial services laws. In addition, the new regulatory focus on applying separate and extensive U.S. regulatory and prudential requirements to FBO activities may be viewed by international supervisors as protectionist in nature and as a departure from accepted norms of international cooperation on financial regulatory matters, thus potentially compromising ongoing multilateral cooperative efforts in financial services supervision.

There is little question that the Final Rules will increase the risk management and governance requirements and costs of large U.S. banking organizations, as well as the 140-odd FBOs that have U.S. operations and meet or exceed the asset thresholds in the Final Rules. Apart from the intermediate holding company requirements that apply to FBOs with large U.S. operations, the risk committee, stress testing (albeit already largely in effect at the present time), risk management oversight, and liquidity requirements will result in a number of necessary organizational, reporting, and governance/oversight changes and may result in changes in funding, liquidity management, and asset/liability management activities as the Final Rules come into effect. That said, the downstream effects of the Final Rules are not likely to become evident for some time.

Contacts

If you have any questions or would like more information on the issues discussed in this LawFlash, please contact any of the following Morgan Lewis lawyers:

Washington, D.C.

Charles M. Horn	202.739.5951	chorn@morganlewis.com
Melissa Hall	202.739.5883	mhall@morganlewis.com
Julie Marcacci	202.739.5160	jmarcacci@morganlewis.com

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