OLIVER WYMAN

Financial Services

# FED PROPOSES MAJOR SHIFT IN REGULATION OF FOREIGN BANKS

AUTHORS
John Lester, Partner
Dylan Walsh, Partner
James Wiener, Partner

MARSH & McLENNAN COMPANIES

On December 14, 2012, the Federal Reserve released a proposal that would dramatically change how the US operations of foreign banks are regulated. The proposed rule was previewed by Fed Governor Tarullo in a speech one week earlier, and the proposal itself confirms that this would be a remarkable and far-reaching policy shift.

## KEY ELEMENTS OF THE PROPOSAL

The core of the proposal is the combination of two new requirements for large US operations owned by foreign banks:

1. Mandatory creation of an intermediate holding company (IHC) to hold all US operations (bank and nonbank) on a consolidated basis, except for foreign bank agencies and branches
2. Application of US prudential regulations on capital, leverage, and liquidity to each IHC, with less stringent requirements for agency and branch networks.

Generally, the proposal would affect foreign banking organizations (FBOs) with more than $50 BN in consolidated global assets, with the most stringent requirements applying to foreign banks whose US operations have more than $50 BN in assets[1]. Specific requirements are a function of a firm's global assets, US assets overall, and non-agency/branch US assets.

1 The US operations of foreign nonbank financial institutions could also be subject to the rule, if designated as systemically significant within the US.

## EXHIBIT 1: SCOPE OF MAJOR REQUIREMENTS

### FBOS > $50 BN OF GLOBAL ASSETS

- *Meet home country capital and leverage standards consistent with Basel 3*
- *Participate in home country stress testing process**
- *Annual internal liquidity stress test*
- *Fed can invoke early remediation actions*
- *US risk committee**

### > $10 BN IN US ASSETS (EXCLUDING AGENCIES AND BRANCHES)

- *Must form IHC, which will be subject to*
  - *US BHC risk-based capital and leverage requirements*
  - *Company-run stress test*
- *Annual liquidity stress test*
- *Single counterparty credit limits***

### COMBINED US ASSETS > $50 BN

- *For branch and agency network: 14-day liquidity buffer held in the US*
- *Participate in home country stress testing process and report results to Fed*
- *Single counterparty credit limits***
- *US Chief Risk Officer*

### IHC > $50 BN IN US ASSETS (EXCLUDING AGENCIES AND BRANCHES)

- *Capital plan rule and CCAR stress testing*
- *30-day liquidity buffer held in IHC*
- *Mandatory early remediation actions*

* FBOs with >$10 BN in global assets also subject to stress testing requirement, and publicly traded FBOs with > $10 BN in global assets also required to establish a US risk committee

** Limits exposure to 25% of FBO/IHC capital and surplus, with lower limit applicable for FBOs/IHCs with assets > $500 BN

Particularly affected would be those institutions that have more than $50 BN in US assets (outside of branches or agencies). All such entities would need to be consolidated into an IHC that would be subject to the most distinctive and onerous elements of the rules for US BHCs, including the CCAR stress testing process, which has become the binding constraint on large US banks' ability to distribute capital to shareholders. Such firms would also need to meet US liquidity rules for large BHCs, including the Basel 3 requirements when these are implemented. Note that these requirements would apply even if no depository institution was itself included in the IHC, and will therefore catch the substantial US capital markets operations of a number of foreign banks.

While US agencies and branches of foreign banks would not be included in the IHC and would not be subject to distinct capital and leverage rules, they would need to meet a number of liquidity requirements, including holding a buffer of liquid assets in the US branch network sufficient to meet 14 days of stressed cash flow needs. (This liquidity requirement is distinct and additional to the 30-day buffer required for the foreign bank's IHC.)

## WHY THE FED HAS PROPOSED THIS APPROACH

The Fed is explicit that this proposed policy shift is a response to major changes in the role of foreign banks in the US financial system in recent decades, and to continuing uncertainty about the ability to resolve global banking and capital markets institutions without triggering broader damage to the financial system and economy. In particular, the proposal highlights the shift toward foreign banks using US operations as a net source of group funding, in large part through short-term borrowing in wholesale funding markets.

While the proposal draws on powers given to the Fed in the Dodd-Frank Act and, in some respects, is shaped by its legislative requirements, the Fed is clearly exercising its own discretion in shaping this proposed approach to regulating foreign banks. Governor Tarullo's speech and the proposal itself make it clear that these changes are directly aimed at the Fed's top priority in financial regulation, namely, reducing systemic risk.

The principal aims of the proposal include:

- Providing a more coherent platform for the Fed to exercise its umbrella supervisory responsibilities over bank and non-bank operations of foreign banking organizations
- Give the Fed more direct oversight of foreign bank participation in the US dollar wholesale funding markets, and reduce the risk of destabilizing runs in that part of the financial system by incentivizing foreign banks to lengthen the term of their US funding
- Avoid ad hoc imposition of restrictions on cross-border and intragroup flows during stressed conditions
- Facilitate orderly resolution of foreign banks' US operations by providing a clear "single point of entry" for exercise of the Orderly Liquidation Authority on foreign bank-owned US operations
- Align the treatment of US and non-US banking groups, at least within the US, by subjecting them to similar capital and liquidity rules.

More generally, the Fed makes the case that the long-standing presumption that home country supervision is adequate is open to question, and that a case-by-case approach of assessing regulatory adequacy would be difficult to execute and prone to misjudgment by the Fed, and would create an uneven and unpredictable regulatory landscape for affected firms.

## RISKS AND COSTS OF THIS NEW APPROACH TO REGULATING FOREIGN BANKS

Such a fundamental change in the regulation of much of the US financial system would come with significant costs and potential risks. The most obvious and direct costs will be incurred by affected foreign banks that need to restructure their financial resource management, management structures, legal entities, and regulatory reporting operations. The more general risks include a range of possible unintended consequences:

- Reduced participation by foreign banks in the US financial system, curtailing domestic competition and the resiliency provided by foreign bank participants not primarily tied to US economic cycles
- Increased cost of credit and financial intermediation, due to less flexible capital and liquidity structures and higher absolute levels of capital and liquidity

- Greater risk of failure of foreign banks, which will face new constraints on access to resources in times of stress
- Retaliatory measures affecting US banks in other jurisdictions
- Breakdown of international coordination of financial regulation and a resulting increase in regulatory arbitrage and unintended consequences

## IMPLICATIONS FOR AFFECTED INSTITUTIONS

This new approach, if implemented as proposed, would have profound effects on foreign banks that are active in the US. For the largest and most complex global institutions, the proposed regime will apply local US requirements that these organizations already satisfy for their home regulators (in some form). However, applying these standards at the subsidiary level will introduce economic frictions as the efficiencies of managing capital, leverage, and liquidity globally are diminished. And these frictions will be accompanied by substantial operational and structural changes with costs of their own.

Major implications for foreign banking organizations subject to proposed requirements would include:

### ECONOMIC COSTS

One principal economic cost for FBOs will be higher capital requirements, and thus lower returns on equity. FBOs subject to the IHC requirement will have to hold separate capital (and capital buffers) for their US subsidiary, and calculate risk-weighted asset (RWA) and total leverage exposure as a standalone entity, missing out on important group-level diversification, hedging, and netting benefits. The application of the CCAR stress testing and capital planning process is likely to raise the effective capital standard and may greatly limit firms' discretion in moving capital out of US operations (and ultimately to shareholders). FBOs will also be required to hold a larger stock of low-yielding liquid assets or secure longer-term US funding, placing further pressure on returns.

### OPERATIONAL COSTS

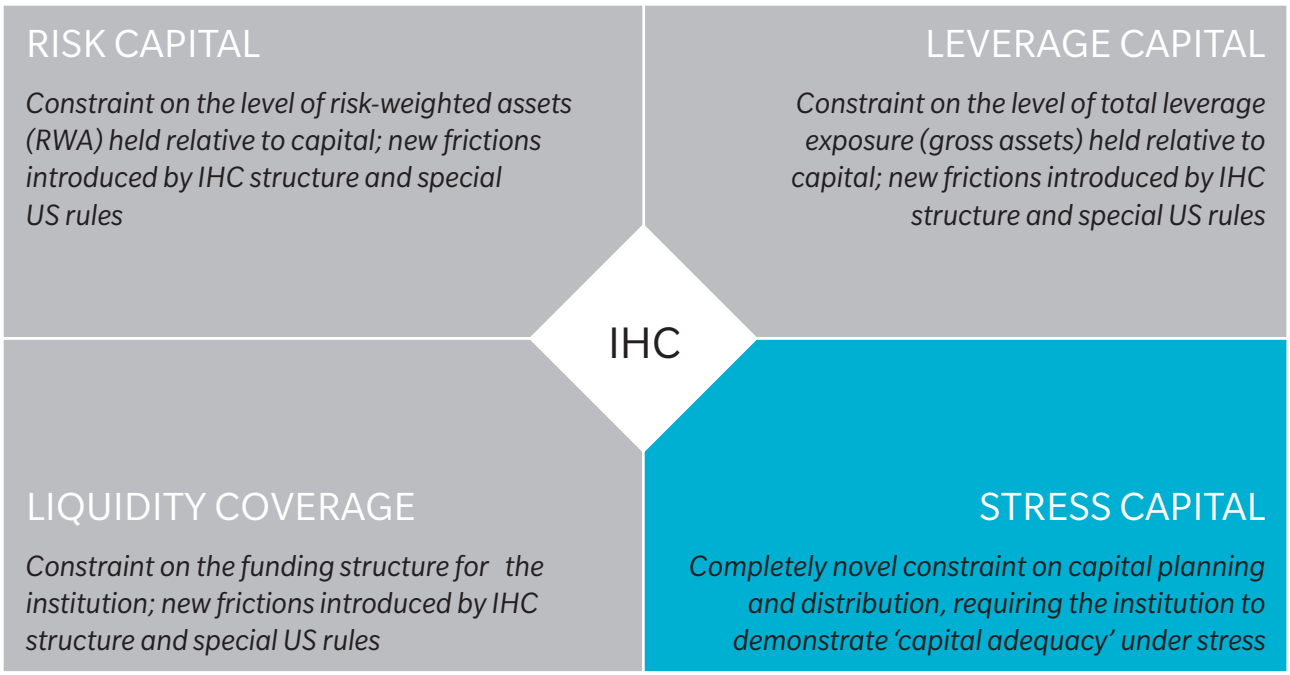
The operational costs for FBOs will largely be driven by the need for an independent risk management and regulatory compliance infrastructure for the US subsidiary. A full range of processes, tools, and (human) resources will need to be deployed to manage the requirements of CCAR. The compliance functions will need to adapt to the new standards of their new "home regulator," developing US compliant risk and liquidity management tools, and seeking approval for new models from the Federal Reserve.

### STRUCTURAL CHANGES

Many FBOs will face the challenge of forming and operating a new, separately capitalized legal entity with robust management capabilities. This will involve restructuring legal entities across the organization (a process that is already underway for many firms, but will be massively complicated by this new challenge) and, in parallel, restructuring transaction booking, trade flows, and intra-group funding mechanisms. It will also require a realignment of centralized management structures, particularly for capital markets institutions that are currently run on a global basis.

As illustrated below, we see the capital, leverage, and liquidity costs of the rule as significant, but frictional in nature. The application of CCAR will be more of a *de novo* challenge for large IHCs.

EXHIBIT 2: MULTI-DIMENSIONAL CONSTRAINTS FACING IHCs




## SUGGESTED AGENDA FOR AFFECTED INSTITUTIONS

Given the far-reaching effects on foreign banks, we suggest that they respond immediately:

### 1. ACTIVELY PARTICIPATE IN THE PUBLIC COMMENT

The IHC proposal represents a step change in the regulation of FBOs in the US. It also mirrors the regime for regulating US bank holding companies, which in many respects have a different risk and liquidity profile from the FBOs that would be covered by the rule. Most FBOs have a less active role in payments, securities services, asset servicing, and capital markets infrastructure than their US counterparts. FBOs can also draw on the strength of their parent organizations, which should be accounted for in assessing an IHC's financial strength. These points argue for a more nuanced regime that would make finer distinctions of the systemic importance of the institutions that would be covered by the rule. FBOs should be making this case.

### 2. ASSESS THE IMPLICATIONS OF THE RULE

All FBOs should be actively reviewing their US profile to understand the implications of the rule, assessing their business under US versions of the international standards for RWA, leverage, and liquidity management. There are subtle but critical differences between US and foreign jurisdiction treatments (e.g. risk-weight calculation for securitizations using the SSFA). Firms will also need to estimate the effective capital required by the Fed-run CCAR stress tests to understand the capital buffers IHCs would be held to.

### 3. ACCOUNT FOR THE RULE'S IMPLICATIONS IN SETTING STRATEGY

Starting now, it will be imperative for foreign banks to consider the pro forma implications of the proposed rule to make strategic decisions about investment and cost-cutting across business lines and geographies. Beyond considering the rule in existing strategy discussions, many FBOs (especially those close to the thresholds for application) should consider strategic moves to manage down US assets, exit, restructure or relocate businesses with substantial capital or liquidity requirements, or conversely, look to add US assets that will help shore up capital or funding within their US operations.

## THE DEBATE TO COME

This proposal is the biggest surprise in implementing the Dodd-Frank Act to date. The Act gives the Fed the power to regulate foreign banks in this way, but no one expected it to be exercised on a blanket basis, breaking from the longstanding tradition of assuming home country group supervision is sufficient. Because the proposal is such a major change from prior regulatory practice, it is certain to draw criticism from affected foreign banks, and potentially from policymakers in other jurisdictions as well.

It is also clear that the Fed's leadership and staff have invested significant time and thought into developing this new approach to regulating foreign banking activities in the US, and consider it to be an important part of modernizing US financial regulations to address vulnerabilities revealed in recent years.

Given the importance of the Fed's policy goals, we believe that critics of the proposal will face an uphill battle in convincing senior Fed officials to make major changes as it is finalized. But the scope and scale of the proposal's impact mean that it deserves the closest scrutiny and analysis. Let the policy debate begin!

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

For more information please contact the marketing department by email at info-FS@oliverwyman.com or by phone at one of the following locations:

AMERICAS
+1 212 541 8100

EMEA
+44 20 7333 8333

ASIA PACIFIC
+65 6510 9700

**JOHN LESTER** is a Partner in the Americas Finance & Risk and Public Policy Practices.

**DYLAN WALSH** is a Partner in the Americas Corporate & Institutional Banking Practice.

**JAMES WIENER** is Partner and Head of the Americas Public Policy Practice.

www.oliverwyman.com



OLIVER WYMAN