

# Dodd-Frank and Foreign Banks

July 21, 2011

# Disclaimer

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This information comprises an overview of specific aspects of banking law and does not constitute legal advice. Although every effort has been made to ensure that the contents of this document are correct, no warranty, express or implied, is made to the accuracy or completeness of the information and the views expressed herein.

In addition, many sections of the Dodd-Frank Act mandate that studies be conducted and that agencies undertake significant rulemaking, and a full and accurate assessment of the impact will only be possible after final rules are in effect.

# Dodd-Frank and Foreign Banks

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- The effect of the Dodd-Frank Act on foreign banks was not a focus of Congress during the legislative process.
- Many provisions have extraterritorial consequences (such as the Volcker Rule), whereas others do not provide foreign banks with “national treatment” (such as the Lincoln Amendment), a guiding principle in U.S. foreign bank regulation.
- We will discuss certain key provisions affecting foreign banks, and the status of rulemaking and implementation of those provisions on this one year anniversary of Dodd-Frank.

## Foreign Bank SIFIs

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- Bank holding companies (“BHCs”) with total consolidated assets of at least \$50bn are systemically important financial institutions, or SIFIs.
  - Foreign banks that own a U.S. bank are BHCs.
- Foreign banks that maintain a U.S. branch, agency or commercial lending subsidiary also are treated as BHCs.
- \$50bn asset threshold currently is a worldwide test.
- The Financial Stability Oversight Council (“FSOC”) must consult with the appropriate foreign regulatory authorities in exercising its systemic oversight authority over foreign nonbank financial companies, foreign-based BHCs and cross-border activities and markets.

# Prudential Standards

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- The Federal Reserve, on its own or at FSOC's recommendation, must establish prudential standards for SIFIs that are more stringent than those applicable to non-systemically important entities.
- Purpose: prevent or mitigate risk to U.S. financial stability that could arise from the material distress, failure or ongoing activities of these companies.
- FSOC may also recommend heightened standards and safeguards for financial activities and practices if FSOC determines that their scope, size or interconnectedness could create or increase the risk of significant liquidity, credit or other problems.

# Prudential Standards

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- The Federal Reserve must establish more stringent prudential standards for:
  - Risk-based capital requirements;
  - Leverage limits;
  - Liquidity requirements;
  - Overall risk management requirements;
  - Resolution plan (“Living Will”) and credit exposure report requirements; and
  - Concentration limits.

# Prudential Standards

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- The Federal Reserve may establish more stringent prudential standards for:
  - A contingent capital requirement;
  - Enhanced public disclosures;
  - Short-term debt limits; and
  - Such other prudential standards as deemed appropriate by the Federal Reserve, on its own or based on FSOC's recommendations.

# Prudential Standards: Considerations

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- In prescribing or recommending more stringent prudential standards, the Federal Reserve and the FSOC must take certain specific factors into consideration:
- Tailored application:
  - The Federal Reserve, on its own or on recommendation by the FSOC, may differentiate among companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities, size, and any other risk-related factors.
  - In other words, this regulatory scheme is NOT a one-size-fits-all approach.

# Prudential Standards: Add'l Requirements

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In addition, the Federal Reserve shall require the following (§165 Dodd-Frank Act):

- Establishment of a risk committee (including BHCs with \$10bn-\$50bn assets) for publicly traded companies.
- Semi-annual stress tests (annually for BHCs with \$10bn-\$50bn assets). Federal Reserve will also conduct its own stress tests.
- A maximum leverage ratio of 15:1 if Council determines that the company poses a “grave threat” to U.S. financial stability.
- Inclusion of off-balance-sheet activities in computing capital requirements.

## Mitigation of Risks

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- If Federal Reserve determines that a systemically important institution poses a great threat to the U.S. financial stability, and upon 2/3 affirmative vote of Council, it can
  - limit such company's ability to merge with, acquire, consolidate with, or otherwise become affiliated with another systemically important institution;
  - restrict the company's ability to offer a financial product;
  - require such company to terminate one or more activities; or
  - impose conditions on the manner in which such company conducts one or more activities (§121 Dodd-Frank Act).

# Mitigation of Risks

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- The Federal Reserve may also require a systemically important institution to sell or otherwise transfer assets or off-balance-sheet items to unaffiliated entities, if other measures are deemed to be inadequate.
- §120 Dodd-Frank Act permits FSOC to recommend heightened prudential standards or safeguards for particular financial activities or practices conducted by any company that is regulated by a primary financial regulatory agency.

## Living Wills: Section 165(d)

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- All SIFIs will be required to produce resolution plans, or living wills, and credit exposure reports.
- SIFI requirements could affect up to approximately 100 foreign banks.
- The 165(d) standard: a plan “for rapid and orderly resolution in the event of material financial distress or failure” that must discuss:
  - Protection of the insured bank from risks of affiliates;
  - Ownership structure, assets, liabilities, and contractual obligations; and
  - Cross-guarantees, major counterparties, and process for determining pledges of collateral.

## Living Wills: Section 165(d)

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- Per Federal Reserve/FDIC proposal, “rapid and orderly” means a reorganization or liquidation that can be accomplished:
  - In a reasonable period of time.
  - In a way that substantially mitigates risk of serious adverse effect on U.S. financial stability.
- “Material financial distress or failure” means either:
  - Losses that would deplete capital without reasonable prospect for recapitalization;
  - Assets less than obligations to creditors; or
  - Inability to pay obligations in ordinary course of business.

## Living Wills: Section 165(d)

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- Regulators need a plan that:
  - Identifies sources of risk;
  - Explains different stress scenarios;
  - Analyzes possible pre-bankruptcy, private sector solutions;
  - Describes an easily understood and coordinated response to material distress;
  - Describes the institution's immediate needs in bankruptcy; and
  - Describes the rights of different creditors.
- Proposed rule sets out content requirements.
- Must be updated annually and when material business changes occur.

## Living Wills: Section 165(d)

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### Current Status:

- Notice of Proposed Rulemaking by Federal Reserve and FDIC published on April 22, 2011.
- Comment Period ended on June 10, 2011.
- IIB submitted a comment letter addressing issues such as the calculation of the \$50bn threshold for foreign banks (worldwide assets v. U.S. assets); a tailored approach of Living Will requirement; the coordination of Living Will requirements with foreign regulators; general concerns regarding the confidentiality of Living Wills; and the definition of certain key terms.

# Living Wills: Section 165(d)

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## Current Status:

- According to statements made during a July 6, 2011 FDIC Board meeting, the final rule implementing Section 165(d) will be consistent with the standards for resolution planning under development by the FSB and the Group of 20.
- Awaiting final rule; no clear indication of where agencies now stand.
- Comments received during the rule's comment period have been plain about industry views on the proposed rule.
  - Key industry proposal: Different Living Will regimes for the very large, global, complex companies, versus smaller companies that have less complex operations.

# Living Wills: Section 165(d)

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## What May Be Expected of Foreign Banking Organizations:

- Preparation of resolution plans and credit exposure reports regarding only U.S.-domiciled subsidiaries and operations.
  - Information re branches, agencies, subsidiaries, and critical operations and core business lines.
  - Mapping of legal entities, interconnections and interdependencies.
  - Detailed explanation of how U.S. operations fit into foreign-based company's overall resolution plan or contingency planning process.

## Living Wills: Section 165(d)

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- Foreign banks have different U.S. profiles:
  - More complex: Bank subsidiary, FHC activities, etc.
  - Less complex: One or more branches or agencies, few nonbanking activities.
  - Types of U.S. activities: Some foreign banking organizations (“FBOs”) are not engaged in “banking” activities in the U.S.
  - Relative size of U.S. and worldwide activities: There are a number of very large FBOs with modest U.S. banking operations.

# New Resolution Authority

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- FDIC authority to effect an orderly resolution of “covered financial companies” as determined by Treasury, FDIC and others (Title II Dodd-Frank Act).
  - Key elements: FDIC-centric resolution and claims scheme; use of bridge companies; treatment of creditors; governance and conflicts of interest mitigation; no taxpayer funding.
- FDIC as receiver for a covered financial company must coordinate “to the maximum extent possible” with appropriate foreign financial authorities regarding the orderly liquidation of any covered financial company with non-U.S. assets or operations.

# FBO Living Will/Resolution Issues

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- Home v. host country activities.
- “Ring fencing” v. resolution of foreign bank.
- Home country resolution regime.
- U.S. governance issues: authority over U.S. activities of FBOs, including nonbanking companies.

# FBO Living Will/Resolution Issues

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- Access to information.
- Interdependencies—affiliate-facing obligations.
- Liquidity sources.
- Recent international developments and effects on U.S. regulation.
  - See, e.g., Financial Stability Board consultative document on effective resolution of systemically important financial institutions (July 19, 2011).

# Collins Amendment

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- Requires minimum leverage and risk-based capital requirements for insured depository institutions, bank and thrift holding companies and nonbank SIFIs (§171 Dodd-Frank Act).
- Applies risk-based capital requirements and Tier 1 to total assets standard that are applicable to insured depository institutions under the prompt corrective action provisions of the Federal Deposit Insurance Act.
  - No deduction for investment in bank subsidiaries.
  - Sets current rates as a floor.
  - Effect on accounting issues and risk weights is unclear.

## Collins Amendment and FBOs

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- Limits discretion in applying Basel III requirements (U.S. can adopt more onerous standards, but cannot adopt laxer standards).
- The requirement of the Collins Amendment would not apply to foreign parents of bank and thrift holding companies, but would apply to any U.S. bank or thrift holding company, including any intermediate holding company, that is owned or controlled by a FBO.

# Collins Amendment and FBOs

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- Impact on capital equivalency/comparability determinations under the International Banking Act (“IBA”): continued case-by-case approach on FBO applications to establish U.S. banking offices, taking into account competitive issues.
- Effective in five (5) years after enactment for BHC subsidiaries of FBOs relying on Letter SR-01-1 issued by the Federal Reserve.

# Volcker Rule

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Basic prohibitions applicable to banking entities:

- Proprietary trading.
- Investing in or sponsoring hedge funds or private equity funds.
- Proprietary trading
  - Taking positions as principal in trading account in securities, derivatives, futures, options “or any other security or financial instrument” as provided by rule.
  - Trading account: Acquiring or taking positions “principally for the purpose of selling in the near term.”

# Volcker Rule

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Basic prohibitions applicable to banking entities:

- Hedge/private fund investment/sponsorship:
  - Investment: Acquisition of equity, partnership or other ownership interest.
  - Sponsorship: GP/equivalent; management selection/control; name-sharing.
  - Covered funds:
    - Private funds exempt under Investment Company Act Sections 3(c)(1) or 3(c)(7).
    - Other funds as determined by the regulators.

# Volcker Rule: Banking Entities

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## What is a “banking entity”?

1. Insured bank or thrift.
2. Any company that controls an insured bank or thrift.
3. *Any company that is treated as a bank holding company for purposes of the International Banking Act of 1978, which includes a non-U.S. bank with a branch or agency office or commercial lending company in the United States.*
4. Any affiliate of the above entities.

Entities with a bank functioning solely in a trust or fiduciary capacity are exempt from these prohibitions.

# Volcker Rule: Proprietary Trading

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## Permissible Transactions

- *Trading solely outside the U.S. by banking entities organized under non-U.S. law and subject to several conditions.*
- Transactions in U.S. government securities (including GSE securities).
- Transactions in connection with underwriting or market-making activities, to the extent designed not to “exceed the reasonably expected near term demands of clients, customers or counterparties.”
- Risk-mitigating/hedging activities designed to reduce specific risks.
- Transactions for customers.
- SBIC investments.
- Purchase or sale of securities and derivatives by a regulated insurance company engaged in the insurance business.

# Volcker Rule: Funds

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## Permissible Activities

- Investment in or sponsorship of a covered fund pursuant to Bank Holding Company Act (“BHCA”) Sections 4(c)(9) or 4(c)(13) “solely” outside of the United States if:
  - interests in the fund are not offered or sold to a U.S. resident; and
  - the banking entity is not directly or indirectly controlled by a banking entity organized in the U.S.
- Bona fide trust or advisory business coupled with *de minimis* investments.
- Prime brokerage services.
- Investment advisory services for covered funds.
- The prudential backstops (see below) for proprietary trading also apply to permissible fund activity.

## Volcker Rule: 23A and 23B

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- Section 23A under the Volcker Rule: A banking entity that serves as an investment adviser to or sponsor of a fund or that organizes and offers interests in a fund may not enter into “covered transactions” with the fund. This is an absolute prohibition.
- Section 23B under the Volcker Rule: A banking entity also is subject to the market terms and other restrictions of Section 23B in respect of transactions with the fund—even if the fund would not otherwise qualify as an “affiliate.”

# Volcker Rule: Nonbanking Entities

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## Nonbanking Entities:

- Prohibitions on proprietary trading and private equity fund/hedge fund ownership or sponsorship do not apply.
- A (U.S. or non-U.S.) nonbanking financial company that is systemically important will be subject to additional capital requirements and quantitative limits on proprietary trading and ownership in or sponsorship of a private equity or hedge fund.
- Nonbanking entities must be designated by FSOC and the regulators.

# Volcker Rule: Prudential Backstops

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- Limits on permitted activities that would:
  - Involve or would result in a material conflict of interest.
  - Result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies.
  - Pose a threat to the safety and soundness of a banking entity.
  - Pose a threat to the financial stability of the United States.
- These limits must be imposed by regulation.
- Significant issues in their adaptation to FBO activities.

# Volcker Rule: Deadlines

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- Volcker Rule provisions take effect on the earlier of:
  - 12 months after date of the issuance of the final rules; or
  - Two years after date of enactment of Dodd-Frank.
- Dodd-Frank requires final rules by Oct. 21; deadline likely to slip. Rules must be based on FSOC study (issued January 2011).
- Federal Reserve has issued a final rule on conformance deadlines.
- Institutions generally will have until July 21, 2014 to bring activities into compliance.
- Federal Reserve may grant up to three (3) one-year conditional extensions.
- Federal Reserve may grant one conditional extension, not to exceed five (5) years, for illiquid funds owned or obligated as of May 1, 2010.

# Volcker Rule: FBOs

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- The Volcker Rule applies to domestic banking operations of FBOs.
- Different rules for banking entities and nonbank foreign financial companies.
- A foreign banking entity may continue to trade in a range of securities.
- FBO dealing, underwriting, and market-making functions in the U.S. should not be affected.
- U.S. venture capital activities of FBOs should largely be unaffected.
- Foreign proprietary trading and fund sponsorship/investment activities are outside the coverage of Volcker Rule regulation, but the regulators still need to define what that coverage is.
- Compliance infrastructure costs could be significant for FBOs with material U.S. operations.
- What the FSOC study says—and doesn't say—about FBOs.

# Lincoln Amendment

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- General requirement:
  - Notwithstanding any other provision of law (including regulations), no ***Federal assistance*** (access to the discount window, FDIC insurance) may be provided to any ***swaps entity*** with respect to any swap, security-based swap, or other activity of the swaps entity (§716 Dodd-Frank Act).
- A “swaps entity” is any swap dealer, security-based swap dealer, major swap participant and major security-based swap participant registered with the CFTC or SEC.
- Insured depository institutions may have affiliates that are swaps entities, so long as the institution is supervised by the Federal Reserve and complies with Sections 23A and 23B of the Federal Reserve Act.

# Lincoln Amendment

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- The Lincoln Amendment and FBOs:
  - Certain “permissible swaps activities” that may be continued without losing federal assistance must be “pushed out” by insured depository institutions.
  - In an apparent drafting oversight, uninsured U.S. branches or agencies of foreign banks were not treated in a manner identical to that of insured depository institutions.
  - Senators Lincoln and Dodd acknowledged this oversight on the Senate floor.

# Lincoln Amendment

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- The Lincoln Amendment and FBOs (cont.):
  - The foreign bank community has called for clarification of this matter so that, at a minimum, the U.S. branches or agencies of foreign banks can conduct swaps operations on a roughly equal footing with their U.S. insured depository institution competitors.
  - Issue: Can this be addressed by regulation or would it require corrective legislation?

# Foreign Bank Access to U.S. Markets

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- For a foreign bank that presents a risk to the stability of the U.S. financial system, the Federal Reserve must take into account whether the home country has adopted, or made demonstrable progress toward adopting, an appropriate system of financial regulation for the financial system of such home country to mitigate such risk (§173 Dodd-Frank Act).
- The Federal Reserve also can terminate a foreign bank office if the home country of a foreign bank that presents that risk has not adopted or made demonstrable progress toward adopting such a system.

# Foreign Bank Access to U.S. Markets

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- Specific guidance on the implementation of these requirements has not been forthcoming, although Federal Reserve approval orders under the BHCA and IBA are now (briefly) addressing financial stability factors.
- In addition, the Collins Amendment (previously discussed) will have an impact on capital equivalency/comparability determinations made on FBO applications to establish U.S. banking offices.

# Foreign Bank Interstate Branching

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- Dodd-Frank Act allows national banks and state-insured banks to establish *de novo* branches outside of their home state if the target state allows *de novo* branching for its own state-chartered banks within such state (§613 Dodd-Frank Act).
- Bank must be well capitalized and well managed (§607 Dodd-Frank Act).
- Foreign banks may establish *de novo* branches and agencies outside of their home states if the establishment of such branch or agency would be allowed for a national bank (for a federal branch or agency) or a state bank (for state branch or agency).

## Sections 23A and 23B

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- The Dodd-Frank Act modifies Sections 23A and 23B of the Federal Reserve Act in significant ways (in addition to the changes in connection with the Volcker Rule). Key changes:
  - “Covered transactions” include repos, derivatives transactions and securities lending transactions but only to the extent of “credit exposure.”
  - Credit exposures must be collateralized and collateral requirements met throughout the life of a credit transaction.
  - Prohibition on the acceptance of low-quality assets or securities as collateral for an extension of credit to or on behalf of an affiliate is extended to derivatives and securities lending transactions.
  - FDIC now participates in exemption process.
- Changes generally will take effect one year following the Transfer Date, *i.e.*, on July 21, 2011.

## Sections 23A and 23B

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- Application to U.S. branches/agencies of foreign banks:
  - Sections 23A and 23B apply only to transactions between a U.S. branch or agency of a foreign bank and U.S. affiliates of a foreign bank engaged in the U.S. in certain activities only permitted to a financial holding company (securities underwriting and dealing, insurance underwriting, merchant banking, insurance company investments and portfolio companies).
  - Sections 23A and 23B do not apply to U.S. branch or agency transactions with other nonbank affiliates.