

Regulatory Flash

Regulation and Public Policies

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Economic Analysis

Financial System &
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US regulation for Foreign Banking Organizations (FBOs)

On February 18th 2014, the Federal Reserve released its final rule that defines the framework for enhanced prudential standards for Foreign Banking Organizations (FBOs). US authorities have not taken into account the recommendations of the industry; the final version is therefore broadly in line with the initial proposal. The reform mainly extends the prudential standards of Dodd-Frank Act (DFA) to foreign entities. FBOs must now create an Intermediate Holding Company (IHC) which must include all their US subsidiaries and comply with DFA. The rule will come into effect in July 2016.

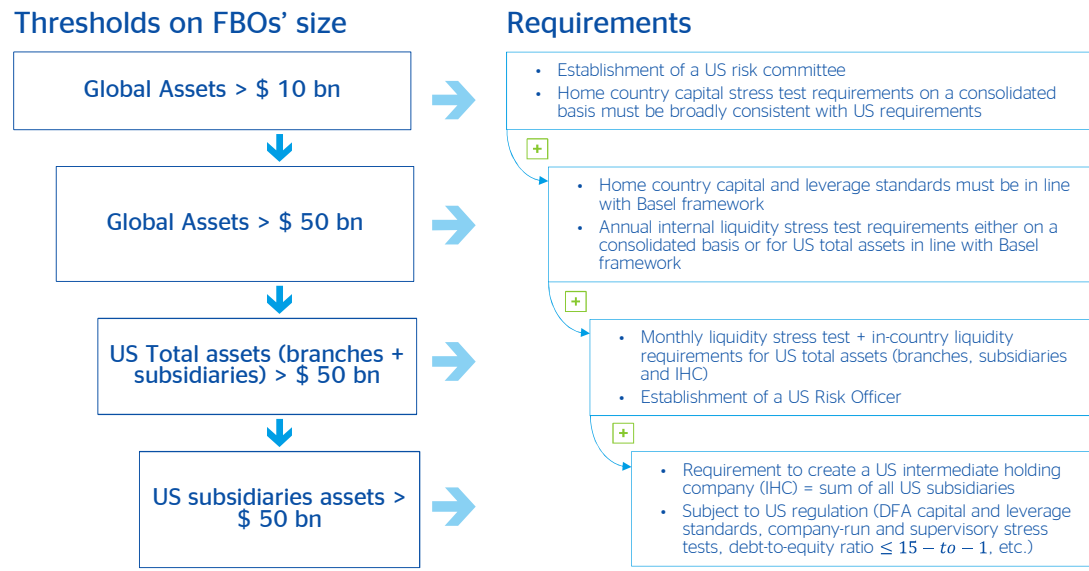
Rationale of new regulation

- FBOs have become **more complex and more interconnected** to the US financial system, along with a higher dependence on unstable short-term wholesale funding.
- US authorities claimed that several FBOs intensively appealed to the Federal Reserve's liquidity facilities during the financial crisis.
- Under DFA and without structural changes, many foreign Bank Holding Companies (BHCs) would have been considered as undercapitalized and face huge capital needs
- As a consequence to the adoption of DFA, several large FBOs organized their structure to **avoid being subject to the US prudential regulation** and rely on their parent company capital for regulatory purposes.

Main Measures

- **Broadly in line with initial proposal despite strong opposition of foreign banks.** The final rule only includes some adjustment in comparison with the initial proposal, inter-alia: (i) narrowing of the scope of FBOs subject to the IHC requirements (threshold increased from \$ 10 bn. To \$ 50 bn. Of US subsidiaries assets); (ii) postponing compliance date from July 2015 to July 2016.
- **The Rule did not adopt the proposals standards on single counterparty credit limits and early remediation requirements.** US authorities are working on these issues that could be defined through separate rules later on.
- **New structural requirements for FBOs.** Above a threshold of \$ 50bn of assets held in their US subsidiaries, FBOs must create an Intermediate Holding Company (IHC) which must include all their US subsidiaries.
- **IHCs subject to DFA prudential requirements.** Depending on the size of both their global assets and their US assets, FBOs will have to comply gradually with stricter rules on their US activities. These rules mainly consist in the transposition of DFA to foreign banks and cover, inter-alia, capital, leverage and liquidity standards, and stress-testing requirements.

Table 1
FBO regulation



Source: BBVA Research

Assessment

- The proposal remains mainly coherent with the **principle of host supervision for subsidiaries**.
- **Improvement of financial stability in the US** since the reform would limit regulatory circumvention and improve the solvency and the resolvability of FBOs within the US.
- **No excessive cost for FBOs already organized through a BHC structure** since these would have anyway been subject to the DFA requirements. The rule will be particularly burdensome for those FBOs with US activities focused on broker dealer business.
- **However, some concerns regarding the implications on cross-border cooperation.** The reform reflects a lack of trust in both foreign regulation and international standards. Worries arise from a possible adoption of similar measures in other jurisdictions with a consequent increase of market fragmentation. European authorities have already threatened to retaliate by imposing stricter rules on US banks.
- **Extraterritoriality of the liquidity framework.** The regulation also raises extraterritoriality issues by the imposition of liquidity requirements on US branches that are traditionally under the competence of their home authorities.
- **The non-adoption of the proposed early remediation framework for FBO is welcomed since this had an extraterritorial reach.** Indeed, it considered capital and leverage indicators of the parent FBO as measures to be taken into account to automatically trigger early remediation at the US level. FBOs would therefore have had to comply with the US requirements at their consolidated global level in order to avoid the consequences of triggering remediation actions.
- **Resolution strategy.** The IHC requirement establishes a single point of contact for FBOs at the US level but remains compatible with both a multiple point of entry resolution strategy and a single point of entry strategy at the global level.

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