New Provisions Require Structural Change for Foreign Banking Organizations

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The Enhanced Prudential Standards (Regulation YY) of the Board of Governors of the Federal Reserve System represent a significant shift in the U.S. regulation of foreign banking organizations (FBOs). In general, Regulation YY, which implements certain provisions of Sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, establishes enhanced prudential standards for large U.S. bank holding companies (BHCs) and FBOs. Most of the compliance obligations for an FBO become applicable on July 1, 2016. However, important exceptions include the intermediate holding company (IHC) implementation plan, which was due January 1, 2015.

Regulation YY increases the breadth and depth of the U.S. regulatory regime governing FBOs. While it does not formally depart from the historical framework of deference to the home country supervisor, it represents more expansive Federal Reserve supervision of FBOs with respect not only to their U.S. banking offices but also to their nonbanking activities and global risk profile.

Regulation YY imposes a tiered structure of requirements based on an FBO's global and U.S. assets. The Federal Reserve estimated that approximately 100 FBOs — some with global assets of as little as $10 billion — would be subject to at least one requirement under Regulation YY. While a relatively small subset of FBOs will be subject to the most extensive requirements, other FBOs could nevertheless feel the impact of the broader set of requirements through heightened supervisory expectations. FBOs have been re-evaluating the nature, structure and size of their U.S. operations in light of the regulation.

An FBO with significant (at least $50 billion) U.S. non-branch assets is required to organize its U.S. operations through a U.S. IHC, which itself is subject to Regulation YY on a consolidated basis, including risk management requirements. The U.S. IHC will need to manage relationships with both its U.S. prudential regulator, the Federal Reserve, and the prudential regulatory authority of its parent. Such managing of relationships with multiple safety and soundness regulators who exercise authority at various levels of the banking organization is akin to how many U.S. financial institutions must manage their regulatory relationships.

Regulation YY also has important governance requirements. For example, it requires an IHC to have a risk committee that approves and periodically reviews the risk management policies and oversees the risk-management framework of the IHC. In addition, the FBO must have a U.S. risk committee that oversees the U.S. operations. The IHC risk committee may serve as the FBO's U.S. risk committee, or the FBO could have a separate U.S. risk committee as either a committee of the FBO's global board of directors or as part of its enterprisewide risk committee. If the IHC risk committee serves as the U.S. risk committee, its oversight responsibilities would include the FBO's U.S. branch operations in addition to the IHC's operations. The FBO parent would still be required, however, to take appropriate measures to ensure that its combined U.S. operations implement the risk management policies overseen by the U.S. risk committee. In addition, the U.S. risk committee must closely coordinate with the FBO parent with respect to fundamental capital and liquidity planning matters (e.g., the U.S. risk committee must approve the FBO's contingency funding plan for its combined U.S. operations and must set the FBO's liquidity risk for its combined U.S. operations with the FBO's board or the FBO's enterprisewide risk committee).

As noted above, FBO IHC implementation plans were due on January 1, 2015. However, an FBO is not required to form an IHC until July 1, 2016. In preparing to comply with the IHC formation requirement, an FBO should consider whether any restrictions exist that could impede or delay the transfer of certain entities under the IHC structure. These restrictions may be more likely to present issues in situations where the FBO parent technically controls the entity for purposes of the IHC requirement but does not have the ability to exercise practical control over it for corporate purposes.

In addition, an FBO that has organized and operates a business division as a unitary entity, such as a global investment banking organization, should assess the optimal allocation and separation of business between the U.S. and other countries (e.g., where personnel should be located, where positions should be booked, how it will coordinate compliance efforts including on matters such as the Volcker Rule, and how to arrange for shared services and recordkeeping/reporting requirements) or whether for business reasons it makes sense to move traditional banking activities, such as primary dealing activities, under the U.S. branch where they were historically located. When forming the IHC, in addition to tax considerations and capital allocation issues, the FBO will want to review the implications of the Federal Reserve's Regulation W and restrictions on affiliate transactions.