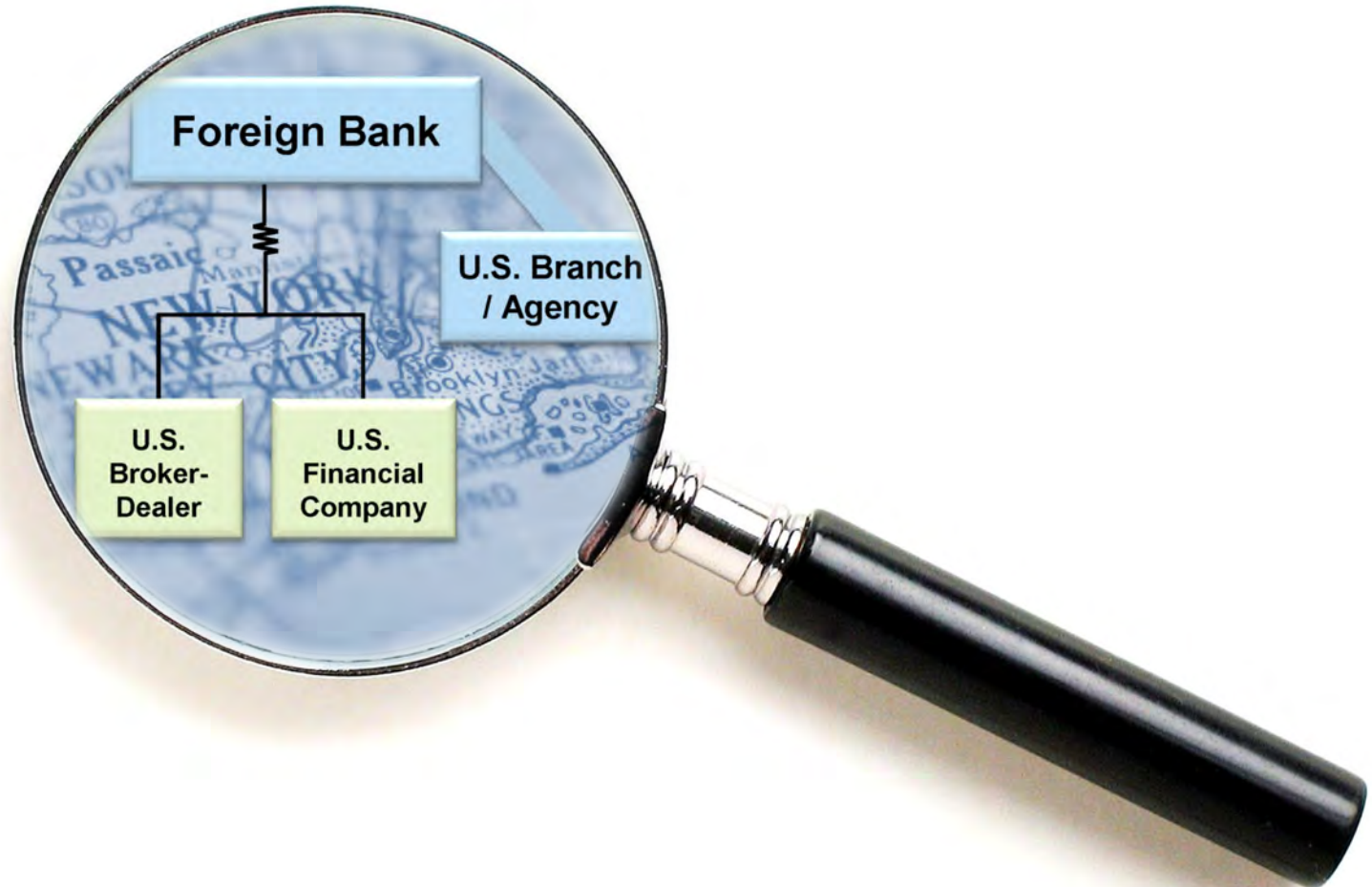


Dodd-Frank Enhanced Prudential Standards for Foreign Banks with Limited U.S. Footprints

Visual Memorandum



March 24, 2014

Davis Polk


Davis Polk & Wardwell LLP

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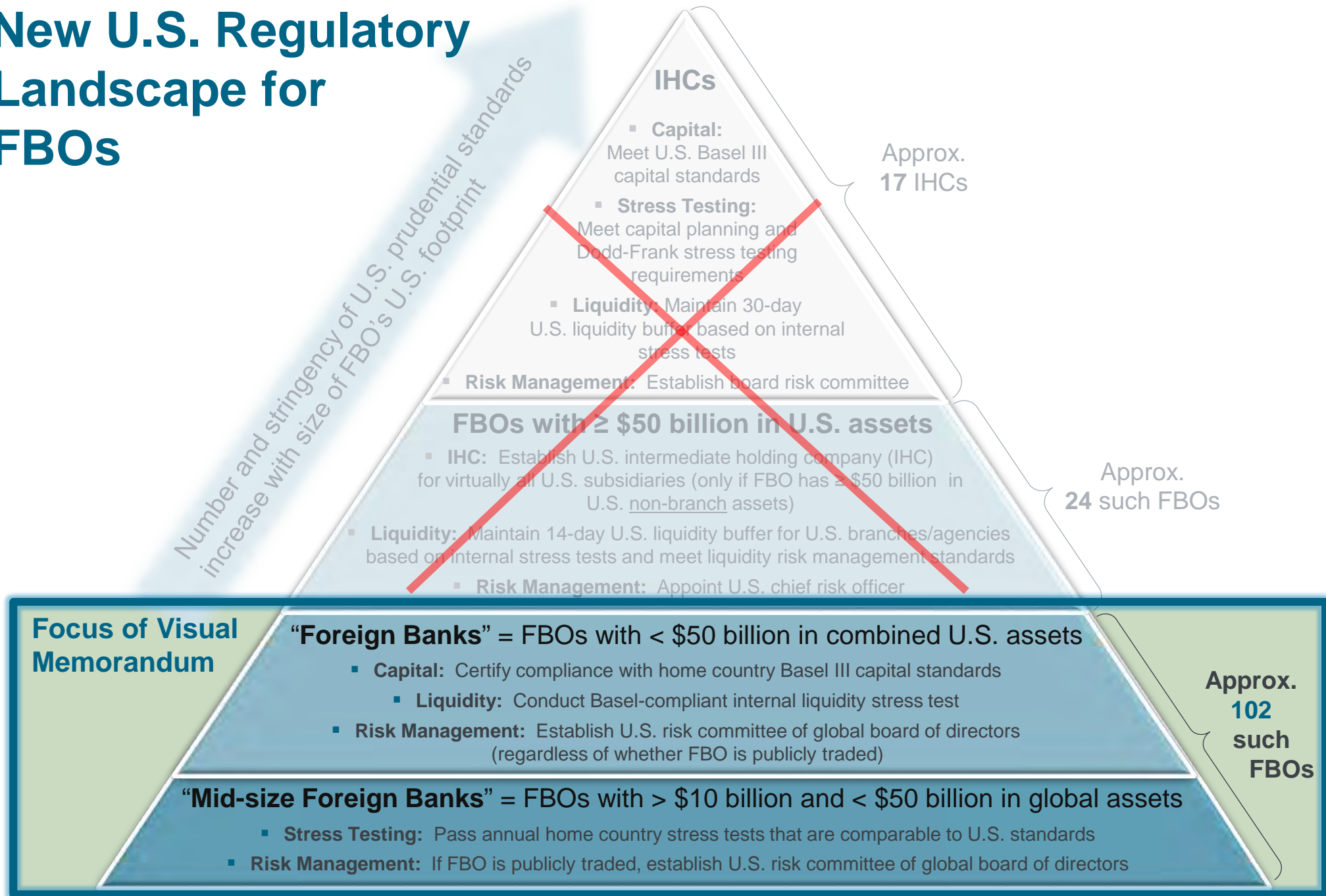
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Tiered Approach for Applying Dodd-Frank Enhanced Prudential Standards

- In February 2014, the U.S. Federal Reserve issued a final rule that adopts a tiered approach for applying Dodd-Frank enhanced prudential standards (EPS) to foreign banking organizations (FBOs).
- Under the EPS Final Rule's tiered approach:
 - The most burdensome requirements, including the U.S. intermediate holding company (IHC) requirement, will **only** apply to FBOs with large U.S. operations.
 - Fewer requirements will apply to FBOs with limited U.S. footprints — IHC requirement will **not** apply to these FBOs.
- **This visual memorandum focuses on the following FBOs with limited U.S. footprints:**
 - **“Foreign Banks”** = FBOs with \geq \$50 billion in global assets and $<$ \$50 billion in **combined U.S. assets** (*i.e.*, U.S. branch/agency assets + U.S. subsidiary assets)*
 - **“Mid-size Foreign Banks”** = FBOs with $>$ \$10 billion and $<$ \$50 billion in **global assets**
- The general compliance date of the EPS Final Rule is **July 1, 2016**.
 - See detailed compliance dates for Foreign Banks on [page 6](#) and for Mid-size Foreign Banks on [page 8](#).

* For ease of reference, an FBO with \geq \$50 billion in global assets and $<$ \$50 billion in combined U.S. assets is referred to in this document as a **“Foreign Bank.”**

New U.S. Regulatory Landscape for FBOs

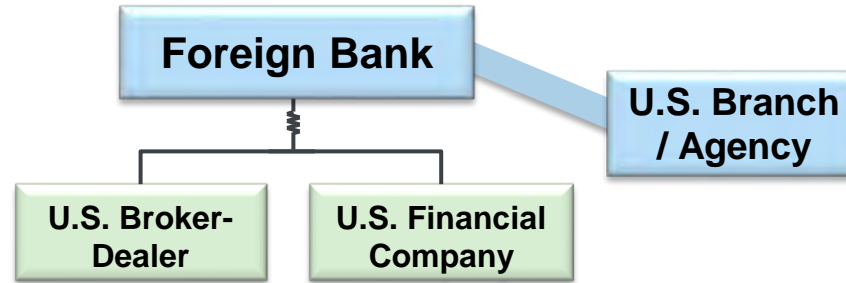


Many details are omitted from this visual overview

Overview of New Requirements for a Foreign Bank

Key Facts

- \geq \$50 billion in global assets
- $<$ \$50 billion in combined U.S. assets



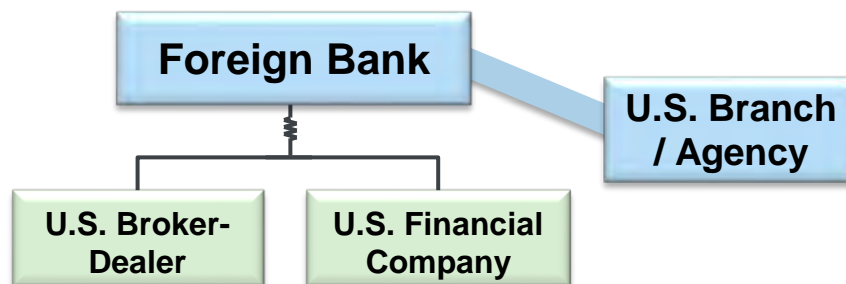
Bottom Line — Not subject to IHC requirement but the following EPS will apply:

- **U.S. Risk Committee:** A Foreign Bank must establish a U.S. risk committee of its global board of directors that meets certain requirements. See [page 10](#) for more details.
 - Non-compliance = Federal Reserve may impose requirements, conditions or restrictions relating to the activities or business operations of the Foreign Bank's **combined U.S. operations** (*i.e.*, U.S. branches/agencies + U.S. subsidiaries).
- **Internal Liquidity Stress Test:** A Foreign Bank must report the results of internal liquidity stress test that meets the Basel Committee's principles for liquidity risk management and incorporates multiple stress test horizons. See [page 12](#) for more details.
 - Non-compliance = combined U.S. operations must maintain **net due to** or **net due from** funding position with non-U.S. affiliates of \leq **25%** of third-party liabilities of combined U.S. operations on a daily basis.

Overview of New Requirements for a Foreign Bank *(cont.)*

Key Facts

- \geq \$50 billion in global assets
- $<$ \$50 billion in combined U.S. assets



- **Home Country Capital Certification:** A Foreign Bank must certify that it meets home country capital standards that are consistent with the Basel capital framework, including Basel III. See [page 14](#) for more details.
 - Non-compliance = Federal Reserve may impose requirements, conditions or restrictions, including risk-based or leverage capital requirements, relating to the activities or business operations of the Foreign Bank's combined U.S. operations.
- **Home Country Capital Stress Test:** A Foreign Bank must be subject to and pass annual home country capital stress tests that are comparable to U.S. standards, including requirements for governance and controls of stress testing practices by management and board of directors. See [page 16](#) for more details.
 - Non-compliance = **105% U.S. asset maintenance** (eligible assets as % of average quarterly liabilities) requirement for U.S. branches/agencies and the Foreign Bank must **conduct annual stress test of U.S. subsidiaries** and report results to the Federal Reserve.
- **Single Counterparty Credit Limits:** To be finalized at a later date.
- **Early Remediation Framework:** To be finalized at a later date.

Compliance Timing for a Foreign Bank

- An FBO that, as of **June 30, 2015**, has \geq \$50 billion in global assets but $<$ \$50 billion in combined U.S. assets must comply with EPS applicable to Foreign Banks beginning on **July 1, 2016**.
- An FBO that, as of **some later date**, has \geq \$50 billion in global assets but $<$ \$50 billion in combined U.S. assets must comply with EPS applicable to Foreign Banks beginning on the **first day of the ninth quarter** following that later date.

Calculating Global Assets and Combined U.S. Assets

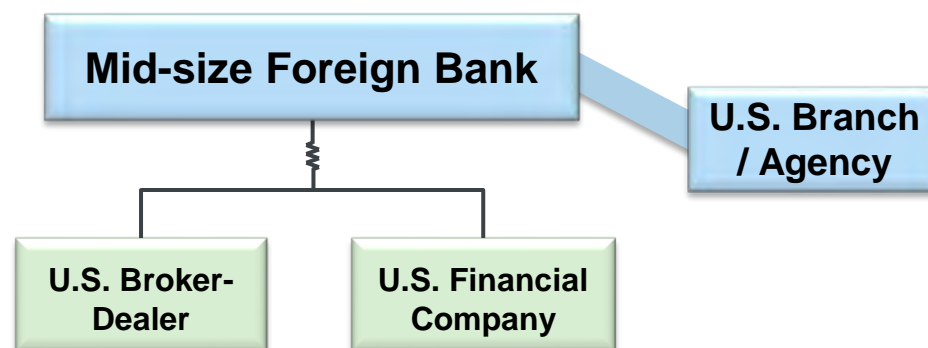
- **Global assets** = average of the FBO's total consolidated assets for the **4 most recent consecutive quarters** as reported by the FBO on Form FR Y-7Q.
 - If the FBO has not filed Form FR Y-7Q for the 4 most recent consecutive quarters, the Federal Reserve will use the average of the FBO's total consolidated assets reported on its 2 most recent Form FR Y-7Q.
 - Total consolidated assets are measured on the as-of date of the most recent Form FR Y-7Q used to calculate the average.
- **Combined U.S. assets** = average of the following amount for the **4 most recent consecutive quarters** as reported by the FBO on Form FR Y-7Q:
 - **Sum** of **(1) the consolidated assets of each top-tier U.S. subsidiary** of the FBO (excluding any Section 2(h)(2) company*) and **(2) the total assets of each U.S. branch/agency** of the FBO.
 - If the FBO has not filed Form FR Y-7Q for the 4 most recent consecutive quarters, the Federal Reserve will use the average of the FBO's combined U.S. assets for the most recent quarter or consecutive quarters as reported on Form FR Y-7Q.
 - Combined U.S. assets are measured on the as-of date of the most recent Form FR Y-7Q used to calculate the average.

* Section 2(h)(2) of the U.S. Bank Holding Company Act allows qualifying FBOs to retain their interest in foreign commercial firms that conduct business in the United States. This statutory exception was enacted in recognition of the fact that some foreign jurisdictions do not impose a clear separation between banking and commerce.

Overview of New Requirements for a Mid-size Foreign Bank

Key Facts

- > \$10 billion in global assets
- < \$50 billion in global assets



Bottom Line — Not subject to EPS except for the following:

- **U.S. Risk Committee**
 - If **publicly traded**, a Mid-size Foreign Bank must establish a U.S. risk committee of its global board of directors that meets certain requirements. See [page 20](#) for more details.
 - Non-compliance = Federal Reserve may impose requirements, conditions or restrictions relating to the activities or business operations of the publicly traded Mid-size Foreign Bank's combined U.S. operations.
 - A **non-publicly traded** Mid-size Foreign Bank is **not** required to establish a U.S. risk committee.
- **Home Country Capital Stress Test:** A Mid-size Foreign Bank (regardless of whether it is publicly traded) must be subject to and pass annual home country capital stress tests that are comparable to U.S. standards, including requirements for governance and controls of stress testing practices by management and board of directors. See [page 22](#) for more details.
 - Non-compliance = **105% U.S. asset maintenance** (eligible assets as % of average quarterly liabilities) requirement for U.S. branches/agencies and the Mid-size Foreign Bank must conduct annual stress test of U.S. subsidiaries and report results to the Federal Reserve.

Compliance Timing for a Mid-size Foreign Bank

Compliance Timing for U.S. Risk Committee Requirement

- A publicly traded FBO that, as of **June 30, 2015**, has > \$10 billion but < \$50 billion in global assets must comply with the U.S. risk committee requirement for publicly traded Mid-size Foreign Banks beginning on **July 1, 2016**.
- A publicly traded FBO that, as of **some later date**, has > \$10 billion but < \$50 billion in global assets must comply with the U.S. risk committee requirement for publicly traded Mid-size Foreign Banks beginning on the **first day of the ninth quarter** following that later date.

Compliance Timing for Home Country Capital Stress Test Requirement

- An FBO that, as of **June 30, 2015**, has > \$10 billion but < \$50 billion in global assets must comply with the home country capital stress test requirement for Mid-size Foreign Banks beginning on **July 1, 2016**.
- An FBO that, as of **some later date**, has > \$10 billion but < \$50 billion in global assets must comply with the home country capital stress test requirement for Mid-size Foreign Banks beginning on the **first day of the ninth quarter** following that later date.

Calculating Global Assets

- **Global assets** = average of the FBO's total consolidated assets for the **2 most recent periods** as reported by the FBO on Form FR Y-7.
 - Total consolidated assets are measured on the as-of date of the most recent Form FR Y-7 used to calculate the average.

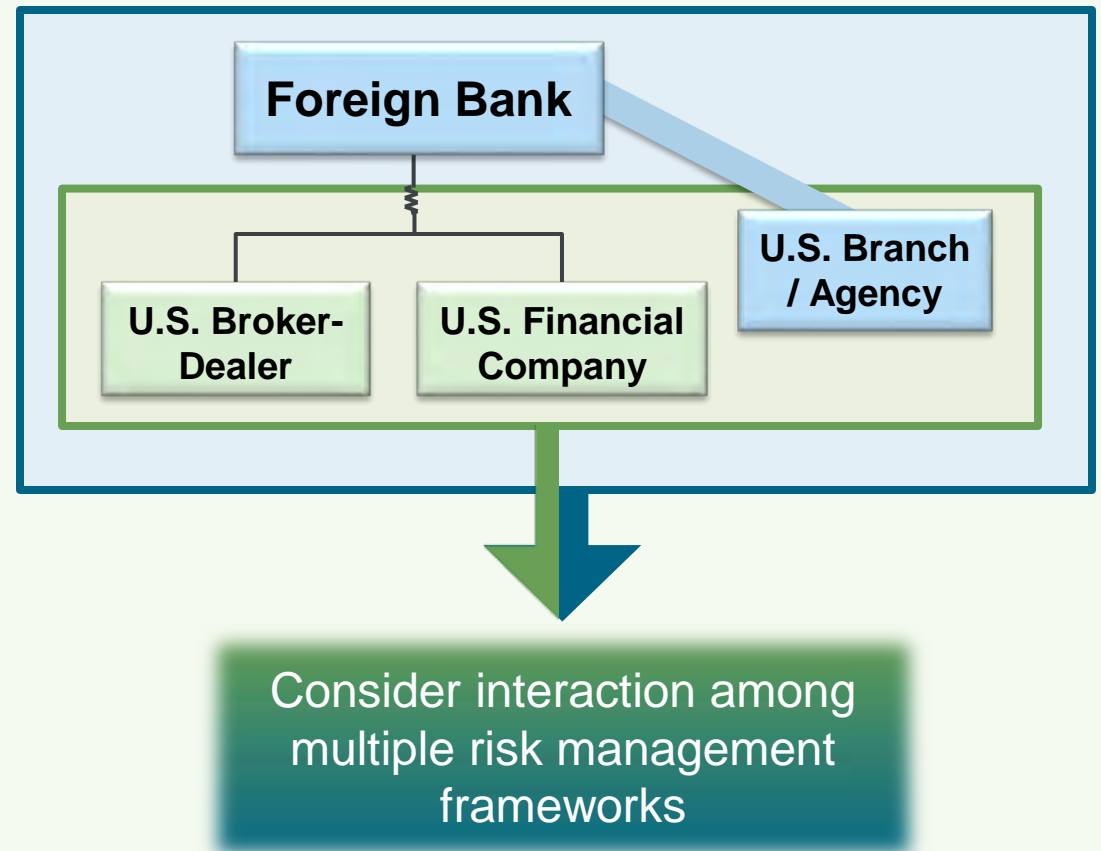
A Closer Look at New Requirements for a Foreign Bank

U.S. Risk Committee Requirement

- The risk management standards in the EPS Final Rule supplement, rather than replace, existing Federal Reserve guidance and supervisory expectations.
- **Board-level U.S. Risk Committee:** A Foreign Bank must maintain a U.S. risk committee of its global board of directors and file an annual certification to that effect concurrently with Form FR Y-7.
- **Location:** U.S. risk committee may be on a stand-alone basis or part of an enterprise-wide risk committee of the global board of directors.
- **Composition:** U.S. risk committee must include at least one member with experience in identifying, assessing and managing risk exposures of large, complex firms.
 - Risk management experience may be acquired in a nonbanking or nonfinancial field.
 - Independent committee member **not required**.
- **Responsibilities:** U.S. risk committee must oversee the risk management policies of the combined U.S. operations.
 - The Foreign Bank must take appropriate measures to ensure that its combined U.S. operations **(1)** implement the risk management policies overseen by the U.S. risk committee and **(2)** provide sufficient information to the U.S. risk committee to enable it to carry out its responsibilities.
- U.S. chief risk officer is **not required**.
- **Consequences for Non-compliance:** Federal Reserve may impose requirements, conditions or restrictions relating to the activities or business operations of the combined U.S. operations.

U.S. Risk Committee Requirement: Interaction Among Multiple Risk Management Frameworks

- A Foreign Bank should consider the interaction among the risk management requirements in:
 - Federal Reserve's EPS Final Rule;
 - Home country regulations; and
 - Applicable stock exchange listing standards.



Internal Liquidity Stress Test Requirement

- A Foreign Bank must report to the Federal Reserve on an annual basis the results of an internal liquidity stress test for either its:
 - Global operations; or
 - Combined U.S. operations.
- The internal liquidity stress test must be conducted consistently with the Basel Committee's principles for liquidity risk management (available [here](#)), as supplemented and revised from time to time.
- The internal liquidity stress test must incorporate 30-day, 90-day and 1-year stress test horizons.
- A Foreign Bank is **not** subject to the EPS Final Rule's U.S. liquidity buffer requirements.
- **Consequences for Non-compliance:** A Foreign Bank's combined U.S. operations must maintain a **net due to** funding position or a **net due from** funding position with non-U.S. affiliates of $\leq 25\%$ of third-party liabilities of U.S. operations on a daily basis.

Internal Liquidity Stress Test Requirement: High-Level Overview of Basel Committee's Principles

The Basel Committee's principles for liquidity risk management provide, among other things, the following guidance regarding internal liquidity stress tests:

- A bank should conduct stress tests on a regular basis for a variety of short-term and protracted institution-specific and market-wide stress scenarios (individually and in combination) to identify sources of potential liquidity strain and to ensure that current exposures remain in accordance with a bank's established liquidity risk tolerance.
- The active involvement of senior management is vital to the stress testing process. Senior management should demand that rigorous and challenging stress scenarios be considered, even in times when liquidity is plentiful.
- In designing stress scenarios, the nature of the bank's business, activities and vulnerabilities should be taken into consideration so that the scenarios incorporate the major funding and market liquidity risks to which the bank is exposed.
- A bank should take a conservative approach when setting stress testing assumptions.
- A bank should consider in its stress tests the likely behavior of counterparties and other market participants.
- A bank should use stress test outcomes to adjust its liquidity risk management strategies, policies and positions and to develop effective contingency plans.

Home Country Capital Certification Requirement

- A Foreign Bank must certify to the Federal Reserve on an annual basis that it meets capital adequacy standards on a consolidated basis established by its home country supervisor that are consistent with the Basel capital framework, including Basel III.
- Home country capital adequacy standards that are consistent with the Basel capital framework include the following components of Basel III:
 - All minimum risk-based capital ratios;
 - Minimum leverage ratio; and
 - Capital buffers.
- **If Home Country Supervisor Has Not Implemented Basel III:** If a home country supervisor has **not** established capital adequacy standards that are consistent with the Basel capital framework, the Foreign Bank must demonstrate to the satisfaction of the Federal Reserve that it would meet or exceed capital adequacy standards on a consolidated basis that are consistent with the Basel capital framework were it subject to such standards.
- **Reporting:** A Foreign Bank must provide to the Federal Reserve reports relating to its compliance with home country capital adequacy measures concurrently with filing Form FR Y-7Q.
- **Consequences for Non-compliance:** Federal Reserve may impose requirements, conditions or restrictions, including risk-based or leverage capital requirements, relating to the activities or business operations of the Foreign Bank's combined U.S. operations.

Home Country Capital Certification Requirement: Basel Committee's RCAP Reports

- In determining whether a Foreign Bank's home country capital standards are consistent with the Basel capital framework, including Basel III, the Federal Reserve intends to take into account reviews performed as part of the Basel Committee's Regulatory Consistency Assessment Programme (RCAP).
- Through the RCAP, the Basel Committee reviews implementing regulations in each member country to determine their consistency with the Basel capital framework.
- To date, the Basel Committee has published reports on Basel III implementation in the following non-U.S. jurisdictions:
 - European Union – report available [here](#).
 - China – report available [here](#).
 - Brazil – report available [here](#).
 - Australia – report available [here](#).
 - Switzerland – report available [here](#).
 - Japan – report available [here](#).
 - Singapore – report available [here](#).

Home Country Capital Stress Test Requirement

- A Foreign Bank must:
 - **(1)** Be subject on a consolidated basis to a capital stress testing regime established by its home country supervisor that includes:
 - An annual supervisory capital stress test conducted by its home country supervisor **or** an annual evaluation and review by the home country supervisor of an internal capital stress test conducted by the Foreign Bank; and
 - Requirements for governance and controls of stress testing practices by management and the board of directors (or equivalent thereof).
 - **(2)** Conduct such stress tests or be subject to a supervisory stress test and meet any minimum standards set by its home country supervisor with respect to the stress tests.

Home Country Capital Stress Test Requirement: Consequences for Non-compliance

- Unless the Federal Reserve otherwise determines in writing, a Foreign Bank that fails to comply with the home country capital stress test requirement must:
 - **Maintain eligible assets in its U.S. branches/agencies** that, on a daily basis, are $\geq 105\%$ of the total **liabilities of its U.S. branches/agencies*** (calculated as the average value over each day of the previous calendar quarter).
 - **Conduct an annual stress test of its U.S. subsidiaries** to determine whether those subsidiaries have the capital necessary to absorb losses as a result of adverse economic conditions.
 - An enterprise-wide stress test that is approved by the Federal Reserve may meet the stress test requirement.
 - **Annually report to the Federal Reserve** a summary of the results of the stress test that includes:
 - A description of the types of risks included in the stress test;
 - A description of the conditions or scenarios used in the stress test;
 - A summary description of the methodologies used in the stress test;
 - Estimates of aggregate losses, pre-provision net revenue, total loan loss provisions, net income before taxes and pro forma regulatory capital ratios required to be computed by the home country supervisor and any other relevant capital ratios; and
 - An explanation of the most significant causes for any changes in regulatory capital ratios.

* **Liabilities of U.S. branches/agencies** = Liabilities of all U.S. branches and agencies, including acceptances and any other liabilities (including contingent liabilities), but excluding: (1) amounts due to and other liabilities to other offices, agencies, branches and affiliates (including the head office) including unremitted profits; and (2) reserves for possible loan losses and other contingencies.

Home Country Capital Stress Test Requirement: Definition of Eligible Asset

- **Eligible Asset** = Any asset held in the United States that is recorded on the general ledger of a U.S. branch/agency, **less** the amount of any specifically allocated reserves held in the United States and recorded on the general ledger of the U.S. branch/agency in connection with such asset.
 - The EPS Final Rule’s definition of “eligible asset” is broadly similar to definition used by the New York State Department of Financial Services.

<u>Not Eligible Assets</u>	
<ul style="list-style-type: none"> ■ Equity securities ■ Assets classified as loss at the preceding examination by a regulatory agency, outside accountant or internal loan review staff ■ Accrued income on assets classified as loss, doubtful, substandard or value impaired at the preceding examination by a regulatory agency, outside accountant or internal loan review staff ■ Prepaid expenses and amortized costs, furniture and fixtures and leasehold improvements 	<ul style="list-style-type: none"> ■ Any amounts due from the head office, other offices and affiliates, including income accrued but uncollected on such amounts ■ The balance from time to time of any other asset or asset category disallowed at the preceding examination or by direction of the Federal Reserve for any other reason until the underlying reasons for the disallowance have been removed ■ Any other asset that the Federal Reserve determines should not qualify as an eligible asset

<u>Eligible Asset Valuation Rules</u>	
<u>Asset</u>	<u>Valuation</u>
<ul style="list-style-type: none"> ■ Marketable debt security 	<ul style="list-style-type: none"> ■ Lesser of principal amount and market value
<ul style="list-style-type: none"> ■ Asset classified as doubtful 	<ul style="list-style-type: none"> ■ 50%
<ul style="list-style-type: none"> ■ Asset classified as substandard 	<ul style="list-style-type: none"> ■ 80%
<ul style="list-style-type: none"> ■ Asset classified as value impaired 	<ul style="list-style-type: none"> ■ Amount representing allocated transfer risk reserve that would be required for exposure at a domestically chartered bank → 0% ■ Residual exposure → 80%
<ul style="list-style-type: none"> ■ Real estate located in the United States 	<ul style="list-style-type: none"> ■ Lesser of net book value and appraised value

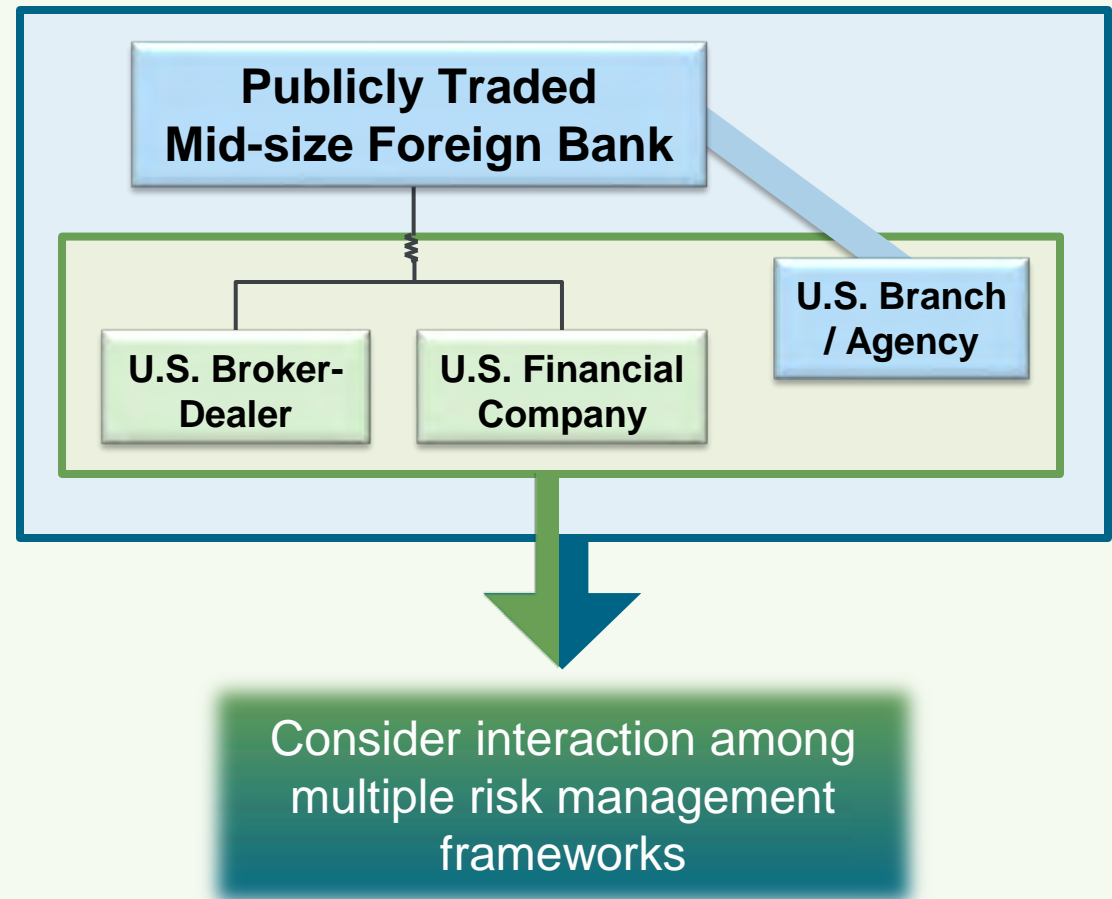
A Closer Look at New Requirements for a Mid-size Foreign Bank

U.S. Risk Committee Requirement for Publicly Traded Mid-Size Foreign Banks

- The risk management standards in the EPS Final Rule supplement, rather than replace, existing Federal Reserve guidance and supervisory expectations.
- **Board-level U.S. Risk Committee:** A **publicly traded** Mid-size Foreign Bank must maintain a U.S. risk committee of its global board of directors and file an annual certification to that effect concurrently with Form FR Y-7.
 - Requirement does **not** apply to a **non-publicly traded** Mid-size Foreign Bank.
- **Location:** U.S. risk committee may be on a stand-alone basis or part of an enterprise-wide risk committee of the global board of directors.
- **Composition:** U.S. risk committee must include at least one member with experience in identifying, assessing and managing risk exposures of large, complex firms.
 - Risk management experience may be acquired in a nonbanking or nonfinancial field.
 - Independent committee member **not required**.
- **Responsibilities:** U.S. risk committee must oversee the risk management policies of the combined U.S. operations.
 - The publicly traded Mid-size Foreign Bank must take appropriate measures to ensure that its combined U.S. operations **(1)** implement the risk management policies overseen by the U.S. risk committee and **(2)** provide sufficient information to the U.S. risk committee to enable it to carry out its responsibilities.
- U.S. chief risk officer is **not required**.
- **Consequences for Non-compliance:** Federal Reserve may impose requirements, conditions or restrictions relating to the activities or business operations of the combined U.S. operations.

U.S. Risk Committee Requirement: Interaction Among Multiple Risk Management Frameworks

- A publicly traded Mid-size Foreign Bank should consider the interaction among the risk management requirements in:
 - Federal Reserve's EPS Final Rule;
 - Home country regulations; and
 - Applicable stock exchange listing standards.



Home Country Capital Stress Test Requirement for All Mid-Size Foreign Banks

- A Mid-size Foreign Bank (**regardless of whether it is publicly traded**) must:
 - **(1)** Be subject on a consolidated basis to a capital stress testing regime established by its home country supervisor that includes:
 - An annual supervisory capital stress test conducted by its home country supervisor **or** an annual evaluation and review by the home country supervisor of an internal capital stress test conducted by the Mid-size Foreign Bank; and
 - Requirements for governance and controls of stress testing practices by management and the board of directors (or equivalent thereof).
 - **(2)** Conduct such stress tests or be subject to a supervisory stress test and meet any minimum standards set by its home country supervisor with respect to the stress tests.

Home Country Capital Stress Test Requirement: Consequences for Non-compliance

- Unless the Federal Reserve otherwise determines in writing, a Mid-size Foreign Bank that fails to comply with the home country capital stress test requirement must:
 - **Maintain eligible assets in its U.S. branches/agencies** that, on a daily basis, are $\geq 105\%$ of the total **liabilities of its U.S. branches/agencies*** (calculated as the average value over each day of the previous calendar quarter).
 - **Conduct an annual stress test of its U.S. subsidiaries** to determine whether those subsidiaries have the capital necessary to absorb losses as a result of adverse economic conditions.
 - An enterprise-wide stress test that is approved by the Federal Reserve may meet the stress test requirement.
 - **Annually report to the Federal Reserve** a summary of the results of the stress test that includes:
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* **Liabilities of U.S. branches/agencies** = Liabilities of all U.S. branches and agencies, including acceptances and any other liabilities (including contingent liabilities), but excluding: (1) amounts due to and other liabilities to other offices, agencies, branches and affiliates (including the head office) including unremitted profits; and (2) reserves for possible loan losses and other contingencies.

Home Country Capital Stress Test Requirement: Definition of Eligible Asset

- **Eligible Asset** = Any asset held in the United States that is recorded on the general ledger of a U.S. branch/agency, **less** the amount of any specifically allocated reserves held in the United States and recorded on the general ledger of the U.S. branch/agency in connection with such asset.
 - The EPS Final Rule’s definition of “eligible asset” is broadly similar to definition used by the New York State Department of Financial Services.

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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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