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Fed's Foreign Bank Plan Stirs Concerns

By Donna Borak

WASHINGTON - A pending proposal by the Federal Reserve Board to overhaul the way U.S. regulators supervise foreign bank operations is raising questions and sparking concern among industry players who fear it may go too far.

Fed Gov. Daniel Tarullo offered a glimpse of the plan late last month in what some have called a "provocative" speech in which he said the central bank plans to supervise foreign bank operations by imposing the same set of requirements that U.S. bank holding companies face.

While that may not sound radical, it represents a sharp departure for the Fed, which has generally applied a case-by-case approach to foreign bank supervision. It has also alarmed some that worry such methods would not take into account the differing structures among the foreign banks operating in the U.S.

"It's going to significantly change how some foreign banks are regulated," said Kim Olson, a principal at Deloitte & Touche LLP. "There have always been a lot of regulations, but it will give the U.S. much more ability to demand capital and liquidity requirements in those U.S. operations."

Banks likely to be affected by the proposal, including Barclays, Deutsche Bank, and HSBC, have refrained from publicly commenting on the speech as they await a detailed proposal which is expected to be released at a board meeting on Dec. 14. Representatives from each bank declined to comment for this article.

But others have objected to the plan.

It appears to be "at odds with Congress' specific direction in Section 165 of Dodd-Frank to take into account comparable home country standards that apply to foreign bank organizations," said Sally Miller, president of the Institute of International Bankers.

Tarullo's speech has also raised a number of critical questions that will ultimately dictate how much the plan could impact the roughly 100 foreign banks that may have to comply with at least some of the new rules (Such firms must have more than $50 billion of globally consolidated assets). That includes whether they would be subject to multiple sets of capital requirements from both the U.S. and their home country and what kind of transition period the Fed is considering given the difficulty in raising capital.

"There is so much yet to be resolved before you can reach definitive conclusions," said H. Rodgin Cohen, a partner at Sullivan Cromwell. "It is clearly intended to be a significant change. But is it so radical as to lead to some of the hysteria? I'm not sure."

For example, Tarullo suggested in his speech the Fed would not propose caps on intra-group flows for foreign banks in "good financial condition," but it's unclear how regulators plan to define that.

Susan Krause Bell
Promontory Financial

That has left many observers anxiously awaiting the actual proposal, which has the potential to force foreign banks to raise millions of dollars in additional capital.

"We won't know how draconian this is until we see the proposal," said Susan Krause Bell, managing director of Promontory Financial Group and a former official at the Office of the Comptroller of the Currency. "The biggest concern is going to be how the capital requirements come out, how the liquidity requirements come out and who is going to be on the list of most significant."

Tarullo, who is responsible for bank supervision on the Fed board, hinted that of the 100 firms involved, potentially two dozen firms would get hit with the bulk of the requirements, while the other institutions would face separate measures.

Under the Fed's approach, a foreign bank's operations - whether it be a broker dealer or the bank's subsidiary - will have to be placed under a first-tier U.S. intermediary holding company, which would be subject to similar requirements as U.S. bank holding companies with assets of $50 billion or more. U.S. branches and agencies of the foreign bank would not be part of the holding company, but would be subject to separate measures, including liquidity requirements.

Additionally, larger firms would also be required to follow the same stress testing exercises, single counterparty credit limits, and early remediation requirements as their U.S. counterparts. Liquidity standards would also be consistent with those applied to the largest bank holding companies in the U.S.

For regulators, pursuit of such an approach affords a number of advantages, such as the ability to implement rules through a single intermediary holding company, while also ensuring they are able to control the systemic risk that those institutions could impose on the U.S. economy.

While bankers are likely to disagree with Tarullo's characterization of the plan as a moderate approach, observers note that the Fed narrowed the scope of what it could have done. For example, regulators could have asked foreign banks to complete a full subsidiarization by requiring branches and agencies to be part of the intermediate holding company.

"It's clear it's not the worst case, which would be formal subsidiarization," said Cohen. "He clearly did not go to the extreme although that doesn't mean it won't create serious issues. I don't see how you can reach definite conclusions or anything close to that until you see what the actual proposal is."

It's taken nearly a year for regulators to release a proposal, which is required under Dodd-Frank. Last December, the Fed, which is responsible for supervising the largest, most complex banks, released its final rule setting capital, liquidity, stress test, and living will requirements. But regulators left off how the package of rules would be applied to the foreign banks.

The shift in supervisory approach has been expected since the financial crisis revealed to regulators flaws with the current process. Many had been expecting such changes to supervision given the failure of Lehman Brothers, which had a substantial broker-dealer subsidiary in the U.K., and severe distress at certain non-U.S. banks with operations in the U.S.

Adding to that, a provision of Dodd-Frank added by Sen. Susan Collins, R-Maine, also calls for major non-U.S. banks to restructure their U.S. operations. A separate batch of rules in the regulatory reform law, known as Sec. 165, requires foreign bank operations with $50 billion or more in global consolidated assets and a presence in the U.S. to increase capital and liquidity.

"In the past the U.S. felt more comfortable in assuming that a foreign parent would provide its U.S. subsidiary support if it became distressed," said Bell. "Now there is a much greater concern that the home authority may not always allow the parent to support a troubled U.S. sub."

The U.S. is following the lead of countries like the United Kingdom and Switzerland, which have been among the first to take steps to move in the direction of ring-fencing.

Regulators are also concerned about foreign banks' overreliance on short-term funding, which runs the risks of potential runs without holding sufficient liquidity. Many banks - large and small - relied on the Fed's discount window during the crisis, including foreign banks, which then funneled U.S. dollars to their own parent companies back in their home country.

"It's recognized that the foreign branches in the U.S. during the crisis, post-crisis and even in the buildup of the crisis changed how they funded themselves and what they did what that money," said Olson. "The view is that it becomes a systemic threat to the U.S. and it's important that federal regulators have the ability to be sure that liquidity that is being held there is sufficient."

The danger, however, is the proposal may go too far in addressing that issue and wind up creating some macroeconomic issues.

"If we make it too difficult for foreign banks to obtain U.S. dollars then inevitably it's going to create pressures in a lot of countries on continuing use of the dollar as the reserve currency," said Cohen. "We clearly want major banks around the world to look upon the United States as a global financial center. We don't want to make it unpalatable or unacceptable for them to be here."