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Client Alert

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New Regulation YY Intermediate Holding Company Requirement and Enhanced Prudential Standards for Large Foreign Banking Operations in the United States

On February 18, 2014, the Federal Reserve issued the final version of new Regulation YY establishing "enhanced prudential standards" for large bank holding companies and large foreign banks operating in the United States. The first part of this client alert describes the Regulation YY requirement that certain foreign banks operating in the US establish an "intermediate holding company" (IHC). The second part describes (1) additional "enhanced prudential standards" that will apply to such IHCs and (2) separate standards that will apply to the US operations of any foreign bank with $50 billion or more in US assets, including foreign banks required to establish IHCs.

I. The IHC Requirement

What is the new requirement for foreign banks to establish an IHC for their US operations?

Under the new Regulation YY, a foreign bank with $50 billion or more in US "non-branch assets" will need to establish (or identify an existing) "intermediate holding company" to hold *all* ownership interests in its US subsidiaries (other than "2(h)(2)" and "DPC" subsidiaries described below). This "intermediate holding company" (IHC) will be supervised by the Federal Reserve under "enhanced prudential standards."

The IHC will not own the foreign bank's US branches or agencies. Those will continue to operate as direct branches or agencies of the foreign bank, not as separate corporate entities.

How do foreign banks determine whether they hold $50 billion or more in US assets so that they are required to establish an "intermediate holding company"?

The new Regulation YY requires a foreign bank to determine the total amount of consolidated assets held by "each top tier US subsidiary" (other than 2(h)(2) and DPC subsidiaries) after eliminating intercompany items between those subsidiaries. This US "non-branch asset" amount is computed for any calendar quarter date based on the average amount of assets reported by the foreign bank to the Federal Reserve for that date and the three preceding calendar quarter end reporting dates (i.e., the annual average based on the four most recent calendar quarter reports on the foreign bank's FR Y-7Q filed with the Federal Reserve).

What are the 2(h)(2) companies and DPC subsidiaries excluded from this computation of the $50 billion threshold?

The new Regulation YY excludes from the computation of US "non-branch assets" of a foreign bank any assets held by a "2(h)(2) company" or "debt previously contracted branch subsidiary."

A "2(h)(2) company" is a foreign commercial company that transacts business in the US. Although a bank holding company would generally be prohibited from owning such a subsidiary, Section 2(h)(2) of the Bank Holding Company Act (12 USC 1841(h)(2)) permits a foreign bank to own such a subsidiary and still conduct a banking business in the US when the foreign bank's ownership is permitted by its home country. Because a foreign bank's ownership of such a company is not part of its US banking business, 2(h)(2) subsidiaries are excluded from the $50 billion US non-branch asset test.

A "debt previously contracted" (DPC) branch subsidiary is a subsidiary formed or acquired by a foreign bank's US branch or agency to secure or collect "debt previously contracted in good faith by that branch or agency." This exclusion recognizes that the DPC subsidiary is an asset of the branch or agency as part of its direct banking business.

What is a subsidiary of a foreign bank under the new rule?

Any company the foreign bank "controls" (as defined in the Bank Holding Company Act) is a subsidiary. This includes any company in which the foreign bank owns 25% or more of any class of voting securities, but also any company for which the foreign bank controls the election of a majority

of directors or otherwise "directly or indirectly exercises a controlling influence over the management or policies" of the company.

A foreign bank's IHC is required to hold "the entire ownership interest" of the foreign bank in US subsidiaries (other than 2(h)(2) and DPC branch subsidiaries). The assets of a "subsidiary" in which the foreign bank holds no "ownership interest" would be counted as non-branch US assets of the foreign bank (unless the subsidiary were a 2(h)(2) or DPC branch subsidiary), but there would be no "ownership interest" to transfer.

The new Regulation YY does not define "ownership interest." The term presumably covers equity interests and other securities representing some "ownership" of a company. Because of the broad definition of "control" used in the new rule, a foreign bank could "control" a company without holding any "ownership interest" in that "subsidiary."

What US subsidiaries must be owned by the intermediate holding company?

Unless the Federal Reserve specifically permits an alternative structure, the "entire ownership interest" held by the foreign bank in *each* US subsidiary (other than 2(h)(2) and DPC branch subsidiaries) must be held by the newly required IHC. Foreign banks are given a grace period during the first year an IHC is required to be established (i.e., from July 1, 2016, through June 30, 2017) during which certain companies (i.e., non-banks and non-bank holding companies) holding 10% or less of a foreign bank's US non-branch assets (that are not bank or bank holding company assets) can continue to be owned outside the IHC.

As noted above, a foreign bank's US branches and agencies are *not* subsidiaries of the foreign bank. They will continue to operate as branches or agencies of the foreign bank, *not* as an IHC or as subsidiaries of an IHC.

How will the IHC requirement affect asset backed commercial conduits or other "variable interest entities" whose assets are consolidated on the books of a US branch of the foreign bank for which an IHC is established?

Because the VIE would not be a "subsidiary" of the foreign bank and the bank would not own any "ownership interest" in the VIE, a foreign bank holding $50 billion or more in non-branch US assets would not be required to transfer any "ownership interest" in the VIE to the IHC it will be required to establish (and would not have any such ownership interest in any case). Because such a VIE's assets and liabilities would be consolidated on the balance sheet of the US branch and not be the assets of a "subsidiary," the assets would not count as "non-branch assets" for purposes of determining whether the foreign bank had $50 billion or more in non-branch assets.

What happens if a foreign bank is not able to transfer to its IHC the entire ownership interest it holds in a US subsidiary?

The new Regulation YY states the Federal Reserve may allow a foreign bank exceptions from the requirement that a single IHC hold all ownership interests of the bank in US subsidiaries (other than 2(h)(2) and DPC branch subsidiaries). Regulation YY notes the possibility that a foreign bank might be legally prohibited from transferring such an ownership interest to its IHC or that "circumstances otherwise warrant" an exemption from the requirement.

Foreign banks covered by the new IHC requirement, however, will need to transfer all ownership interests in their US subsidiaries to a qualifying IHC unless the Federal Reserve specifically approves an exemption.[1]

For what period must a foreign bank calculate its US non-branch asset amount to determine whether it is required to establish an IHC?

First, a foreign bank must calculate this amount for the four calendar period ending on June 30, 2014. If the foreign bank's average non-branch asset amount for this period exceeds $50 billion, the foreign bank will be required to submit to the Federal Reserve by January 1, 2015, a plan for either (1) forming a qualifying IHC or (2) reducing its non-branch asset amount to less than $50 billion for four consecutive quarters through June 30, 2015 (i.e., on *each* of the four FR Y-7Q reports filed for periods after June 30, 2014).[2]

Second, a foreign bank reporting an average of $50 billion or more in non-branch assets for the four calendar quarter test period ending on June 30, 2015, must establish a qualifying IHC by July 1, 2016.

Regulation YY leaves open what action the Federal Reserve might take if a foreign bank reported less than $50 billion in *average* non-branch assets on the four FR Y-7 reports it filed for the periods July 1, 2014, through June 30, 2015, but failed to meet a filed plan for reporting less

1 Regulation YY states that the Federal Reserve may impose additional obligations on foreign banks receiving such an exemption. In particular, if the Federal Reserve permits a foreign bank to establish more than one IHC to hold interests in US subsidiaries, the Federal Reserve expects to treat each IHC as holding $50 billion or more in non-branch assets, regardless of its actual asset holdings.

2 The Federal Reserve may require a foreign bank to file such a plan before January 1, 2015 (or permit a foreign bank to file the plan later).

than $50 billion in assets on *each* such report or for establishing an IHC.[3]

If a foreign bank is required to establish an IHC by July 1, 2016, will it be released from this requirement in the future if, after June 30, 2015, it reduces the amount of its US non-branch assets below $50 billion?

Yes, but only if the foreign bank's non-branch US assets are below $50 billion for *each* of four consecutive calendar quarters, as shown on form FR Y-7Q filed by the foreign bank with the Federal Reserve for such four consecutive quarters.[4]

What happens if a foreign bank has less than $50 billion in non-branch assets on June 30, 2015, but later reports $50 billion or more in non-branch assets?

A foreign bank that is not required to establish an IHC on July 1, 2016, will be required to establish a qualifying IHC by the "first day of the ninth quarter following the date on which its U.S. non-branch assets equal or exceed $50 billion." Thus, a foreign bank that only meets the $50 billion non-branch asset test on a quarterly reporting date after June 30, 2015 (based on the four calendar quarter average asset test), will have two years to form the required IHC in compliance with the new Regulation YY.

Unlike foreign banks covered by the initial July 1, 2016, deadline, however, such newly required IHCs will not be entitled to the transition relief that permits the IHC to own only 90% (not 100%) of non-depositary, non-BHC subsidiary assets for one year. An IHC required to be formed after July 1, 2015, will need to hold all ownership interests in non-2(h)(2), non-DPC branch subsidiaries from the first day the IHC is required to be established.

How will the IHC requirement affect existing US bank holding companies owned by foreign banks?

Many large foreign banks own US banks through US bank holding companies. If such US bank holding companies hold $50 billion or more in assets (as several do), they expected to be subject to "enhanced prudential standards" under Dodd-Frank. Some foreign banks, however, have restructured their US operations either to eliminate their US bank holding company or to bring its assets below $50 billion in the hope this would avoid Dodd-Frank mandated enhanced prudential standards. Regulation YY (as intended) will frustrate such efforts unless the foreign bank reduces its US non-branch assets below $50 billion. Even then such a foreign bank would be subject to other "enhanced prudential standards" described below unless its "combined US assets," including assets booked at US branches and agencies, were less than $50 billion.

Regulation YY permits a foreign bank to designate its existing US bank holding company as the IHC required by the new rule. To do so, the existing bank holding company would need to hold all "ownership interests" of the foreign bank in US subsidiaries to the extent required by the new rule. As described below, after the new Regulation YY enhanced prudential standards fully apply to an IHC, the corresponding Regulation YY enhanced prudential standards for US bank holding companies with $50 billion or more in assets will not apply to the IHC or to any bank holding company subsidiary it may own.

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3 Because Section 225.3 of the new rule permits the Federal Reserve either to impose "other requirements or restrictions" it "deems necessary" or to "extend or accelerate any compliance date," the Federal Reserve could order a foreign bank to establish an IHC if it failed to reduce its non-branch assets below $50 billion on any quarterly reporting date after June 30, 2014, even though the foreign bank reported less than $50 billion in average non-branch assets for the four reporting dates after June 30, 2014. According to Section 252.152(c)(2) of Regulation YY, a foreign bank that reports less than $50 billion in *average* non-branch assets on its FR Y-7Q reports filed for the four calendar quarters ending on June 30, 2015, would not be required to form an IHC on July 1, 2016. As noted above, however, if such average non-branch asset amount for a foreign bank were $50 billion or more for the four calendar quarters ending on June 30, 2014, Regulation YY would require the foreign bank to file with the Federal Reserve a detailed plan for either forming an IHC by July 1, 2016, or reducing its non-branch assets below $50 billion on *each* of the four calendar quarter reporting dates after June 30, 2014, through June 30, 2015.

4 Foreign banks might be able to restructure their US operations to book more of their assets directly at branches and agencies in order not to meet the $50 billion asset test. As described above, Regulation YY specifically contemplates this result by permitting foreign banks that meet the test on June 30, 2014, to submit plans for reducing their non-branch assets below the $50 billion threshold. As explained in footnote 3 above, however, Regulation YY is not clear whether it requires foreign banks to reduce their non-branch assets below $50 billion on each quarterly reporting date after June 30, 2014, or only for the average amount reported in the four reports covering calendar quarter dates after June 30, 2014.

In the preamble explaining the new rule, the Federal Reserve explained it will monitor foreign banks to determine whether they transfer assets to their branches and agencies to avoid the IHC requirement and whether this creates risks. This topic was also discussed at the Federal Reserve Board's open meeting that approved the new Regulation YY. The rule's general provisions allowing the Federal Reserve to modify the application of the rule would permit the Federal Reserve to require a foreign bank to establish an IHC even though the bank reduced its non-branch US assets below $50 billion either before or after the initial June 30, 2015, period for computing whether a foreign bank is required to establish an IHC.

How will the IHC requirement affect US branches and agencies of a foreign bank?

As noted above, US branches and agencies are not subsidiaries of the foreign bank. They will continue to operate as branches and agencies of the foreign bank itself, not as IHCs or as subsidiaries of IHCs. As described below, however, Regulation YY enhanced prudential standards will apply to such branches or agencies of a foreign bank if the foreign bank's combined US assets equal or exceed $50 billion.

II. Other Enhanced Prudential Standards for IHCs

If a foreign bank is required to establish an intermediate holding company, how will the IHC be regulated?

First, The IHC itself will be required to meet "enhanced prudential standards" established by the new Regulation YY even if the IHC is not a bank holding company (i.e., even if it does not own a US bank). The risk-based capital and leverage "enhanced" requirements will be the same Basel III standards that will apply to bank holding companies generally beginning in 2015 (except the IHC will not need to apply the "advanced approaches" for computing risk-based capital requirements). An IHC will also need to meet enhanced prudential standards for (1) capital planning and stress testing; (2) liquidity; and (3) risk management requirements patterned off the equivalent "enhanced prudential standards" that will apply to US bank holding companies with $50 billion or more in assets.

Second, a foreign bank with $50 billion or more in US assets (including assets booked at the foreign bank's US branches and agencies) will be subject to several "enhanced prudential standards" under the new Regulation YY. Any "foreign banking organization" required to establish an IHC will be covered by these standards, because it will hold $50 billion or more in both "US assets" and "US non-branch assets." At the consolidated foreign bank level, these requirements include certifications of compliance with (1) risk-based capital and leverage requirements consistent with Basel III, and (2) capital stress testing requirements. For the foreign bank's combined US operations, these requirements include (1) liquidity and (2) risk management (including US risk committee and US chief risk officer) requirements.

What are the risk-based capital requirements for an IHC?

The same as will apply to bank holding companies starting January 1, 2015, under the Federal Reserve Board's Basel III risk-based capital rules issued in 2013, except an IHC will not need to compute its risk-based capital compliance under the "advanced approaches" unless it chooses to do so, even if the IHC meets the asset threshold for using the advanced approaches (i.e., $250 billion in total assets or $10 billion in on-balance sheet foreign exposures).

The new risk-based capital rule will require bank holding companies and IHCs to hold regulatory capital of various quality in various quantities as a percentage of risk-weighted assets (i.e., common equity Tier 1 capital of 4%; Tier 1 capital of 6%; and total capital of 8% of risk-weighted assets) and to establish an additional 2.5% capital conservation buffer of common equity Tier 1 capital, built from earnings or new capital issuances, to avoid restrictions on dividends, discretionary executive bonuses, and other "distributions."

As noted above, a foreign bank that is required to establish an IHC (as well as any foreign bank that otherwise has $50 billion or more in combined US assets) will separately need to certify to the Federal Reserve that it meets its home country regulator's Basel III (or later Basel) risk-based capital requirements (or, if such requirements don't exist, demonstrate to the Federal Reserve that it would meet the Basel standards).

What is the leverage restriction for an IHC?

Starting January 1, 2018,[5] an IHC will need to comply with the same leverage restriction as applies to bank holding companies (i.e., Tier 1 capital must equal at least 4% of total consolidated assets). The Federal Reserve delayed the application of this "generally applicable leverage ratio" because of concerns that foreign banks not currently subject to a leverage requirement for their US operations would need time to adapt to the new restriction. Foreign bank owned US bank holding companies already are required to comply with this leverage restriction. Therefore, any bank holding company subsidiary of an IHC (and the IHC itself if it was a bank holding company before being designated as an IHC) will need to comply with the existing leverage restriction until the separate (but identical) restriction applies to the IHC in 2018.

Also, if the IHC meets the asset criteria for an "advanced approaches" bank holding company (i.e., consolidated assets of $250 billion or more or on-balance sheet foreign exposures of $10 billion or more) it will need to comply with the "supplementary leverage ratio" restriction scheduled to apply to advanced approaches bank holding

5 The Federal Reserve can order earlier compliance if it determines a foreign bank has acted to evade the leverage test. This presumably would involve movements of assets to the IHC when it is not yet subject to the leverage test from a bank or bank holding company subject to the leverage test during that period.

companies starting January 1, 2018. On April 8, 2014, the federal banking agencies issued a "notice of proposed rulemaking" that would revise the computation of this ratio to reflect Basel III changes. Currently, the supplementary leverage ratio would require an advanced approaches bank holding company to hold Tier 1 capital equal to at least 3% of on-and off-balance sheet exposures, beginning in 2018.

Finally, as noted above, any foreign bank required to have an IHC (or that otherwise has $50 billion or more in US assets) would need to certify to the Federal Reserve that it complies with any Basel III (or later Basel) leverage restriction established by its home country regulator (or, if any such Basel III or later restriction has not been enacted by its home country, demonstrate to the Federal Reserve that it would comply).

What are the capital planning requirements for an IHC?

The same "comprehensive capital analysis and review" or CCAR requirements as apply to any bank holding company with $50 billion or more in assets under the Federal Reserve's Regulation Y.[6]

What are the capital stress test requirements for an IHC?

The same separate company run and Federal Reserve supervised semi-annual and annual stress test requirements established by the new Regulation YY for bank holding companies with $50 billion or more in assets. Regulation YY only requires IHCs to comply with these requirements beginning October 1, 2017. Before that time any existing US bank or bank holding company subsidiary of a foreign bank required to have an IHC must comply with any capital stress test requirements applicable to it under Regulation YY.[7]

Separately, the foreign bank (as a foreign banking organization with $50 billion or more in US assets) will need to provide to the Federal Reserve summary information about the results of its home country capital stress testing. If the foreign bank is a net borrower through its US operations (i.e. its US operations provide funding to its non-US operations), it must submit to the Federal Reserve more detailed information about the results of its home country stress testing.

If the foreign bank does not meet any of these requirements (because, for example, its home country regulator does not require stress testing at least annually or the tests do not provide the required information) the foreign bank must maintain US "eligible assets" equal to 108% of its US liabilities unless the Federal Reserve specifically notifies the foreign bank otherwise.

What are the risk committee and US chief risk officer requirements for an IHC?

An IHC will need to have a risk committee that is a committee of its board of directors (or equivalent body) with at least one independent member and one member with qualifying experience specified in the rule. Foreign banks with $50 billion or more in US assets are also required to have a US risk committee and a US chief risk officer. The IHC's risk committee can be the US risk committee for the foreign bank's US operations, but the committee must perform separate functions (i.e., the IHC risk committee monitors the IHC's risk and the foreign bank's US risk committee monitor the bank's combined US operations, including the bank's US branches and agencies). The foreign bank's US chief risk officer monitors the bank's combined US operations. There is no separate requirement for the IHC to have a chief risk officer.

What are the liquidity requirements for an IHC?

The new Regulation YY establishes liquidity requirements for IHCs as part of broader liquidity risk management and liquidity stress testing (including liquidity buffer) requirements for foreign banks with $50 billion or more in US assets. The US risk committee and US chief risk officer for such a foreign bank must perform detailed functions related to liquidity risk for the bank's combined US operations. Separately, such a foreign bank must stress test the liquidity requirements of its (1) IHC (if any), (2) US branches and agencies, and (3) combined US operations (including any IHC). The liquidity stress testing must cover overnight, 30 and 90 day, and one year periods, similar to the liquidity stress testing required for bank holding companies with $50 billion or more in assets under a separate part of Regulation YY.

Based on the results of the 30 day liquidity stress tests, an IHC will be required to maintain a 30 day liquid asset "buffer" and the foreign bank's branches and agencies will need to maintain such a buffer to cover the first 14 days of the 30 day stress period.

These liquidity management procedures are detailed and will require foreign banks to maintain in the US liquid assets to cover stressed potential liquidity needs.

6 If the IHC, as a bank holding company, or its existing bank holding company subsidiary is relying on SR01-01, it will only need to meet Regulation Y capital planning requirements after July 21, 2015, as provided in Regulation Y.

7 If the IHC, as a bank holding company, or its existing bank holding company subsidiary is relying on SR01-01, it will only need to meet the capital stress testing requirements starting with the stress test cycle that begins on October 1, 2015.

If an IHC owns a US bank holding company, will that bank holding company continue to be regulated as a bank holding company?

Yes, subject to two special rules. First, if the subsidiary bank holding company has $50 billion or more in assets, it will not need to comply with each enhanced prudential standard that would otherwise apply to it under the new Regulation YY (in each case after such standard begins to apply to the IHC under the transition rules described above). Second, if the subsidiary bank holding company would otherwise be required to apply the "advanced approaches" for computing its risk-based capital requirement (because it has $250 billion or more in assets or $10 billion or more in on-balance sheet foreign exposures), it may request Federal Reserve approval not to apply the advanced approaches for such computation.

What happened to the single counterparty limits and early remediation requirements included in the original proposal for foreign bank enhanced prudential standards?

The Federal Reserve indicated in the preamble to the release of the new Regulation YY that such standards would be enacted in the future. Large foreign banks should expect their US operations to be subject to additional "enhanced prudential standards" as the Federal Reserve continues to establish such standards.

For More Information

For more information, please contact Tim Mohan (312.845.2966) or your primary Chapman attorney, or visit us online at chapman.com.

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