



## INSTITUTE OF INTERNATIONAL BANKERS

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### **REGULATION AND SUPERVISION OF U.S. BRANCHES AND AGENCIES OF FOREIGN BANKS BY U.S. BANKING AUTHORITIES AND THE APPLICATION OF U.S. REGULATORY CAPITAL REQUIREMENTS TO SUCH BANKS**

Banking organizations headquartered outside the United States (“foreign banks”) conduct a substantial portion of their banking activities in the United States through branch offices of the bank<sup>1</sup> pursuant to licenses granted either by New York or one of the other states or, if the foreign bank so chooses, by the Office of the Comptroller of the Currency (“OCC”).<sup>2</sup> In the aggregate, U.S. branches of foreign banks hold over \$2 trillion of assets, accounting for approximately 15% of total banking assets in the United States.<sup>3</sup>

The discussion below summarizes key aspects of how U.S. branches of foreign banks are regulated and supervised in the United States as separately licensed offices of the banks, focusing in particular on the key role the Federal Reserve plays in this process. This brief review is followed by a discussion of how the Federal Reserve, in applying U.S. capital requirements to foreign banks that maintain U.S. branches, gives appropriate deference to home country standards while providing sufficient flexibility to ensure compliance with U.S. regulatory capital requirements in a manner that is consistent with national treatment.

#### **The U.S. Bank Regulatory Approach to U.S. Branches as Separately Licensed Offices of Foreign Banks**

U.S. branches are not separately capitalized entities, but their operations are separately examined by U.S. banking authorities and assigned supervisory “ROCA” ratings.<sup>4</sup> In addition,

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<sup>1</sup> Strictly speaking, foreign banks may establish “branches” and “agencies” in the United States, the principal difference between the two types of offices being that a “branch” is authorized to accept deposits from U.S. persons but an “agency” is not. Foreign banks conduct principally wholesale banking activities through their branches and agencies. The deposits of branches are not insured by the FDIC (with the exception of 8 foreign banks that are permitted, pursuant to “grandfather” authority granted under federal banking law, to maintain FDIC-insured branches subject to the same limits on deposit insurance coverage applicable to all other FDIC-insured depository institutions (according to the Federal Reserve data referenced in note 2 below, these grandfathered insured branches have less than \$30 billion total assets in the aggregate)).

<sup>2</sup> According to the information most recently published by the Federal Reserve (reported as of September 30, 2010), there are 199 state-licensed foreign bank branches and agencies, 106 of which are licensed by the New York State Banking Department. According to information most recently published by the OCC (reported as of February 28, 2011), there are 51 federal branches and agencies, 35 of which are located in New York.

<sup>3</sup> According to the Federal Reserve data, state-licensed branches and agencies in the aggregate have total assets of approximately \$1.89 trillion (of which \$1.81 trillion is held by branches), and federal branches and agencies have total assets of approximately \$140 billion (almost all of which is held by branches).

<sup>4</sup> The “ROCA” rating system consists of separate assessments of a branch’s risk management, operations, compliance and asset quality, as well as an overall composite assessment of the branch.



## INSTITUTE OF INTERNATIONAL BANKERS

U.S. branches maintain separate books and records in accordance with U.S. regulatory requirements and file with U.S. regulators quarterly reports of their assets and liabilities (“Call Reports”).

In general, U.S. branches are limited to the same types of activities as are permissible for their U.S. domestic bank counterparts. Inasmuch as foreign banks’ U.S. branches do not have their own capital, restrictions on such activities that are based on capital (for example, lending limits) are applied to branches by reference to the foreign bank’s capital, as calculated under its home country standards.

U.S. regulators have the authority to take over and oversee the liquidation of the operations of U.S. branches. These proceedings are undertaken pursuant to so-called “ring-fencing” provisions whereby the assets of the branch are distributed first to satisfy the claims of creditors that have done business with the branch, with the balance, if any, then distributed to the appropriate authority in the foreign bank’s home country.

### **Federal Reserve Regulation and Oversight of U.S. Branches of Foreign Banks**

The Federal Reserve plays an especially important role in the regulation and oversight of foreign banks and their U.S. branches. Foreign banks seeking to enter the U.S. market through a branch are required to obtain the Federal Reserve’s prior approval (as well as approval from the appropriate federal or state licensing authority). In reviewing an application to establish a branch, the Federal Reserve takes into account, among other considerations, the financial and managerial resources of the foreign bank, and the Federal Reserve may impose such conditions on its approval as it deems necessary.<sup>5</sup>

A key consideration in acting on an application to establish a U.S. branch is whether the foreign bank is subject to “comprehensive supervision or regulation on a consolidated basis by the appropriate authorities in its home country.”<sup>6</sup> In addition, in the case of an application by a foreign bank that “presents a risk to the stability of the United States financial system,” the Federal Reserve may consider “whether the home country of the foreign bank has adopted, or is making demonstrable progress toward adopting, an appropriate system of financial regulation for the financial system of such home country to mitigate such risk.”<sup>7</sup>

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<sup>5</sup> See generally, 12 U.S.C. 3105(d).

<sup>6</sup> See 12 U.S.C. 3105(d)(2)(A).

<sup>7</sup> This factor was added by Section 173(a) of the Dodd-Frank Act, *codified at* 12 U.S.C. 3105(d)(3)(E).



## INSTITUTE OF INTERNATIONAL BANKERS

The Federal Reserve considers a variety of factors in determining whether a foreign bank satisfies the “comprehensive consolidated supervision” (“CCS”) requirement.<sup>8</sup> In the event the Federal Reserve is unable to find that a foreign bank meets the CCS requirement, the Federal Reserve nevertheless may permit the bank to establish a U.S. branch if it determines that “the appropriate authorities in the home country of the foreign bank are actively working to establish arrangements for the consolidated supervision of such bank.”<sup>9</sup>

The Federal Reserve has the authority to examine each foreign bank’s U.S. branch. In exercising this authority the Federal Reserve seeks to coordinate with the appropriate state or federal authority to the extent possible to reduce burden and avoid unnecessary duplication of examinations, and it may request that its examination be conducted simultaneously with that of the other appropriate examining authority.<sup>10</sup>

The Federal Reserve also has the authority to order a foreign bank to terminate the activities of its state-licensed branch upon its determination, after notice and an opportunity for a hearing and notice to the appropriate state bank supervisor, that there is reasonable cause to believe that the foreign bank, or any of its affiliates, has committed a violation of law or engaged in an unsafe or unsound banking practice in the United States.<sup>11</sup>

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<sup>8</sup> The relevant provisions of the Federal Reserve’s Regulation K (12 C.F.R. 211.24(c)(1)(ii)) provides that in making a CCS determination, the Federal Reserve shall assess, among other factors, the extent to which the foreign bank’s home country supervisor:

- (A) Ensures that the foreign bank has adequate procedures for monitoring and controlling its activities worldwide;
- (B) Obtains information on the condition of the foreign bank and its subsidiaries and offices outside the home country through regular reports of examination, audit reports, or otherwise;
- (C) Obtains information on the dealings and relationship between the foreign bank and its affiliates, both foreign and domestic;
- (D) Receives from the foreign bank financial reports that are consolidated on a worldwide basis, or comparable information that permits analysis of the foreign bank's financial condition on a worldwide, consolidated basis;
- (E) Evaluates prudential standards, such as capital adequacy and risk asset exposure, on a worldwide basis.

<sup>9</sup> See 12 U.S.C. 3105(d)(6)(A)(i).

<sup>10</sup> See generally, 12 U.S.C. 3105(c)(1).

<sup>11</sup> See 12 U.S.C. 3105(e)(1)(B). In addition, in the case of a foreign bank that “presents a risk to the stability of the United States financial system,” the Federal Reserve may order the bank to terminate the activities of its state-licensed branch if the Federal Reserve finds that “the home country of the foreign bank has not adopted, or made demonstrable progress toward adopting, an appropriate system of financial regulation for the financial system of such home country to mitigate such risk.” (This latter authority was added by Section 173(b) of the Dodd-Frank Act, *codified at* 12 U.S.C. 3105(e)(1)(C).) In the case of a federal branch, the Federal Reserve is authorized to recommend to the OCC that it terminate the license of the federal branch on the basis of the same types of concerns that can trigger termination of a state-licensed branch’s activities.



## INSTITUTE OF INTERNATIONAL BANKERS

### **Federal Reserve Regulation and Oversight of Foreign Banks' U.S. Operations – Application of Capital Requirements to Foreign Banks That Maintain U.S. Branches**

The Federal Reserve exercises broad regulatory and oversight authority over not only the operations of foreign banks' U.S. branches, but also their overall U.S. operations, both banking and nonbanking.<sup>12</sup> Consistent with the international framework for the supervision of cross-border banking activities, this approach reflects the understanding that foreign banks are subject to primary supervision by their home country authorities, with the Federal Reserve, as a host country supervisor, exercising appropriate oversight of their U.S. operations.

A foreign bank that maintains a U.S. branch is treated as a bank holding company and as such is subject to the requirements of the Bank Holding Company Act ("BHC Act"), including its activity restrictions, "in the same manner and to the same extent that bank holding companies are subject to such provisions."<sup>13</sup> Dating to the International Banking Act of 1978, the policy of national treatment has been the guiding principle for implementing these requirements. This principle calls for "parity of treatment between [foreign and U.S. banks] in like circumstances,"<sup>14</sup> but it is recognized that parity of treatment does not mean identical treatment. Instead, national treatment is accomplished by applying the requirements applicable to U.S. banking organizations in a manner that appropriately takes into account the differences resulting from foreign banks' operating in the United States through U.S. branches.

The practical consequences of implementing the national treatment principle are well illustrated by the approach taken by the Federal Reserve when applying U.S. regulatory capital requirements to foreign banks that maintain U.S. branches. This approach recognizes that (i) a U.S. branch does not maintain its own capital and (ii) the foreign bank itself is subject to capital requirements prescribed by its home country authority. In the case of a foreign bank whose home country applies capital standards consistent with those adopted by the Basel Committee on Banking Supervision (the "Basel Committee"),<sup>15</sup> the bank's capital as calculated under those standards is accepted as the starting point for the U.S. regulatory assessment.<sup>16</sup> In the case of banks that are subject to Basel II's requirements, this assessment takes into account any

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<sup>12</sup> See, e.g., "Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations," Federal Reserve Supervision and Regulation Letter 08-9 (October 16, 2008).

<sup>13</sup> See 12 U.S.C. 3106(a).

<sup>14</sup> S. Rep. No. 1073, 95<sup>th</sup> Cong. 2d Sess. 2, reprinted in 1978 U.S. Code Cong. and Admin. News 1421, 1422.

<sup>15</sup> In its 2010 survey of countries around the world to measure the progress that has been made with respect to implementation of the revised international capital accords adopted by the Basel Committee in 2006 ("Basel II") the Financial Stability Institute found that 112 of the 133 countries responding to the survey have implemented or are currently planning to implement Basel II. See "2010 FSI Survey on the Implementation of the New Capital Adequacy Framework," *Occasional Paper No. 9* (August 2010).

<sup>16</sup> See, e.g., 12 C.F.R. 225.2(r)(3)(i)(A).



## INSTITUTE OF INTERNATIONAL BANKERS

transitional provisions implemented by the home country. If a foreign bank's home country has not adopted capital standards consistent with the Basel Committee's standards, then the foreign bank, rather than being able simply to utilize the ratios calculated under the home country standard as the basis for the U.S. regulatory assessment, is subject to a finding by the Federal Reserve that its capital is equivalent to the capital that would be required of a U.S. banking organization.<sup>17</sup> That finding, however, is based on the assessment of the home country standards and does not call for the foreign bank to calculate its capital using U.S. standards.

Thus, the analysis of a foreign bank's capital properly takes as its starting point the standards of the bank's home country and then undertakes to assess how those standards compare to the standards applicable to U.S. banking organizations under U.S. requirements. This approach neither gives complete deference to home country capital requirements nor requires a foreign bank strictly to abide by each of the U.S. requirements or to calculate its capital pursuant to U.S. rules.

The purpose of the analysis is not to force the foreign bank to conform its capital to U.S. requirements, but instead to determine whether the foreign bank's capital as calculated under its home country requirements is sufficiently equivalent or comparable to that applicable to a similarly situated U.S. banking organization. Consistent with national treatment, this approach recognizes that for U.S. regulatory purposes there is no need to ascertain whether home country requirements are identical to those of the United States. This approach provides the Federal Reserve flexibility in making determinations regarding foreign banks' capital without imposing on foreign banks any requirement to apply U.S. standards in calculating their capital ratios.

For example, one of the requirements applicable to a U.S. bank holding company that elects to operate as a financial holding company ("FHC"), and thereby engage in the expanded securities underwriting and dealing, merchant banking, insurance and other nonbank financial activities that are permissible for FHCs under the BHC Act (as amended by the Gramm-Leach-Bliley Act), is that each of its insured depository institution subsidiaries be maintained in a "well capitalized" condition.<sup>18</sup> To be well capitalized, each such subsidiary must have risk-based tier 1 and total risk-based capital ratios equal to at least 6% and 10%, respectively. In the case of determining whether a foreign bank that maintains a U.S. branch is well capitalized for FHC purposes, Section 4(1)(3) of the BHC Act requires the Federal Reserve to apply "comparable" standards, "giving due regard to the principle of national treatment and equality of competitive opportunity."<sup>19</sup>

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<sup>17</sup> See, e.g., 12 C.F.R. 225.2(r)(3)(i)(B).

<sup>18</sup> See 12 U.S.C. 1843(l)(1)(A). Section 606(a) of the Dodd-Frank Act added the new requirement that the bank holding company itself also satisfy the FHC "well capitalized" requirement. As discussed in the text below, in the case of a foreign bank that is treated as a bank holding company because it maintains a U.S. branch the FHC well capitalized requirement already applies to the foreign bank itself.

<sup>19</sup> See 12 U.S.C. 1843(l)(3).



## INSTITUTE OF INTERNATIONAL BANKERS

In implementing the provisions of Section 4(1)(3) with respect to a foreign bank whose home country has adopted risk-based capital standards consistent with those prescribed by the Basel Committee, the Federal Reserve requires the foreign bank to meet the 6%/10% minimum risk-based capital requirement applicable to domestic FHCs, but this determination is based on the bank's risk-based capital ratios as calculated under its home country standards.<sup>20</sup> In addition, the foreign bank's capital must be comparable to the capital required for a U.S. bank owned by an FHC.<sup>21</sup> If the foreign bank's home country has not adopted capital standards consistent with those of the Basel Committee, then the bank must obtain a determination from the Federal Reserve that its capital (as calculated under home country standards) is otherwise comparable to the capital that would be required of a U.S. bank owned by an FHC.<sup>22</sup> For purposes of assessing comparability, the Federal Reserve may consider additional factors, including the composition of the foreign bank's capital, the ratio of the foreign bank's tier 1 capital to total assets ("leverage ratio"), home country accounting standards, the foreign bank's long-term debt ratings, its reliance on government support to meet capital requirements and whether it is subject to comprehensive supervision or regulation on a consolidated basis.<sup>23</sup>

Thus, consistent with national treatment, the approach taken by the Federal Reserve with respect to assessing the capital of foreign bank FHCs that maintain U.S. branches gives appropriate deference to home country standards while providing sufficient flexibility to ensure compliance with the U.S. "well capitalized" regulatory requirement.

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<sup>20</sup> See 12 C.F.R. 225.90(b)(1)(i) and (ii).

<sup>21</sup> See 12 C.F.R. 225.90(b)(1)(iii).

<sup>22</sup> See 12 C.F.R. 225.90(b)(2)

<sup>23</sup> See 12 C.F.R. 225.92(e).