



BANKING LEGISLATION & POLICY

Fourth Quarter 2012

Volume 31, Number 4

HIGHLIGHTS

This issue contains detailed descriptions of:

- [The Federal Reserve System's Plan for Foreign Bank Supervision](#), including:
 - [Intermediate Holding Company Requirement](#)
 - [Capital Requirements](#)
 - [Liquidity Requirements](#)
 - [Intermediate Holding Company Requirement](#)
 - [Single Counterparty Credit Limits](#)
 - [Risk Management Requirements](#)
 - [Stress Testing](#)
 - [Debt-to-Equity Limitations](#)
 - [Early Remediation](#)
- [Bilateral Resolution Plans for Large, Complex Financial Institutions](#), including:
 - [Top-Down Resolution Strategy](#)
 - [Containment](#)
 - [Recapitalization](#)
 - [Organizational Restructuring](#)
 - [Effect of Resolution on Subsidiaries](#)
 - [Liquidity Support](#)
 - [Resolution Strategy Alternatives](#)

In addition, it summarizes [other notable legislative, regulatory, and judicial developments that occurred during the fourth quarter of 2012](#).

The Federal Reserve System's Plan for Foreign Bank Supervision

On December 14, 2012, the Board of Governors of the Federal Reserve System unanimously approved a [proposal](#) that would strengthen oversight of the U.S. operations of foreign banks. This plan, which

implements Sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, would require foreign banking organizations to create an intermediate holding company over

their U.S. subsidiaries.¹ This new proposal seeks to level the playing field between U.S. bank holding companies and their foreign counterparts in response to increased [regulation](#) proposed by the Board of Governors over U.S. bank holding companies in December 2011. In addition, this plan would require foreign banking organizations to maintain stronger capital and liquidity positions for their U.S. operations to better withstand future financial hardships.

Around 107 foreign banking organizations could be affected by this proposal. Although the plan generally applies to foreign banking organizations with a U.S. banking presence and total global consolidated assets of \$50 billion or more, stricter rules are proposed for foreign banking organizations with combined U.S. assets of \$50 billion or more. Also, Fed officials predict that roughly 25 foreign banks would probably need to restructure their U.S. operations should the proposal be adopted in its current form.

The Federal Reserve is adopting a substantial phase-in period for foreign banking organizations to adapt to these new rules. All foreign banking organizations with global consolidated assets of \$50 billion or more on July 1, 2014, would be required to satisfy the rules stated in this proposal by July 1, 2015. The Board of Governors is accepting comments from the public on this proposal through March 31, 2013.

Intermediate Holding Company Requirement

A foreign banking organization with \$50 billion or more in global consolidated assets and with \$10 billion or more in total U.S. assets (excluding its U.S. branch and agency assets) would be required to organize its U.S. subsidiaries under a single U.S. intermediate holding company. A U.S. branch or

U.S. agency of one of the affected foreign banking organizations would be allowed to operate independently of the single U.S. intermediate holding company. Once a U.S. intermediate holding company is created, this intermediate holding company would be subject to the proposal's new capital and liquidity requirements.

While the Dodd-Frank Act did not specifically require the creation of intermediate holding companies for foreign banking organizations, the Board of Governors decided on this structural framework to facilitate the supervision of each foreign banking organization's U.S. operations. By imposing capital and liquidity requirements on the consolidated foreign operations within a holding company structure, the proposed regulation treats them much like U.S. bank holding companies. This approach clarifies the regulatory role of the Board of Governors over these operations, streamlines regulation, and, to some extent, insulates these organizations from stresses on their foreign affiliates not located in the U.S.

Capital Requirements

Intermediate holding companies of foreign banking organizations would be subject to the same risk-based capital and leverage standards that govern U.S. bank holding companies. Therefore, those foreign banking organizations affected would have to bolster the consolidated capital positions of their U.S. intermediate holding companies to match their U.S. competitors.

Intermediate holding companies with total consolidated assets of \$50 billion or more would need to follow the Board of Governors' annual capital plan rule and its associated capital planning requirements. Meanwhile, their foreign banking organizations would be required to demonstrate to the Board of Governors' satisfaction that they have

¹For more information on the Dodd-Frank Wall Street Reform and Consumer Protection Act, see [Banking Legislation and Policy, Volume 29, Number 2](#).

met home-country capital standards consistent with the Basel capital framework.²

Liquidity Requirements

To ensure parallel treatment between domestic and foreign banking organizations, foreign banking organizations with combined U.S. assets of \$50 billion or more would have to follow enhanced liquidity requirements, similar to the rules put forth in the Board of Governors' December 2011 proposal for large U.S. banking organizations. These foreign banking organizations would have to maintain a 30-day buffer of highly liquid assets in the United States, and, for the first 14 days of the buffer, these assets must be held by the foreign banking organization's U.S. branch and agency network. Also, the foreign banking organizations would have to establish a risk committee that would conduct monthly liquidity stress tests and review a foreign banking organization's liquidity risk tolerance. Foreign banking organizations with combined U.S. assets of less than \$50 billion would face less stringent standards.

Single Counterparty Credit Limits

Just like for U.S. bank holding companies, the proposal would impose a 25 percent net credit exposure limit between an intermediate holding company or the combined U.S. operations of a foreign banking organization and a single unaffiliated counterparty. An intermediate holding company would not be allowed to have an aggregate net credit exposure to any single unaffiliated counterparty in excess of 25 percent of the intermediate holding company's capital stock and surplus. In addition, the combined U.S. operations of a foreign banking organization could not have an aggregate net credit exposure to any single unaffiliated counterparty greater than 25 percent of the consolidated regulatory capital of the foreign banking organization.

Furthermore, the proposal would impose harsher net credit exposure limits between a U.S. intermediate holding company or a foreign banking organization with total consolidated assets greater than or equal to \$500 billion and financial counterparties of similar size (i.e., a major counterparty). This limit would be consistent with the stricter limit established for major U.S. bank holding companies and U.S. nonbank financial companies supervised by the Board of Governors.

Risk Management Requirements

Foreign banking organizations with \$10 billion or more in global consolidated assets need to establish a U.S. risk committee that has at least one member with appropriate risk expertise. However, foreign banking organizations with \$50 billion or more in U.S. assets would be subject to additional constraints. Examples of such constraints would be including at least one member independent of the foreign banking organization on the risk committee and appointing a U.S. chief risk officer (employed by a U.S. subsidiary or office of the foreign banking organization) responsible for creating and maintaining the foreign banking organization's risk management framework.

Stress Testing

Foreign banking organizations with \$10 billion or more in total consolidated assets have to prove that they are subject to home-country stress testing that is generally consistent with the Board of Governors' requirements. Intermediate holding companies with total consolidated assets between \$10 billion and \$50 billion need to perform company-run stress tests just like a U.S. bank holding company, but intermediate holding companies with total consolidated assets of \$50 billion or more need to undergo stress testing conducted by the Board of Governors. Depending on the rigors of home-country stress testing and the size of their U.S. operations, U.S. branches and

² For more information on the Basel capital framework, see [Banking Legislation and Policy, Volume 29, Number 3](#).

agencies of foreign banking organizations would be subject to varying degrees of stress testing conducted by the Board of Governors.

Should a foreign banking organization not meet the stress test requirements put forth by the Board of Governors, the Board would require a foreign banking organization to meet an asset maintenance requirement. An asset maintenance requirement is roughly analogous to a capital requirement. The main difference is that the requirements limit the asset exposure of the U.S. foreign banking operations to its non-U.S. affiliates, for example, by restricting the share of loans that a foreign banking organization can make to its non-U.S. affiliates. These asset maintenance requirements range from 105 percent of third-party liabilities for foreign banking organizations with total consolidated assets between \$10 billion and \$50 billion to 108 percent of third-party liabilities for foreign banking organizations with total consolidated assets greater than or equal to \$50 billion.

Debt-to-Equity Limitations

Foreign banking organizations with total consolidated assets of \$50 billion or more must maintain a debt-to-equity ratio of 15 to 1. This debt-to-equity limitation would be placed on a foreign banking organization's U.S. intermediate holding company and any U.S. subsidiary not organized under a U.S. intermediate holding company. In addition, a 108 percent asset maintenance level would be levied on a foreign banking organization's U.S. branch and agency network.

Early Remediation

To prevent financial distress, foreign banking organizations with total consolidated assets of \$50 billion or more would be subject to early remediation triggers put in place by the Board of Governors. Triggers would be based on foreign banking organization fundamentals such as capital ratios, stress test results, market indicators, risk

management weaknesses, and liquidity shortcomings. Violation of a trigger by a foreign banking organization would result in regulatory actions deemed appropriate by the Board of Governors.

Bilateral Resolution Plans for Large, Complex Financial Institutions

On December 10, 2012, the Federal Deposit Insurance Corporation (FDIC) and the Bank of England (BoE) released a [joint proposal](#) that outlines resolution plans for globally active, systemically important financial institutions (G-SIFIs).³ The proposal discusses how the FDIC and the BoE (collectively, the "resolution authorities") would resolve failed or failing G-SIFIs within their jurisdiction. In the U.S., Title II of the Dodd-Frank Act expanded the FDIC's receivership authority to include bank holding companies and nonbank financial companies.⁴ However, in the UK, the power of the BoE to act as a resolution authority is still pending on the approval of the Financial Services Bill and the European Union Recovery and Resolution Directive (RRD). The following sections discuss the actions the FDIC and the BoE would take under the proposed resolution plans.

Top-Down Resolution Strategy

The proposal would implement a top-down resolution strategy in which a single national resolution authority, the FDIC or the BoE (depending on where the institution is headquartered), focuses resolution powers on the

³ The Financial Stability Board (FSB) publishes an updated list of G-SIFIs annually. As of November 2012, there are 28 G-SIFIs. For the FSB list, see http://www.financialstabilityboard.org/publications/r_121031a.c.pdf.

⁴ Title II of the Dodd-Frank Act directs the secretary of the Treasury (subject to judicial review) to appoint the FDIC as a receiver for a distressed financial company if the secretary determines that the failure of the company would create systemic financial instability. For more information on the FDIC's receivership authority, see [Banking Legislation and Policy, Volume 30, Number 3](#).

top-tier holding company of a financial group. The proposal argues that the top-down approach makes it possible for a single national regulator to take command of resolution, thus decreasing the need for complicated cross-border coordination between different authorities and legal systems. Under the top-down resolution approach, shareholders and creditors at the top tier recapitalize and absorb the losses of the various entities within the holding company. The proposal assumes that once the top-tier holding company is recapitalized, the private sector will regain confidence and provide additional capital, which can then be down-streamed toward troubled subsidiaries.

Containment

To begin the resolution process, the FDIC will first transfer assets from receivership to a temporary new entity known as a bridge financial holding company, while leaving most liabilities (shareholder claims and subordinated and unsecured debt) behind in receivership, thus creating a new well-capitalized financial holding company.⁵ In the UK, the BoE may establish a new bridge financial company or a temporary trustee to hold the group's equity and debt securities until the group is recapitalized.

Recapitalization

In order to determine the capital needed to restore the group to solvency, the resolution authority will evaluate the losses on assets and liabilities held in receivership. The resolution authority will then recapitalize and restructure the liabilities of the holding company by imposing a bail-in, in which the losses are assigned to equity holders and subordinated and unsecured creditors. The proposal states that the bail-in will eliminate the

need for a large bailout using government loans or taxpayer money.

After the bail-in, equity holders will likely be wiped out and their claims will lose all or most of their value. In addition, debt held by subordinated and unsecured creditors will be canceled or written down to reduce outstanding liabilities and to make up for losses that equity holders cannot cover. After the write-down, the resolution authority will then conduct a debt-to-equity exchange in which remaining unsecured and subordinated debt will be converted to equity in either the new bridge institution (U.S. and UK) or the original institution after the temporary trustee is dissolved (UK). As a result, ownership of the restructured institution will be transferred from existing equity holders to creditors.

Organizational Restructuring

In addition to capital restructuring, the G-SIFI may also be operationally restructured by the resolution authority. The extent of operational restructuring depends on the cause of the failure. If the cause was localized to specific subsidiaries or business lines, these activities would be reorganized, sold, or liquidated, and responsible senior management would be replaced. If the cause of failure was systemic and spread across multiple business lines, then the activities and governance of the G-SIFI may be completely overhauled and the G-SIFI may be split into smaller, nonsystemic firms. In the U.S., where SIFIs are required to submit annual plans for a rapid and orderly resolution under the Bankruptcy Code, the FDIC may use these plans to inform SIFIs' restructuring decisions.⁶

⁵ The bridge financial holding company is only temporarily under FDIC control. Title II of the Dodd-Frank Act requires the FDIC to sell the company to a private acquirer within five years. Thus, a bridge financial company acts as a "bridge" to a private acquirer.

⁶ Title I of the Dodd-Frank Act requires SIFIs to submit their resolution plans to the FDIC, the Federal Reserve Board, and the Financial Stability Oversight Council for review. For more information on individual SIFI resolution plan requirements, see [Banking Legislation and Policy, Volume 30, Number 3](#).

Effect of Resolution on Subsidiaries

The proposal supports the top-down resolution approach by arguing that it allows a distressed G-SIFI to be recapitalized with the least disruption to its viable subsidiaries and minimizes financial instability. A G-SIFI may have hundreds or thousands of domestic and foreign subsidiaries. Resolving a G-SIFI at the subsidiary level would require numerous insolvency proceedings, which would disrupt critical business operations provided by viable subsidiaries. In contrast, the proposal states that the top-down approach would mostly preserve the balance sheet of viable subsidiaries and allow them to continue operating and providing critical services, thus limiting contagion and reducing risks to financial stability.

Liquidity Support

The proposal also includes alternative sources of short-term capital to finance subsidiaries if they are unable to obtain adequate capital from their top-tier holding company or private funding. In the U.S., the FDIC may use the Orderly Liquidation Fund, which is maintained by the U.S. Treasury, to lend short-term capital. Similarly, authorities in the UK may also provide short-term capital to subsidiaries on a fully collateralized haircut basis. However, the proposal does not discuss where the UK authority's short-term capital funds will come

from. The proposal also envisages prior arrangements by regulators with prominent counterparties, for example, clearinghouses, to ensure minimal disruption of activities for functioning subsidiaries of organizations in resolution.

Resolution Strategy Alternatives

The proposal strongly favors and defends the top-down resolution approach. However, the proposal also acknowledges that, depending on the G-SIFI's capital structure and circumstances, the top-down approach may not work unless the top-tier holding company has enough capital in equity and credit to absorb the losses of subsidiaries. However, in the UK, subsidiaries—rather than the top-tier holding company—hold a significant portion of the group's unsecured debt. In situations in which there is not enough equity or debt at the top tier to recapitalize the group, resolution authorities may apply a multiple-point-of-entry approach. Under this approach, resolution powers and bail-ins are applied at both the holding company and the subsidiary level. Since the resolution authority of the top-tier holding company has very limited jurisdiction over foreign subsidiaries, the multiple-point-of-entry approach would require close coordination with foreign regulators.

Federal Regulation

Federal Reserve System

U.S. District Court Rules in Favor of New York Fed's 2008 AIG Bailout

On November 19, 2012, a United States District Court judge in New York [dismissed](#) a \$25 billion lawsuit filed by Starr International Company, Inc. against the Federal Reserve Bank of New York. Led by its chairman Maurice Greenberg, the former chief executive officer of AIG from 1968 to 2005, Starr International sued the New York Fed as a result of the 2008 bailout in which the U.S. government received about 90 percent of AIG's outstanding common stock shares. Starr International, which, with a 12 percent stake, was the largest shareholder of AIG stock before the 2008 bailout, claimed that the New York Fed violated the Fifth Amendment by seizing AIG common stock without due process of law or just compensation under Delaware law (since AIG is a Delaware corporation). Consequently, in an amended complaint dated January 31, 2012, Starr International sought damages of at least \$25 billion.

U.S. District Judge Paul A. Engelmayer dismissed this lawsuit, believing that the New York Fed appropriately exercised its authority to preserve the banking system and minimize losses to the public. Not only did Starr International fail to prove that the New York Fed unjustly took AIG shareholder property under Delaware law but also Judge Engelmayer ruled that Delaware law was applicable in this situation. The New York Fed is in charge of preserving the stability of the U.S. banking system and economy, and, in light of the 2008 financial crisis, the New York Fed could preempt Delaware law and execute its bailout of AIG.

As of now, Starr International is considering whether to appeal Judge Engelmayer's decision to the Second Circuit Court of Appeals in New York. Additionally, Starr International is still suing the New York Fed in the United States Court of Federal Claims in Washington, D.C. Although different legal theories are being used to argue this case, Starr International is seeking the same amount — \$25 billion in damages. Despite the U.S. government's attempts to dismiss this case, Judge Wheeler allowed the lawsuit to proceed on July 2, 2012.

Update: On January 9, 2013, the AIG board of directors decided not to join or take over the prosecution of this federal lawsuit. In a unanimous decision, the board rejected any participation in the suit and refused to let Starr International pursue any claims on AIG's behalf.

Federal Reserve and Foreign Central Banks Extend Swap Line Agreements into 2014

On December 13, 2012, the Federal Reserve decided to extend [existing swap line agreements](#) with the Bank of Canada, the Bank of England, the European Central Bank, and the Swiss National Bank through February 1, 2014. The swap line agreements, in which the Federal Reserve provided dollars to these foreign central banks in exchange for their foreign currencies, were scheduled to expire on February 1, 2013. These swap line agreements were revived in the spring of 2010 from the swap line agreements that the Federal Reserve had made from December 2007 to February 2010 with 14 foreign central banks during the recent financial crisis. The Bank of Japan, another foreign central bank that has swap line agreements with the Federal Reserve, will consider extending these swap line agreements at its next monetary policy meeting.

The Treasury Department

Treasury to Sell Last of U.S. Government's AIG Common Stock Shares

On December 11, 2012, the Treasury Department agreed to a \$7.6 billion [deal](#) that would sell the last of the U.S. government's shares of common stock in AIG. Although the Federal Reserve System already ended its association with AIG when Maiden Lane III sold the last of its AIG portfolio in August 2012, the Treasury has been slowly selling off its common stock shares since May 2011 over the course of six installments.

Originally, the Treasury acquired its AIG common stock shares under the Troubled Asset Relief Program and owned 92 percent of AIG, its highest stake in the company. The final installment, equal to about 16 percent of AIG, placed nearly 234.2 million shares of common stock at \$32.50 apiece. After the transaction is completed, only a small government position will remain in AIG, as the Treasury still has warrants to purchase another 2.7 million shares of AIG common stock that were issued in accordance with the terms of AIG's 2008 bailout.

Treasury Determination on the Regulation of Foreign Exchange Swaps and Forwards

On November 16, 2012, the secretary of the Treasury released a [determination](#) that foreign exchange swaps and foreign exchange forwards should not be regulated as swaps under the Commodity Exchange Act in most cases, including registration, mandatory clearing, and margin. However, foreign exchange derivatives were not covered by the exemption and would be regulated as swaps.

Foreign exchange swaps and forwards will not be subject to “real-time” trade reporting requirements, but they will be subject to swap data repository trade reporting requirements applicable to swaps and historical swaps. In addition, foreign exchange swaps and forwards will be subject to the Commodity Futures Trading Commission’s enhanced authority. Thus, foreign exchange swaps and forwards will face restrictions such as fair dealing and disclosure and suitability obligations.

Federal Legislation

Proposed Legislation

U.S. Senate Fails to Extend TAG

The U.S. Senate failed to advance [S.3637](#) on December 13, 2012. As a result, the transaction account guarantee (TAG) program was allowed to expire at the end of 2012. Sponsored by Senate Majority Leader Harry Reid (D-Nevada), S.3637 was a bill that would have extended the TAG program until the end of 2014. This program provided a temporary full guarantee by the Federal Deposit Insurance Corporation (FDIC) for funds held at FDIC-insured depository institutions in noninterest-bearing transaction accounts above the existing deposit insurance limit.

Enacted Legislation

ATMs No Longer Need Physical Fee Disclosure Requirement

On December 20, 2012, President Obama signed [H.R. 4367](#) into law. Sponsored by Representative Luetkemeyer (R-Missouri), this bill passed the House of Representatives on July 9, 2012, and the Senate on December 11, 2012, with no opposition. This legislation would prevent frivolous lawsuits against banks by amending the Electronic Fund Transfer Act. Now, banks no longer need to put a physical reminder (e.g., a sign) of potential transaction fees on ATMs.

Change in How the CFPB Handles Confidential Information

On December 20, 2012, President Obama signed [H.R. 4014](#) into law. Sponsored by Representative Huizenga (R-Michigan), this bill passed the House of Representatives on March 26, 2012, and the Senate on December 11, 2012, with no opposition. This legislation clears up an oversight in the Dodd-Frank Act that did not give the Consumer Financial Protection Bureau the same explicit authority as other banking regulators in guarding confidential information of banks from scrutiny by outside parties and the public.