Fed Bank Plan Would Trap Capital, Hurt Risk Management

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In December 2012, the Federal Reserve published a proposal describing how enhanced standards mandated by the Dodd-Frank Act would be applied to Foreign Banking Organizations. It would be the most significant regulatory development for FBOs since the passage of the International Banking Act of 1978, which introduced the principle of national treatment for FBOs.

In terms of global financial risk management, the proposal contains serious flaws, particularly by inhibiting the flow of capital to situations where it's needed most.

The proposed rulemaking would compel larger FBOs with U.S. operations to set up International Holding Company (IHCs) for virtually all of their U.S subsidiaries. That would essentially end the Fed's willingness to rely on the parent company for financial support of an FBO's U.S. operations.

U.S. capital, liquidity and other regulatory mandates will have to be met in the United States. U.S. branches and agencies of FBOs would remain outside of the IHC structure, but would nevertheless have to comply with enhanced liquidity requirements.

The recent plan to regulate and supervise FBOs in the United States marks a significant change in the approach taken historically by the Fed. TD Bank a chartered bank subject to the provisions of the Bank Act of Canada provides a good case in point.

It's the second largest banking organization in Canada, with total consolidated assets of about $ 818 billion as of January 31. TD Bank U.S. Holding Company, headquartered in Portland, Maine, is the tenth largest bank holding company in the United States, with total consolidated assets of $ 216 billion as of January 31.

Not surprisingly, TD Bank is balking at the sweeping rule change, and we think that it has a powerful case to make in terms of global financial risk management. "The one size fits all mandate requiring FBOs to operate through an intermediate level holding company neither differentiates the risk profiles presented by the various FBOs doing business in the U.S. nor does it take into account the various forms of doing business in the United States that the Federal Reserve has long permitted FBOs to adopt," Riaz Ahmed, head of corporate development, enterprise strategy and treasury at TD Bank Group, wrote to the Fed Board of Governors on April 30.

The requirement would also put FBOs "at a competitive disadvantage to U.S. domestic banks doing business in the U.S.," he contended.

Further, curbs on capital and liquidity in the proposal "will make efficient and effective global risk management and funding much more difficult to accomplish and will also lead to inconsistent and conflicting standards," Ahmed noted, adding that "TD is not alone in making this observation."

The proposal would generally impose a single operating mandate on all FBOs doing business in the United States regardless of their existing business model. That would effectively trap capital and make consolidated risk management and global capital allocation more harder, especially among larger organizations.

The proposed regulatory structure "would also make the resolution of multinational banking organizations more challenging," according to Ahmed.

The bank risk manager further suggested that the Fed align U.S. requirements as much as possible with requirements of the Basel III liquidity coverage ratio framework. Alignment with Basel III liquidity requirements would reduce the risk that the rules diverge from a global perspective and legal-structure focus.

Currently, how the proposal is stated may result in an FBO being forced to modify its business model to mitigate the impact of the proposal's requirements and possibly hurt U.S. wholesale investors by driving demand for wholesale funding offshore.

TD Bank argues that the requirement for all FBOs to maintain a separate liquidity buffer held exclusively in the United States is not appropriate for those FBOs in jurisdictions that have fully adopted the Basel III liquidity coverage ratio.

Maintaining multiple liquidity pools throughout an organization that manages liquidity on a consolidated basis is inefficient and creates operational risk and difficulties.

Another concern for foreign bank holding companies articulated by TD would be the requirement to hold a minority interest within an IHC structure. That may have adverse downstream impacts on the investee entity's other investors, the bank group contends.

Minority interests owned by an FBO may be governed by pre-existing contractual arrangements that could not reasonably have been anticipated by the proposal's requirements. For example, the investee entity would have to comply with restrictions on capital distributions, among other things, if the FBO entered early remediation under the proposal.

The requirement may also increase the complexity and uncertainty of the FBO's global recovery and resolution planning. Along with TD Bank, we urge the Fed to consider alternative organizational structures for holding such investments that do not cause adverse capital consequences. Any plan should be able to accommodate particular characteristics while still ensuring that the FBO has enough capital should the investment fail.

TD Bank also suggests that the Fed should give credit to FBOs whose home-country regulatory regimes are much the same as that of the United States, that have a demonstrated track record of strong supervision and are fully and early adopters of the Basel III capital and liquidity frameworks.

There must be a fair balance between the need of a global company to consolidate and the responsibility of regulators to assure themselves that all entities operating within their jurisdiction have the capital and liquidity to support those operations.

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