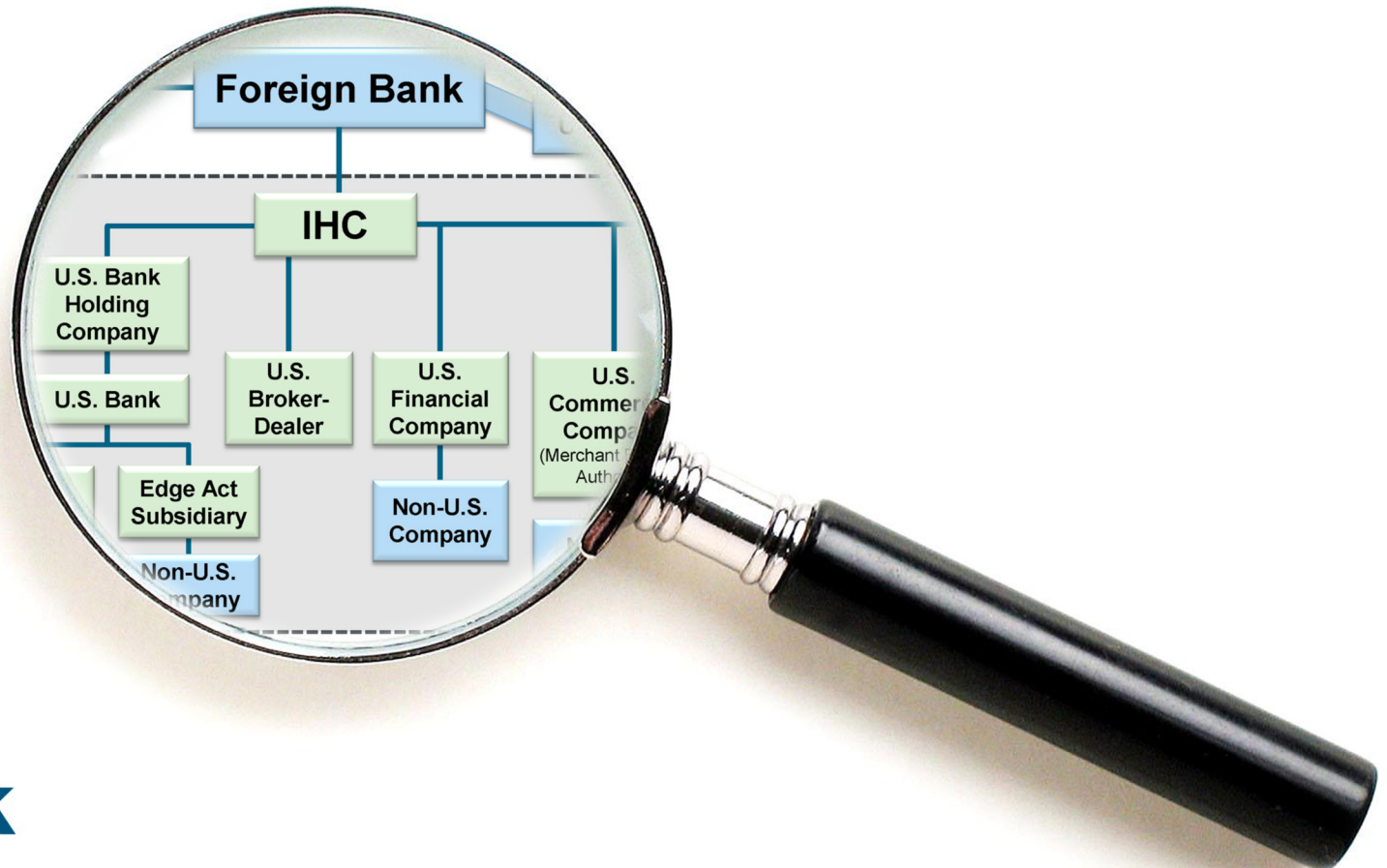


U.S. Intermediate Holding Company

Structuring and Regulatory Considerations for Foreign Banks



April 2, 2014

Davis Polk


Davis Polk & Wardwell LLP

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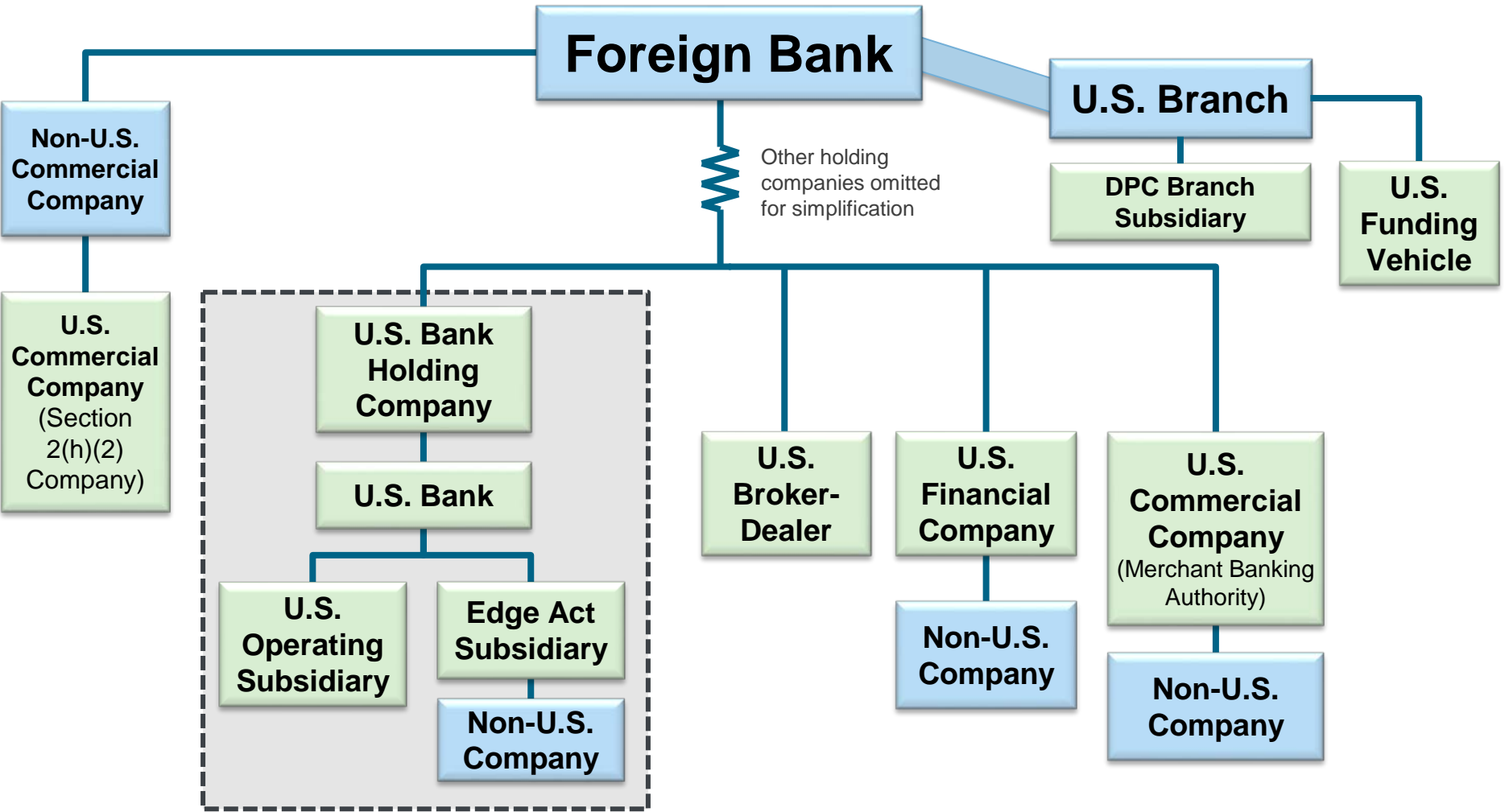
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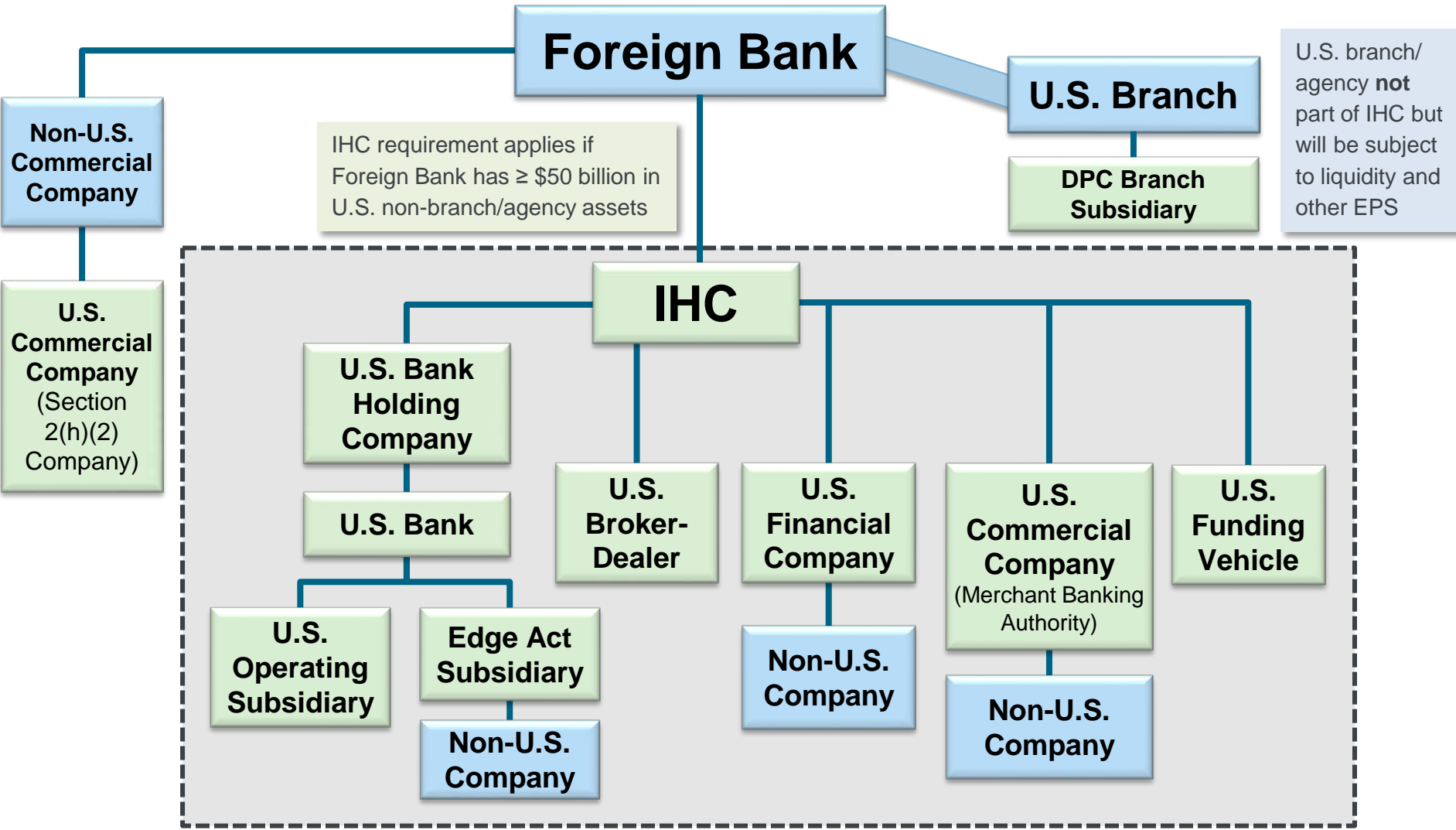
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
Overview of the IHC Requirement

- The Federal Reserve's Dodd-Frank enhanced prudential standards (EPS) final rule requires a foreign banking organization with **≥ \$50 billion in U.S. non-branch/agency assets** (Foreign Bank)* to place virtually all of its U.S. subsidiaries underneath a top-tier U.S. intermediate holding company (IHC).
- The IHC will be subject to U.S. Basel III, capital planning, Dodd-Frank stress testing, liquidity, risk management requirements and other U.S. EPS on a consolidated basis.
- **Complexity:** Establishing an IHC involves complex corporate structuring, regulatory, capital, liquidity, tax and corporate governance considerations and significant legal analysis.
- **Optimization:** It is critical that the IHC be structured in an efficient and optimal manner from a business, operations, capital, funding, liquidity, tax, risk management and corporate governance perspective.
- **Key Compliance Dates** (see [IHC Compliance Timeline](#))
 - **January 1, 2015:** A Foreign Bank must submit an IHC implementation plan to the Federal Reserve, which will be reviewed for reasonableness and achievability.
 - **July 1, 2016:** An IHC must be established and fully compliant with EPS.



	U.S. legal entity		Non-U.S. legal entity	
	Subject to U.S. Basel III and Dodd-Frank stress testing requirements. If ≥ \$50 billion in assets, also subject to capital planning, liquidity, risk management and other EPS on a consolidated basis			"Control" relationship under Federal Reserve's definition of "control"



	U.S. legal entity		Non-U.S. legal entity	
	Subject to U.S. Basel III, capital planning, stress testing, liquidity, risk management and other EPS on a consolidated basis			"Control" relationship under Federal Reserve's definition of "control"

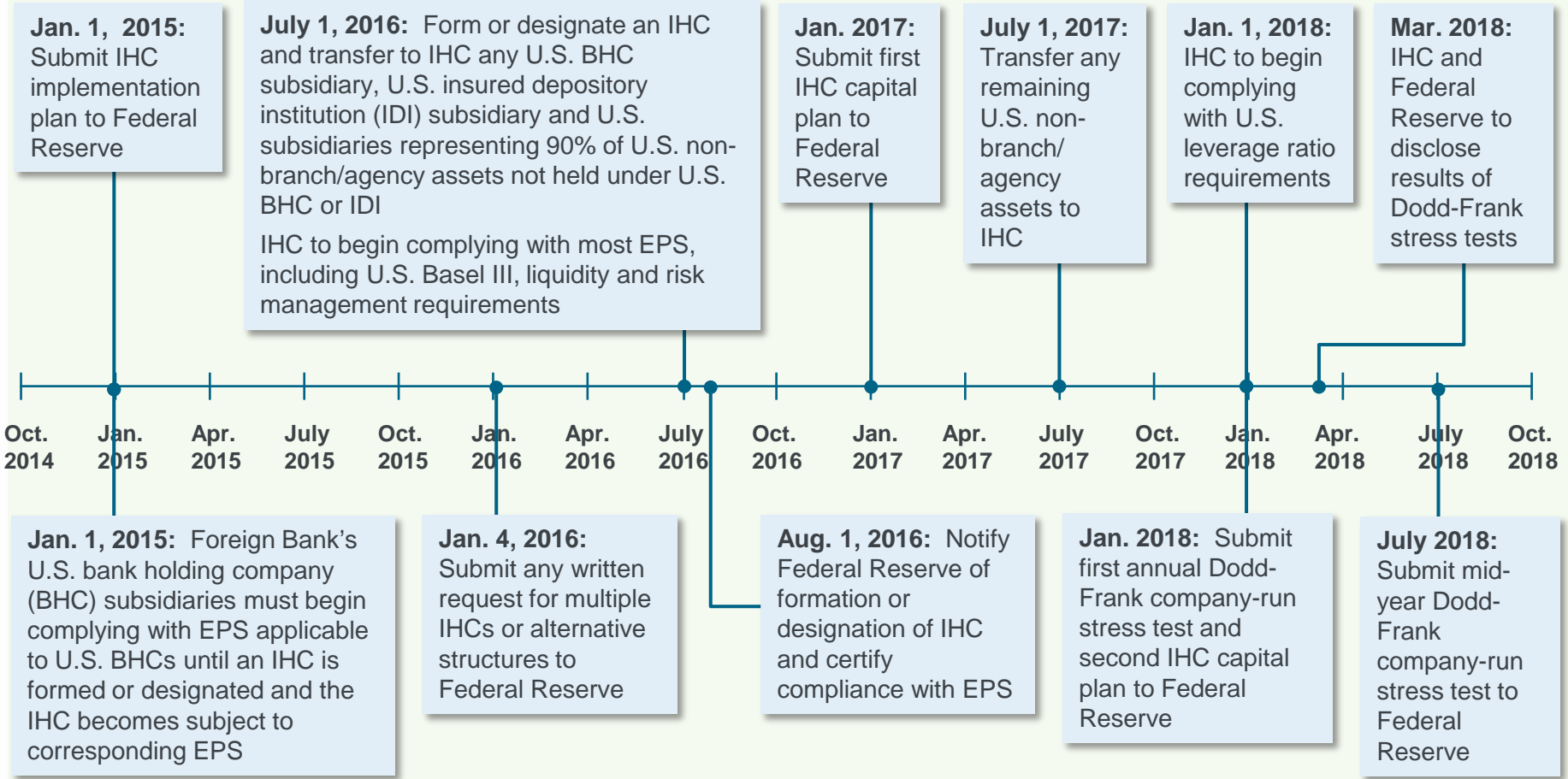
IHC: Key Structuring and Regulatory Considerations for Foreign Banks

- Designate an existing entity as the IHC or establish a new IHC?
- Request permission from the Federal Reserve to establish multiple IHCs or use other alternative organizational structures?
- Should a U.S. subsidiary divest control of certain non-U.S. entities so that they will not be part of the IHC?
- Which ownership structures will be the most tax efficient?
- How will the IHC's structure affect its ability to repatriate profits to the Foreign Bank parent?
- Which ownership structures will minimize the IHC's investments in the capital of unconsolidated financial institutions, which are subject to a punitive capital deduction regime under U.S. Basel III and home country Basel III rules?
- How should the IHC hold certain subsidiaries so as to minimize the adverse impact of minority interest treatment under U.S. Basel III and home country Basel III rules?
- Should the IHC issue U.S. Basel III-compliant capital instruments to third-party investors or receive funding from the Foreign Bank parent?

IHC: Key Structuring and Regulatory Considerations for Foreign Banks *(cont.)*

- Will the Foreign Bank be able to recognize U.S. capital and liquidity resources trapped in the IHC for purposes of calculating its own capital and liquidity ratios under home country standards?
- How should the IHC balance the different asset composition incentives created by risk-based capital, leverage capital and liquidity requirements under U.S. Basel III and home country Basel III rules?
- How will the U.S. liquidity buffer, U.S. Basel III liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) requirements affect the IHC's and U.S. branch/agency's funding models?
- What is the optimal risk management and corporate governance structure for the IHC and the Foreign Bank's U.S. operations?
- How should the Foreign Bank reconcile U.S. and home country risk governance requirements and expectations?

IHC Compliance Timeline



1. Establishing an IHC

Calculating \$50 Billion U.S. Non-Branch/Agency Assets Applicability Threshold

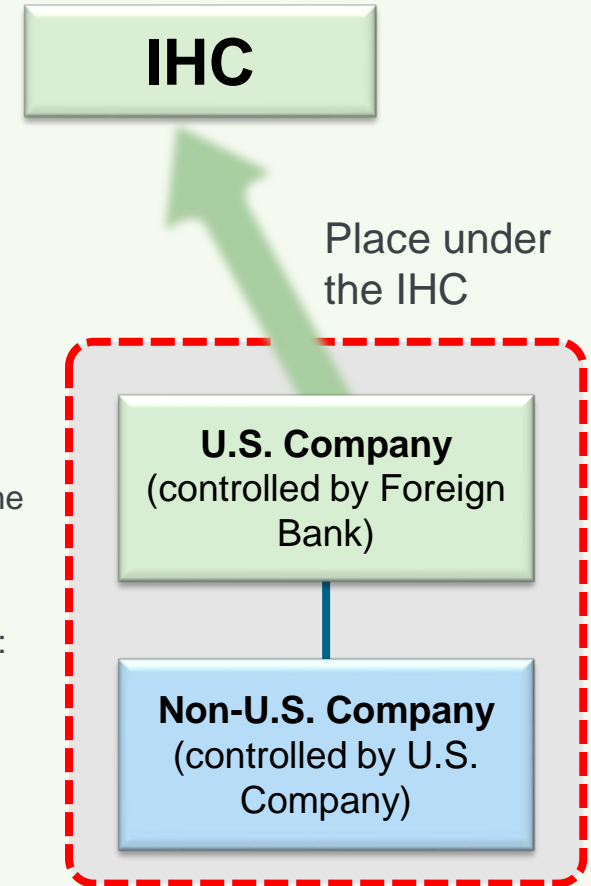
- The IHC requirement applies to a foreign banking organization (FBO) with **≥ \$50 billion** in U.S. non-branch/agency assets.

Calculating U.S. Non-Branch/Agency Assets

- Calculated as the **average** of the **sum** of the total consolidated assets of an FBO's **top-tier U.S. subsidiaries** (excluding any Section 2(h)(2) company and DPC branch subsidiary, as defined on [next page](#)) for the **four most recent consecutive quarters**, as reported to the Federal Reserve on Form FR Y-7Q.
- The amount calculated above may be **reduced** by the amount corresponding to any balances and transactions between any top-tier U.S. subsidiaries that would be eliminated in consolidation if an IHC were already formed.
- The amount calculated above may **not** be reduced by the amount corresponding to balances and transactions between the FBO's U.S. subsidiaries, on the one hand, and the FBO's branches or agencies or non-U.S. affiliates, on the other.

Which Entities Must Be Placed Under the IHC?

- Any **U.S. company** “controlled” by the Foreign Bank must be placed under the IHC.
 - U.S. company includes a corporation, partnership, limited liability company, business trust, special purpose entity, association or similar organization that is:
 - Incorporated in or organized under the laws of the United States or in any U.S. state, commonwealth, territory or possession, the Commonwealth of Puerto Rico, the Commonwealth of the North Mariana Islands, the American Samoa, Guam, or the United States Virgin Islands.
 - Any non-U.S. company “controlled” by the U.S. company will also become part of the IHC.
- **Limited Exceptions:** The following companies do not need to be placed under the IHC and do not count towards the \$50 billion applicability threshold:
 - **Section 2(h)(2) company***
 - **DPC branch subsidiary** = a subsidiary of a Foreign Bank’s U.S. branch/agency that holds assets acquired in the ordinary course of business for the sole purpose of securing or collecting debt previously contracted (DPC) in good faith by the U.S. branch/agency.



* Section 2(h)(2) of the U.S. Bank Holding Company Act allows qualifying Foreign Banks to retain their interest in foreign commercial firms that conduct business in the United States. This statutory exception was enacted in recognition of the fact that some foreign jurisdictions do not impose a clear separation between banking and commerce.

Definition of Control

- Any U.S. company **controlled** by the Foreign Bank must be placed under the IHC.
- **U.S. Bank Holding Company Act Definition of “Control”**: For purposes of the EPS final rule, a Foreign Bank controls a company if the Foreign Bank:
 - Directly or indirectly or acting through one or more other persons owns, controls, or has power to **vote $\geq 25\%$** of any class of voting securities of the company;
 - Controls in any manner the election of a **majority of the directors** or trustees of the company; **or**
 - Directly or indirectly exercises a **controlling influence** over the management or policies of the company.
- **Subsidiary**: A company controlled by a Foreign Bank is referred to as the Foreign Bank’s “subsidiary.”

Definition of Control *(cont.)*

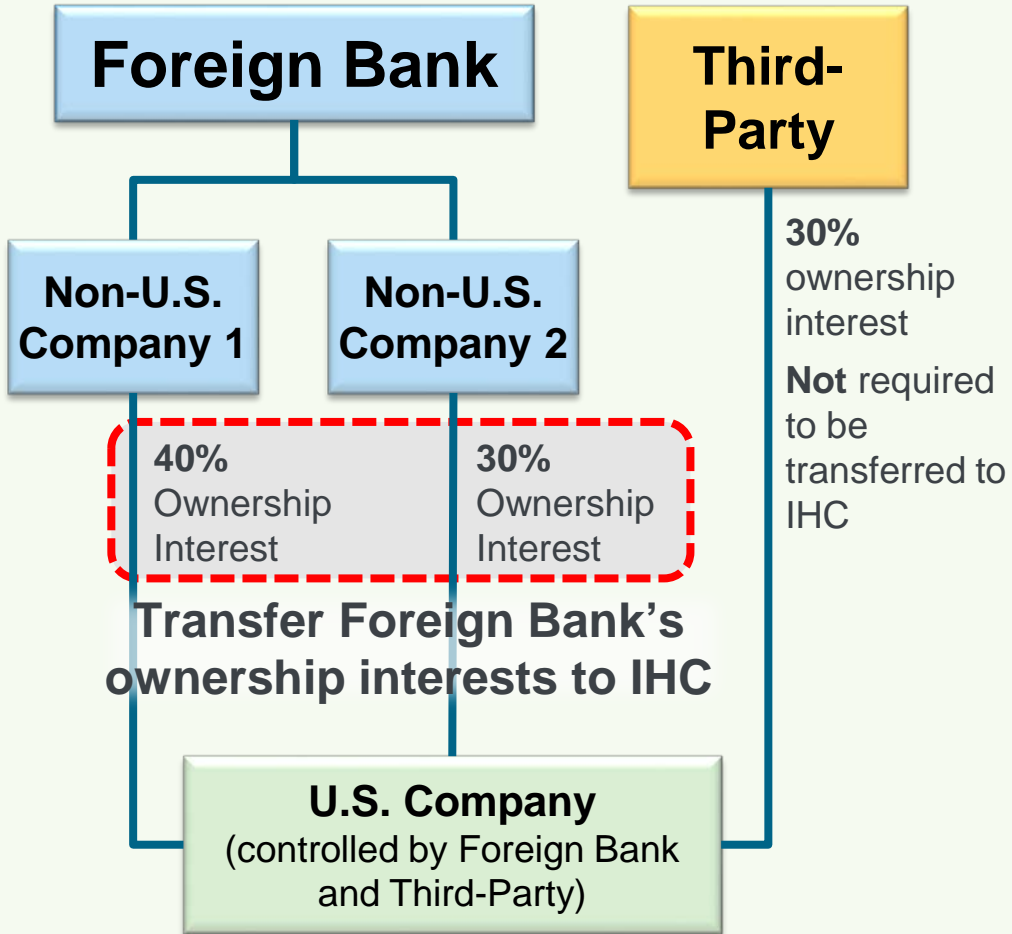
- Whether control exists depends on all the facts and circumstances.
 - Control is broader than accounting consolidation.
 - A Foreign Bank may “control” many unconsolidated companies.
 - Control can exist where a Foreign Bank’s ownership interest is anywhere between 5% and 25% of any class of a company’s voting securities and there are other indicia of control. See [next page](#).
 - A company may be controlled by more than one legal entity.

Definition of Control *(cont.)*

- **Controlling Influence:** In assessing whether a Foreign Bank (together with all of its affiliates and subsidiaries) directly or indirectly exercises a controlling influence over the management or policies of a company, the Federal Reserve considers a number of indicia of control, including:
 - The Foreign Bank's direct and indirect investment in the total equity of the company (both voting and non-voting).
 - Whether the company has another, larger controlling shareholder that is not affiliated with the Foreign Bank.
 - The number and proportion of the Foreign Bank's representatives on the board of directors of the company and their positions.
 - The existence of covenants or contractual terms in favor of the Foreign Bank (e.g., veto rights), which limit the company's discretion regarding key business decisions.
 - The quality and quantity of direct and indirect business transactions and relationships between the Foreign Bank and the company.

Transferring Foreign Bank's Ownership Interests in U.S. Subsidiaries to IHC

- A Foreign Bank must transfer **all** of **its** ownership interests in a U.S. subsidiary to the IHC and may **not** retain any ownership interest in the U.S. subsidiary directly or through non-U.S. affiliates.
- However, a Foreign Bank is **not** required to be the 100% owner of any U.S. subsidiary.
 - In other words, a Foreign Bank is **not** required to buy out other, unaffiliated third-party investors in a U.S. subsidiary.



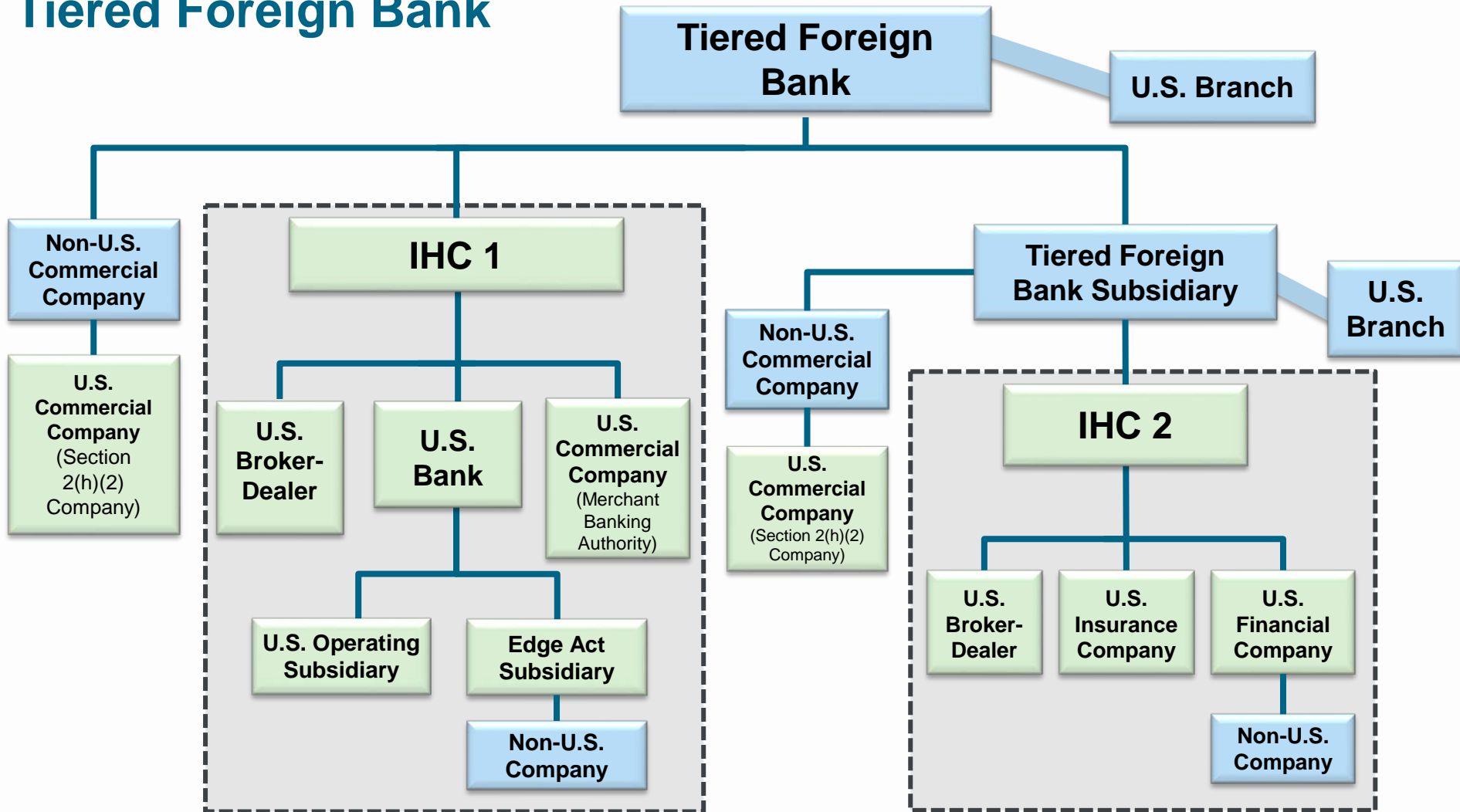
Alternative Organizational Structures





- Upon written request by a Foreign Bank, the Federal Reserve will consider whether to permit the Foreign Bank to establish multiple IHCs or use an alternative organizational structure to hold its combined U.S. operations under the following circumstances:
 - Under applicable home country law, the Foreign Bank may not own or control one or more of its U.S. subsidiaries (excluding any Section 2(h)(2) company or DPC branch subsidiary) through a single IHC.
 - The Federal Reserve determines that the circumstances otherwise warrant an exception based on the Foreign Bank's activities, scope of operations, structure or similar considerations.
- **Timing:** A Foreign Bank must submit a written request for an alternative organizational structure by **January 4, 2016**.
 - In practice, discussions with the Federal Reserve need to begin much earlier.
- One situation the Federal Reserve has stated may warrant an alternative organization is where the Foreign Bank controls multiple lower-tier FBOs that have separate U.S. operations (Tiered Foreign Bank). See visual on [page 19](#).

Alternative Organizational Structures *(cont.)*

- The Federal Reserve stated that, generally, it is **unlikely** to permit a Foreign Bank to form a separate IHC for the sole purpose of holding a nonbank subsidiary separate from banking operations or to designate a company that is not a top-tier U.S. company as the IHC.
- The Federal Reserve may impose conditions on the operations of a Foreign Bank that it authorizes to adopt an alternative organizational structure.
 - If a Foreign Bank operates through multiple IHCs, all of the Foreign Bank's IHCs will be subject to EPS, even if an IHC's assets are less than \$50 billion.
 - **Passivity Commitments:** In narrow circumstances where a Foreign Bank's interest in a U.S. subsidiary is permitted to be held outside the IHC, the Federal Reserve expects to require passivity commitments or other supervisory agreements to limit the exposure to and transactions between the IHC and the subsidiary.
 - The Federal Reserve's standard passivity commitments typically include undertakings not to, among other things, enter into any banking or nonbanking transactions except for maintaining deposit accounts with a maximum aggregate balance of \$500,000 on substantially the same terms as those for unaffiliated persons.
 - Under certain circumstances, generally relating to pre-existing business relationships, the business relationship commitment is negotiable with the Federal Reserve.

Possible Alternative Structure for a Tiered Foreign Bank



	U.S. legal entity		Non-U.S. legal entity	
	Subject to U.S. Basel III, capital planning, stress testing, liquidity, risk management and other EPS on a consolidated basis			“Control” relationship under Federal Reserve’s definition of “control”

IHC Implementation Plan

- A Foreign Bank with U.S. non-branch/agency assets of \geq \$50 billion as of **June 30, 2014** must submit an implementation plan to the Federal Reserve outlining its proposed process to come into compliance with the IHC requirement and associated EPS.
 - The applicability threshold for the requirement to submit an IHC implementation plan is based on a **snapshot** of a Foreign Bank's U.S. non-branch/agency assets as of June 30, 2014.
 - In contrast, the threshold for determining whether a Foreign Bank is subject to the IHC requirement is based on the **average** of a Foreign Bank's U.S. non-branch/agency assets over four quarters.
- **Timing:** A Foreign Bank must submit its IHC implementation plan by **January 1, 2015**.
- **Federal Reserve Review:** The IHC implementation plan is expected to facilitate dialogue between a Foreign Bank and the Federal Reserve.
 - The Federal Reserve expects to evaluate all IHC implementation plans, including those with respect to reducing U.S. non-branch/agency assets below the \$50 billion applicability threshold, for reasonableness and achievability.

Contents of IHC Implementation Plan

- The IHC implementation plan must include or describe all of the following:
 - A list of the Foreign Bank's U.S. subsidiaries setting forth the ownership interest in each subsidiary and an organizational chart showing the ownership hierarchy.
 - For each U.S. subsidiary that is a Section 2(h)(2) company or a DPC branch subsidiary, the name, asset size and a description of why the U.S. subsidiary qualifies as a Section 2(h)(2) company or a DPC branch subsidiary.
 - Projected timeline for transfer of the Foreign Bank's ownership interests in U.S. subsidiaries to the IHC.
 - Quarterly pro forma financial statements and regulatory capital ratios for the IHC through January 1, 2018.
 - Projected timeline for, and description of, all **planned capital actions** or strategies for capital accumulation for the IHC to comply with U.S. Basel III.
 - **Compliance plan for liquidity and risk management requirements.**
 - Any exemptions that may be sought or any plans to reduce U.S. non-branch/ agency assets below \$50 billion for four consecutive quarters prior to July 1, 2016.
- If applicable, a Foreign Bank may consider describing any alternative organizational structure proposals in its IHC implementation plan.

After-the-Fact Notice to Federal Reserve

- A Foreign Bank must notify the Federal Reserve within **30 days** of establishing or designating an IHC.
 - The Federal Reserve stated in the preamble to its December 2012 EPS **proposed rule** that an after-the-fact notice requirement for the formation of an IHC and required changes in corporate structure would reduce the burden on Foreign Banks.
 - The final rule text of the after-the-fact notice requirement is the same as the proposed rule text.
- A Foreign Bank's notification to the Federal Reserve must include:
 - A **description** of the IHC, including its name, location, corporate form and organizational structure;
 - A **certification** that the IHC meets all applicable EPS; and
 - Any other information that may be required by the Federal Reserve.

U.S. Requirements that Apply to the IHC

- **EPS:** An IHC will be subject to U.S. Basel III, capital stress testing, liquidity standards and other EPS on a consolidated basis.
 - An IHC will **not** also be subject to EPS for U.S. BHCs even if the IHC is also a BHC.
- **Examinations and Inspections:** An IHC will be subject to umbrella supervision by the Federal Reserve, which may examine or inspect an IHC and any of its subsidiaries.
- **Reporting:** An IHC will be required to submit periodic reports to the Federal Reserve.
 - The Federal Reserve will specify the form and content of IHC reporting requirements in a separate rule.
- **U.S. BHC Requirements:** An IHC that is also a BHC will continue to be subject to all applicable BHC Act requirements and Federal Reserve regulations (other than EPS for U.S. BHCs).
 - *E.g.*, Regulation Y, Regulation K and BHC examination, inspection and reporting requirements.

2. U.S. Basel III and Related Structuring Issues for IHCs

IHC Subject to U.S. Basel III Capital Standards

- An IHC will generally be subject to the **same** U.S. risk-based and leverage capital standards that apply to a U.S. BHC — even if the IHC does not control a U.S. bank.
- **All IHCs** will be subject to the U.S. Basel III capital rules (and any successor regulation), including the U.S. Basel III standardized approach for calculating risk-weighted assets (RWAs) for credit risk and the U.S. leverage ratio.
 - **Compliance with the U.S. leverage ratio by the IHC is delayed until January 1, 2018.**
 - However, a U.S. BHC subsidiary of a Foreign Bank must continue to comply with U.S. leverage ratio requirements **until** the IHC becomes subject to those requirements on January 1, 2018, even if the U.S. BHC subsidiary is designated as the IHC.
- An IHC will **not** be subject to the U.S. advanced internal ratings-based approach for credit risk and advanced measurement approaches for operational risk (advanced approaches capital rules) **unless** the IHC expressly opts in.
- However, an IHC that crosses the applicability threshold for the advanced approaches capital rules (\geq \$250 billion in total consolidated assets **or** \geq \$10 billion of on-balance sheet foreign exposures) will still be subject to:
 - U.S. Basel III supplementary leverage ratio.
 - U.S. Basel III countercyclical buffer (if deployed).
 - Unrealized gains and losses flowing through to the IHC's Common Equity Tier 1 capital.
- An IHC will be subject to the U.S. Basel 2.5 market risk capital rule (and any successor regulation) if it crosses the applicability threshold (aggregate trading assets and trading liabilities of \geq 10% of total assets or \geq \$1 billion).

Multiple Capital Ratio Calculations for IHCs

Risk-based Capital Ratios

4.5% minimum Common Equity Tier 1 risk-based capital ratio

6% minimum Tier 1 risk-based capital ratio

8% minimum total risk-based capital ratio

> 2.5% capital conservation buffer

0% to 2.5% countercyclical capital buffer*

Leverage Ratios

4% minimum U.S. leverage ratio

3% minimum Basel III supplementary leverage ratio*

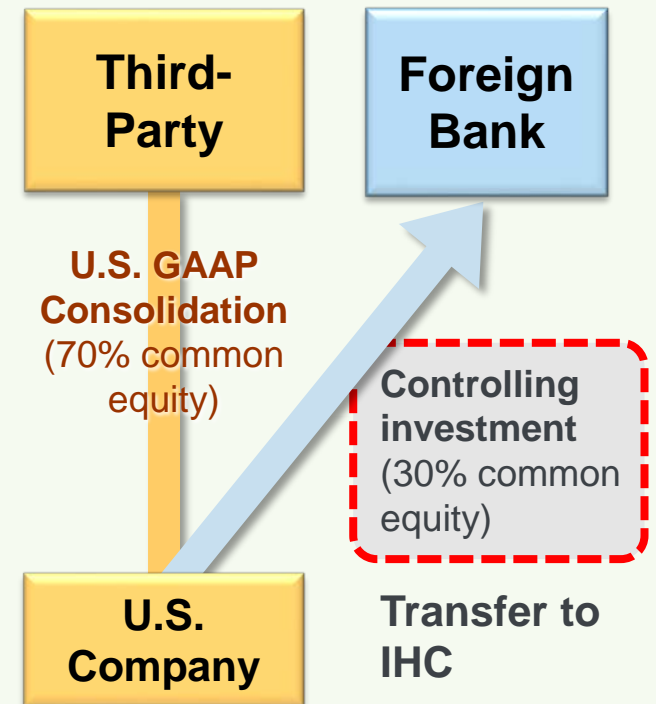
Home Country Capital Standards: A Foreign Bank must also calculate regulatory capital ratios using home country capital standards on a group-wide consolidated basis, including the IHC's assets and exposures.

U.S. Basel III Issues for IHCs

- Significant differences between U.S. Basel III and home country Basel III regimes giving rise to multiple capital calculations and different capital optimization outcomes. See [page 58](#).
- Compliance with the U.S. leverage ratio and, in the case of the largest IHCs, the U.S. Basel III supplementary leverage ratio may be burdensome where the IHC has a large broker-dealer subsidiary. See Davis Polk [visual memo](#) on the Basel Committee's revised Basel III leverage ratio.
- Capital deduction for investments in the capital of unconsolidated “financial institutions” (broadly defined in U.S. Basel III) and certain Volcker Rule covered funds. See flowcharts on [U.S. Capital Treatment of IHC's Investments in Consolidated and Unconsolidated Entities](#).
- U.S. Basel III's and home country Basel III's limited recognition of minority interests. See [page 30](#).
- Eligibility criteria for regulatory capital instruments under U.S. Basel III vs. home country Basel III regime. See [page 60](#).
- IHCs that cross the applicability threshold for the U.S. market risk capital rule will need to obtain separate approval from the Federal Reserve for their internal models. There may also be implications for the IHC's Volcker Rule compliance program.

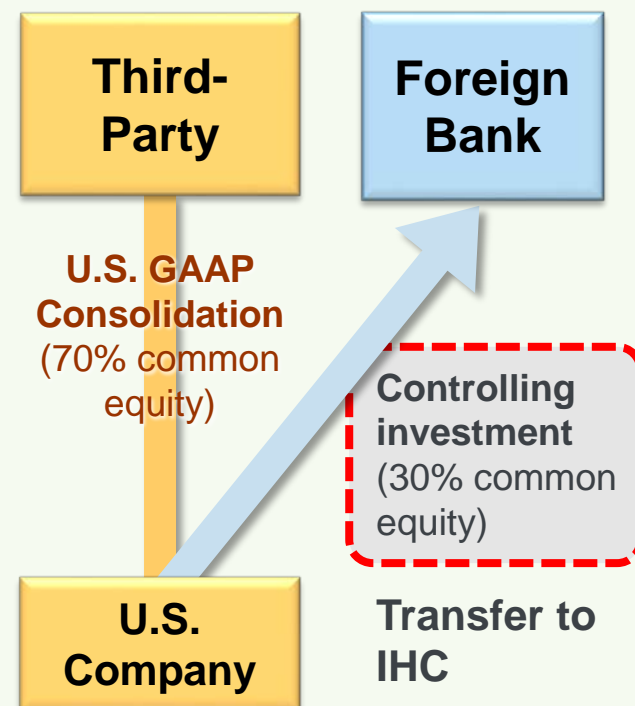
Unconsolidated U.S. Companies Controlled by the Foreign Bank

- **Unconsolidated U.S. Company Controlled by the Foreign Bank** = a U.S. company that is controlled by the Foreign Bank but does **not** consolidate into the Foreign Bank under U.S. GAAP.
- A Foreign Bank's ownership interest in the U.S. company must be transferred to the IHC.
- **Ensuring Compliance with U.S. Requirements:** The U.S. company's activities will be attributed to the IHC.
 - Accordingly, the IHC must ensure that the U.S. company does not engage in activities that are inconsistent with U.S. laws and regulations that apply to the IHC.



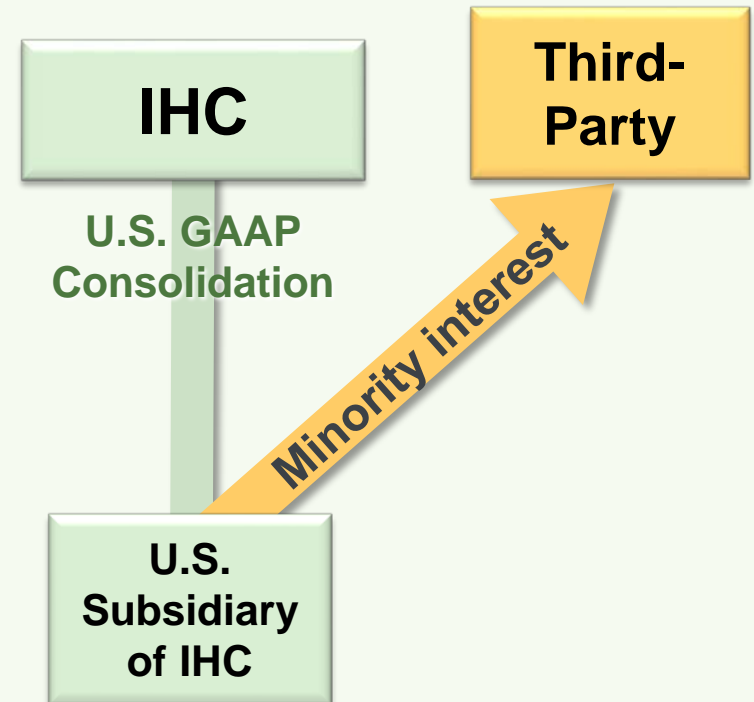
Unconsolidated U.S. Companies Controlled by the Foreign Bank *(cont.)*

- **U.S. Basel III Capital Treatment:** An IHC's controlling investment in an unconsolidated U.S. company may result in adverse regulatory capital consequences under U.S. Basel III and home country Basel III rules.
 - U.S. Basel III will require the IHC to deduct from its regulatory capital certain investments in the capital of unconsolidated financial institutions.
 - "Financial institution" is broadly defined.
 - See flowcharts on [U.S. Capital Treatment of IHC's Investments in Consolidated and Unconsolidated Entities](#).



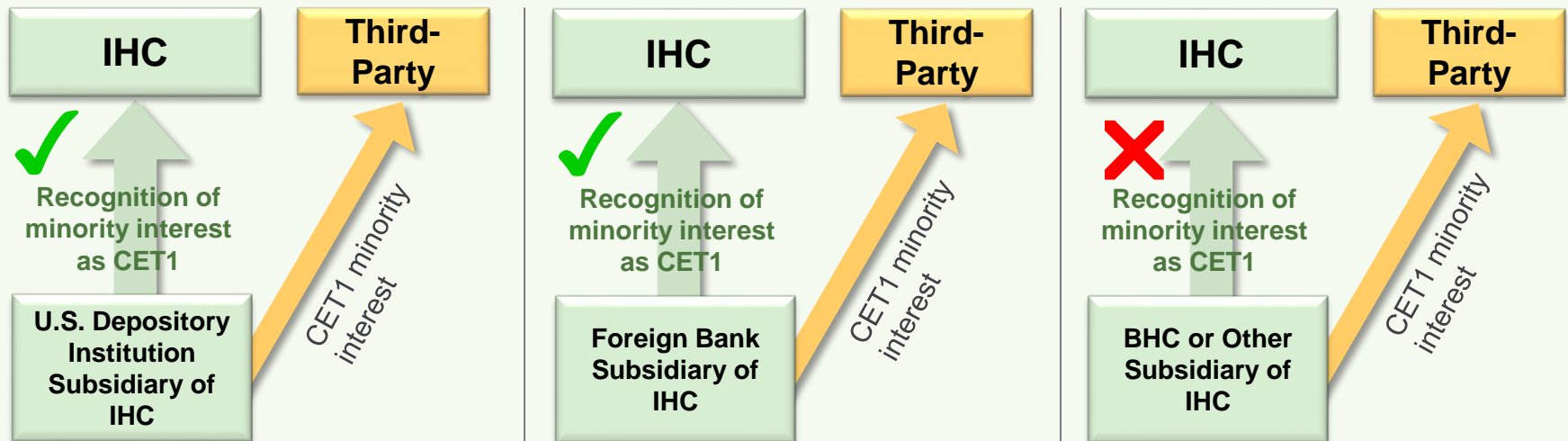
Non-wholly Owned Subsidiaries of the IHC

- **Non-wholly Owned Subsidiary** = a U.S. GAAP consolidated subsidiary of the IHC that is not wholly owned by the IHC due to the presence of third-party minority interests.
- **Limited Recognition of Minority Interests under U.S. Basel III:** U.S. Basel III places strict quantitative and qualitative limits on the ability of the IHC to count minority interests towards its consolidated regulatory capital.
 - Home country Basel III rules may provide for similar minority interest treatment.



U.S. Basel III's Limited Recognition of Minority Interests: Qualitative Limits

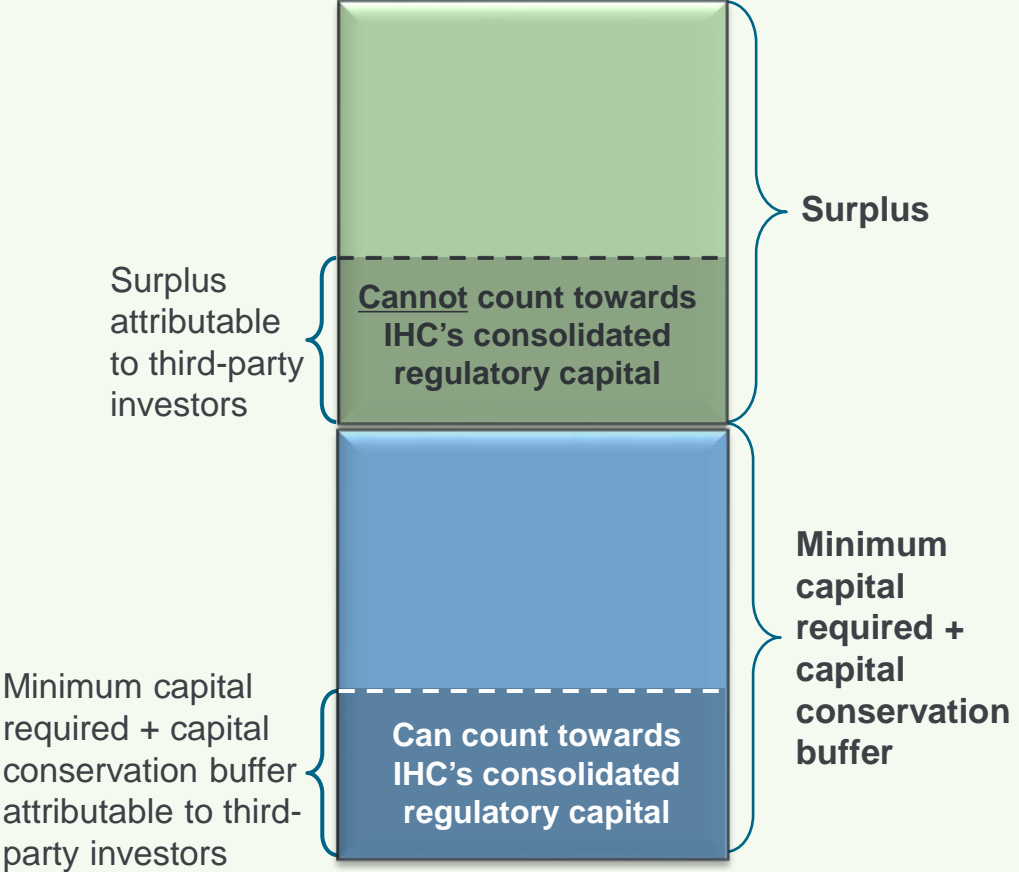
- The capital instrument giving rise to the minority interest must, if it were issued by the IHC directly, meet all of the eligibility criteria for the relevant tier of capital under U.S. Basel III.
- In addition, only Common Equity Tier 1 capital (CET1) issued by a **U.S. depository institution** or **foreign bank** subsidiary to third-party investors can count towards an IHC's consolidated CET1 (subject to quantitative limit).
- CET1 issued by any other type of consolidated subsidiary to third-party investors **cannot** count towards the IHC's consolidated CET1, but can count towards the IHC's consolidated Additional Tier 1 capital (subject to quantitative limit).



U.S. Basel III's Limited Recognition of Minority Interests: Quantitative Limits

- The amount of a consolidated subsidiary's **surplus** capital that is attributable to third-party investors **cannot** count towards the IHC's consolidated regulatory capital.
 - Surplus** = amount by which subsidiary's actual capital **exceeds** the subsidiary's minimum capital requirements + capital conservation buffer (or equivalent standards established by the subsidiary's home country supervisor).
 - If a subsidiary is **not** subject to capital adequacy standards "similar" to those of the IHC, the IHC must **assume** that the capital adequacy standards of the IHC (*i.e.*, U.S. Basel III) apply to the subsidiary.

Actual Capital Base of IHC's Consolidated Subsidiary



Balancing Risk-Based Capital, Leverage Capital, Liquidity and Funding Requirements

- The following regulatory requirements may create different balance sheet composition and funding incentives and burdens for IHCs:
 - U.S. Basel III risk-based capital ratios
 - U.S. leverage ratio and, if applicable, U.S. Basel III supplementary leverage ratio
 - U.S. liquidity buffer requirement in EPS final rule
 - U.S. Basel III LCR (not yet finalized)
 - U.S. implementation of the Basel III NSFR (not yet proposed)
 - Measures to address certain risks related to short-term wholesale funding (not yet proposed)
- **Structuring the IHC in a way that optimizes these different requirements involves a delicate balancing act.**
- See comparison tables beginning on [page 63](#).

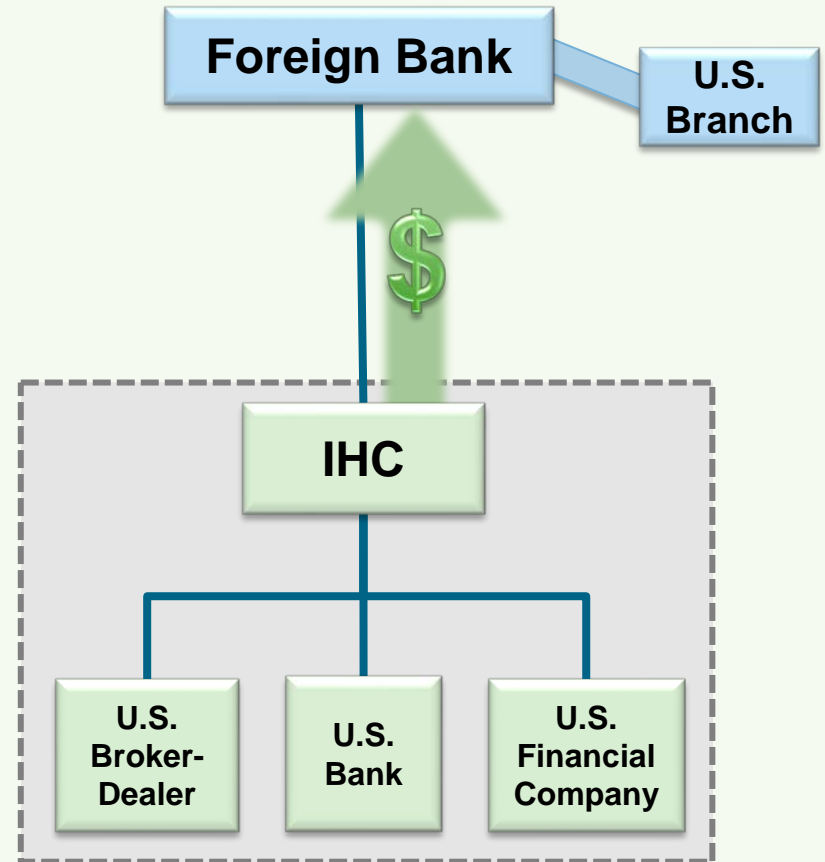


3. Capital Planning and Dodd-Frank Stress Testing Issues for IHCs

Distributing IHC's Earnings to Foreign Bank Parent

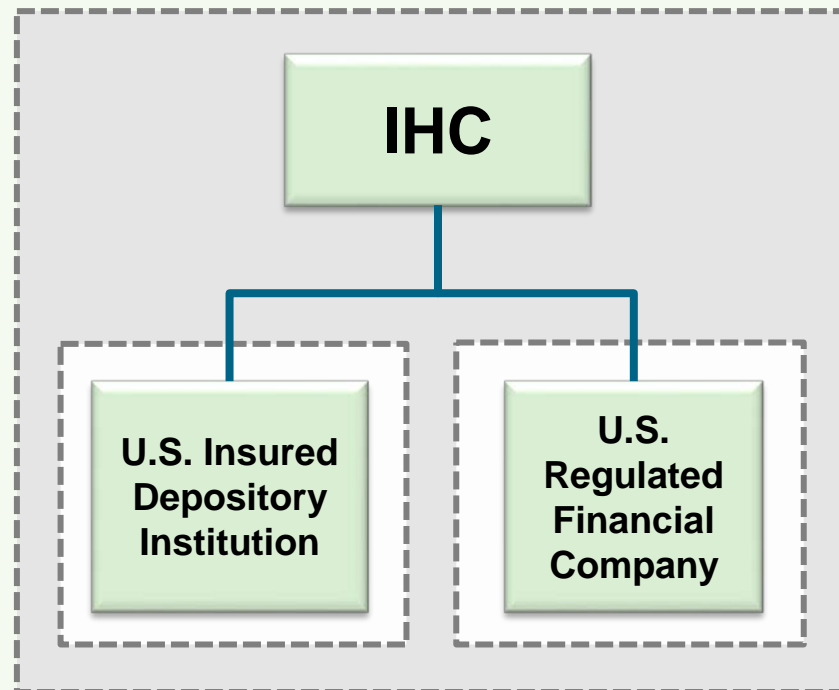
An IHC's ability to distribute earnings to its Foreign Bank parent will depend on the IHC maintaining:

- **U.S. Basel III Capital Buffers:** A Common Equity Tier 1 capital conservation buffer and, if applicable and deployed, a Common Equity Tier 1 countercyclical capital buffer above the minimum U.S. Basel III risk-based capital ratios in order to avoid restrictions on capital distributions and bonus payments to executive officers.
- **Stress Test Buffers:** Capital levels above minimum risk-based and leverage capital ratios under the Federal Reserve's supervisory stress scenarios in order to pass annual supervisory stress tests and to avoid an objection from the Federal Reserve to annual capital plan on *quantitative* grounds.
- **Strong Governance, Processes and Systems:** Robust capital planning and stress testing governance, controls, processes and systems to avoid an objection from the Federal Reserve to its annual capital plan on *qualitative* grounds.



Multiple U.S. Capital Planning and Stress Testing Requirements for IHC and Its Subsidiaries

- **IHC:**
 - Must conduct semi-annual Dodd-Frank **company-run** stress tests;
 - Must submit an annual **capital plan** to the Federal Reserve; and
 - Will be subject to annual Dodd-Frank **supervisory stress tests** and **capital plan analysis** conducted by the Federal Reserve.
- **U.S. IDI subsidiary of IHC:**
 - Must conduct annual Dodd-Frank company-run stress tests if the IDI has >\$10 billion in total consolidated assets.
- **Other U.S. financial subsidiaries of IHC:**
 - Section 165(i) of the Dodd-Frank Act requires all financial companies with >\$10 billion in total consolidated assets that are regulated by a primary federal financial regulatory agency to conduct annual company-run stress tests.



Capital Planning for IHC

- **Contents of Capital Plan:** An IHC must submit an annual capital plan to the Federal Reserve that includes:
 - An assessment of the IHC's expected uses and sources of capital over a nine-quarter planning horizon;
 - A description of the IHC's planned capital actions (e.g., dividend payments, redemptions, issuances of capital instruments) over the planning horizon;
 - Projections of the IHC's revenues, losses, reserves and pro forma capital levels over the planning horizon under expected conditions and stressed scenarios, including those provided by the Federal Reserve;
 - A detailed description of the IHC's process for assessing capital adequacy.
 - A discussion of how the IHC will, under stressed conditions, maintain capital commensurate with its risks, maintain capital above the minimum U.S. Basel III regulatory capital ratios and above a Tier 1 common ratio of 5% and serve as a source of strength to its subsidiary depository institutions (if any).
 - A discussion of how the IHC will, under expected and stressful conditions, maintain sufficient capital to continue its operations by maintaining ready access to funding, meeting its obligations to creditors and other counterparties, and continuing to serve as a credit intermediary;
 - The IHC's capital policy; and
 - A discussion of any expected changes to the IHC's business plan that are likely to have a material impact on its capital adequacy or liquidity.

Federal Reserve's Quantitative and Qualitative Assessment of Capital Plans

- The Federal Reserve will perform a **quantitative** and **qualitative** assessment of an IHC's capital plan.
- **Quantitative Assessment:** An IHC must demonstrate in its capital plan that it can maintain capital above the minimum U.S. Basel III regulatory capital ratios and above a Tier 1 common ratio of 5% during each quarter of the planning horizon under stressed economic and financial market conditions.
 - The quantitative assessment is based on the IHC's and the Federal Reserve's post-stress capital analysis.
- **Qualitative Assessment:** Even if an IHC has enough capital to quantitatively pass a stress test, the Federal Reserve can still object to the IHC's capital plan on qualitative grounds if, among other things:
 - The IHC's capital-adequacy assessment process—including corporate governance and controls around the process as well as risk identification, risk measurement and risk management practices supporting the process—are not sufficiently robust;
 - The assumptions and analyses underlying the IHC's capital plan are inadequate;
 - The IHC's capital adequacy process or proposed capital distributions would constitute an unsafe or unsound practice, or would violate any law, regulation, Federal Reserve order, directive or any condition imposed by, or written agreement with, the Federal Reserve; or
 - There are outstanding material, unresolved supervisory issues.
- **Consequences of Objection:** If the Federal Reserve objects to a capital plan on qualitative **or** quantitative grounds, the **IHC may not make any capital distribution** other than those capital distributions with respect to which the Federal Reserve has indicated in writing its non-objection.

Dodd-Frank Stress Tests for IHC

What Is a Dodd-Frank Stress Test?

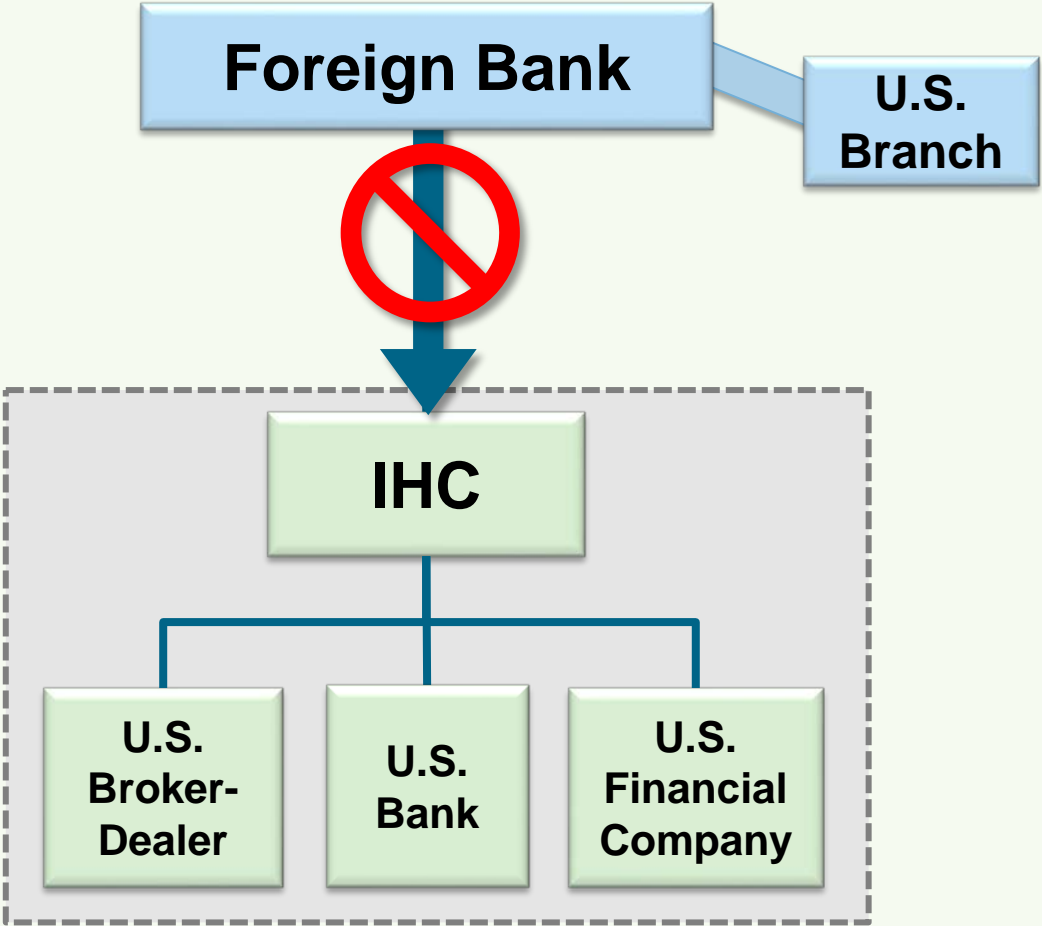
- Under the Dodd-Frank regulatory regime, a stress test is a process to assess the potential impact of various hypothetical economic scenarios on the consolidated earnings, losses and regulatory capital of an IHC over a nine-quarter planning horizon.

What Is a Stress Test Used For?

- **Federal Reserve:** The Federal Reserve analyzes the quality of an IHC's stress test processes and results.
 - The Federal Reserve will likely consider an IHC's stress test processes and results when evaluating proposed actions that impact the IHC's capital, such as dividend payments, redemptions of regulatory capital instruments and M&A transactions.
- **IHC Board and Management:** An IHC's board of directors and senior management must consider Dodd-Frank stress test results in the normal course of business, including capital planning, assessment of capital adequacy, exposures, concentrations and risk positions, development or implementation of any recovery or resolution plans and risk management practices.
- **Public Disclosure:** An IHC must publicly disclose a summary of its Dodd-Frank company-run stress test results. The Federal Reserve will publish summaries of each IHC's supervisory stress test results.
 - An IHC may disclose additional stress testing information beyond what is required by the Federal Reserve's Dodd-Frank stress testing rules, including explanations of any differences between the stress testing methodologies of the IHC and its Foreign Bank parent that led to the divergent results.

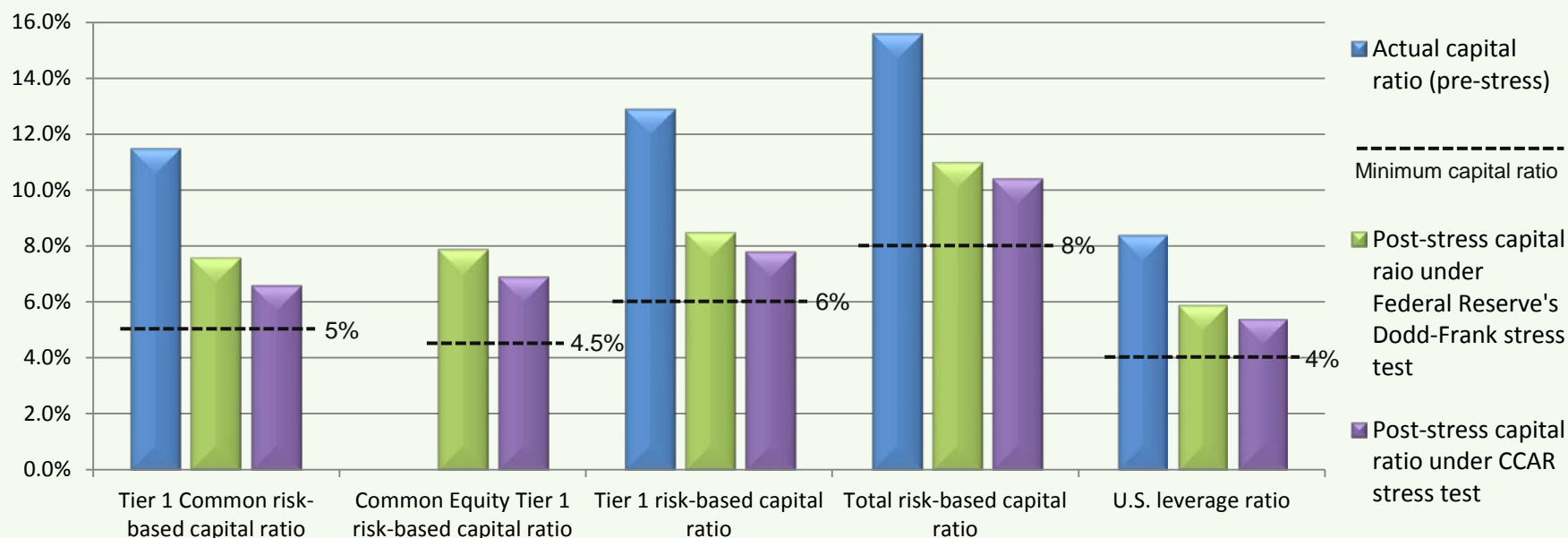
IHC Cannot Assume Foreign Bank Parent Support

- In demonstrating its ability to maintain capital above minimum requirements under stress scenarios, the IHC will **not** be permitted to assume in its capital plan any Foreign Bank parent support through guarantees and keepwell agreements.
- Similarly, for Dodd-Frank stress testing purposes, the IHC must project its regulatory capital ratios without consideration of possible support from its Foreign Bank parent.
- Subject to the foregoing, an IHC may otherwise include in its capital plan any parent support through guarantees and keepwell agreements.



Large Capital Buffer Needed to Pass Stress Tests and Receive Capital Plan Approval

- The severity of the Federal Reserve's hypothetical stress test scenarios means that an IHC will likely need to maintain a large capital buffer on an on-going basis in order to maintain risk-based and leverage capital ratios above minimum requirements under stressed conditions.
- This will have the practical effect of trapping excess capital in the IHC.
- Below is a chart showing the *average* pre-stress and post-stress capital ratios of the 30 U.S. BHCs that were subject to the Federal Reserve's 2014 Dodd-Frank supervisory stress tests and Comprehensive Capital Analysis and Review (CCAR).

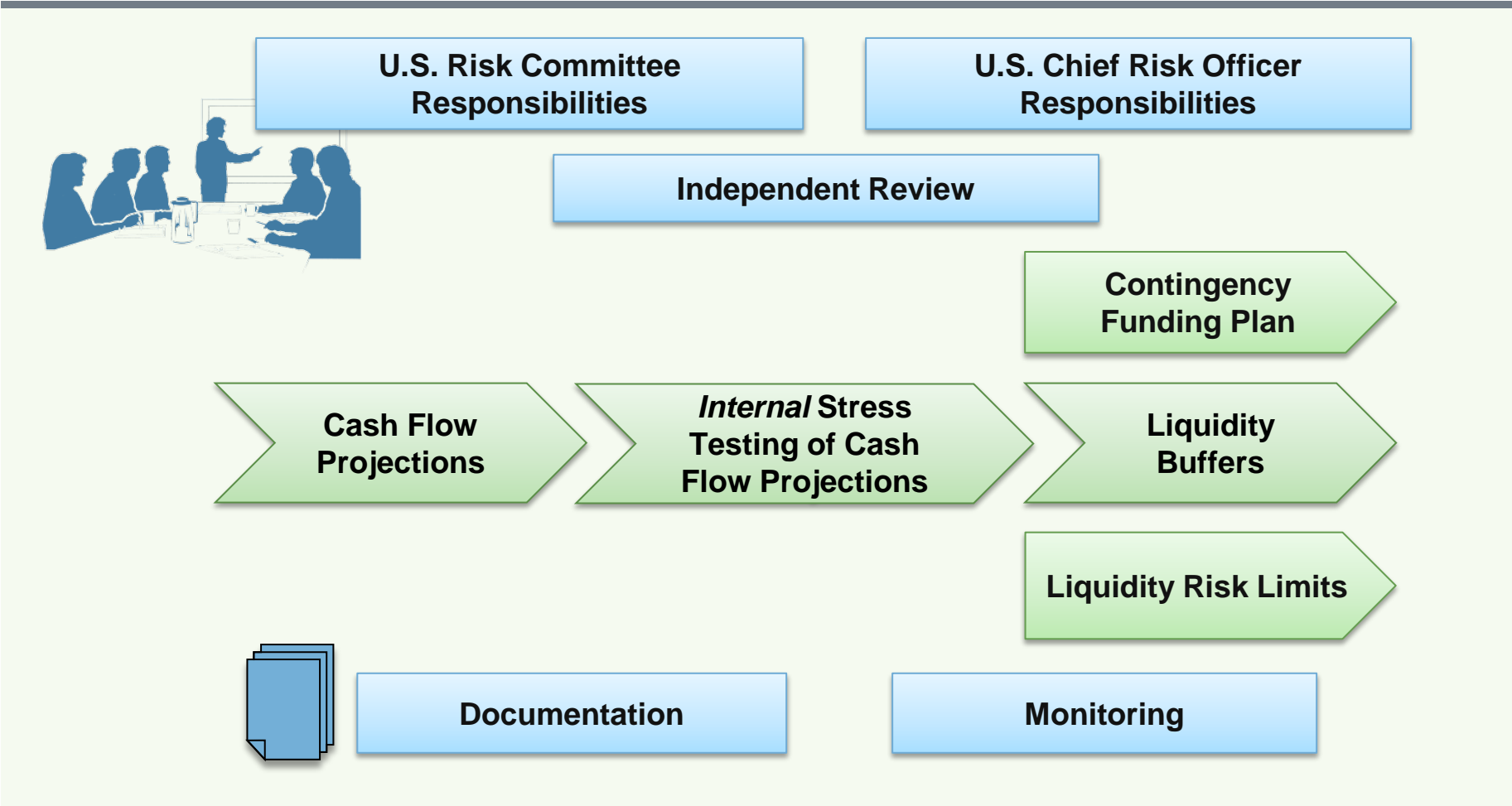


4. U.S. Liquidity Requirements for IHCs

Qualitative and Quantitative U.S. Liquidity Requirements

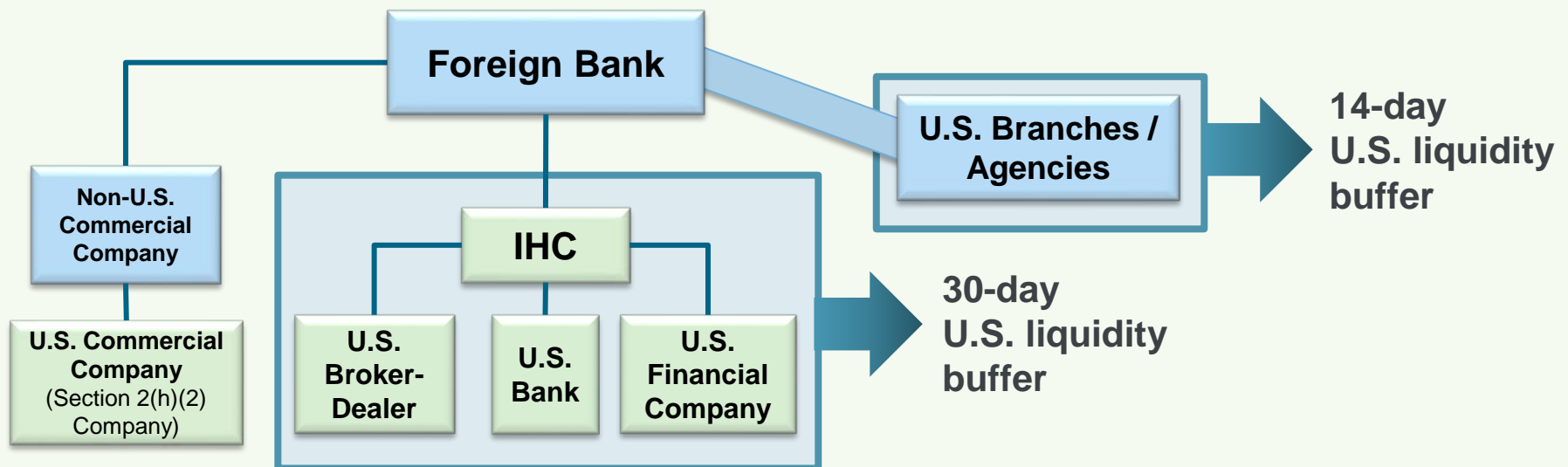
- **EPS Final Rule's Qualitative Liquidity Framework:** The EPS final rule subjects an FBO with \geq \$50 billion in U.S. assets (including U.S. branch/agency assets) to a qualitative liquidity framework, including liquidity risk management standards and a U.S. liquidity buffer requirement based on the results of internal liquidity stress testing.
- **U.S. Basel III Quantitative Liquidity Framework:** The Federal Reserve stated that it intends, through future separate rulemakings, to implement the Basel III LCR and NSFR for the U.S. operations of **some or all** FBOs with \geq \$50 billion in U.S. assets.
- **Relationship Between Qualitative and Quantitative Liquidity Frameworks:** The qualitative liquidity framework in the EPS final rule will exist alongside of, and is designed to complement, the Basel III LCR and NSFR.
 - A key difference between the LCR and the U.S. liquidity buffer requirement in the EPS final rule is that the former is based on **prescribed** cash inflow and outflow rates and assumptions under the standardized supervisory stress scenario, whereas the latter is based on the results of a Foreign Bank's **internal liquidity stress testing**.
- **Greater of Two U.S. Liquidity Buffer Requirements:** Like similarly-sized U.S. BHCs, IHCs will likely be subject to two U.S. liquidity buffer requirements – the U.S. Basel III LCR and the U.S. liquidity buffer requirement in the EPS final rule.
 - As a practical matter, an IHC must maintain enough eligible liquid assets to meet the greater of the two U.S. liquidity buffer requirements.

Components of Qualitative Liquidity Framework



U.S. Liquidity Buffer Requirement for IHC and U.S. Branches/Agencies

- Among other things, the qualitative liquidity framework in the EPS final rule requires a Foreign Bank to maintain **separate U.S. liquidity buffers** (based on results of internal liquidity stress tests) for its IHC and U.S. branches/agencies.
- The EPS final rule **prescribes a specific method** for calculating the U.S. liquidity buffers for a Foreign Bank's IHC and U.S. branches/agencies.



5. Risk Governance and Other U.S. Regulatory Issues for IHCs

IHC Risk Governance: At the Center of Effective Risk Management and Regulatory Compliance



IHC Risk Committee

- An IHC must maintain a risk committee of its board of directors.
- The IHC's risk committee may also serve as the Foreign Bank's U.S. risk committee.
 - If it also serves as the Foreign Bank's U.S. risk committee, the IHC's risk committee must approve and periodically review the risk management policies and oversee the risk management framework of the Foreign Bank's **combined U.S. operations**, which include both the IHC and the U.S. branches/agencies.
- **Responsibilities:** The IHC's risk committee must:
 - Approve and periodically review the IHC's risk management policies and oversee the IHC's risk management framework; and
 - Meet at least quarterly and otherwise as needed and fully document and maintain records of its proceedings, including risk management decisions.
- An IHC risk committee that also serves as the U.S. risk committee has certain liquidity risk management responsibilities. See [page 54](#).
- The IHC must take appropriate measures to implement the risk management policies approved by the risk committee and provide sufficient information to the risk committee to enable it to carry out its responsibilities.
- **Risk Management Framework:** The IHC's risk management framework must be commensurate with the IHC's structure, risk profile, complexity activities and size and consistent with the risk management policies for the combined U.S. operations. The framework must include:
 - Policies and procedures establishing the IHC's risk management governance, risk management procedures and risk control infrastructure; and
 - Processes and systems for implementing and monitoring compliance with such policies and procedures.

IHC Risk Committee *(cont.)*

- **Risk Management Experience:** The IHC’s risk committee must include **at least one member** with experience in identifying, assessing and managing risk exposures of large, complex financial firms.
 - The term “financial firm” includes a bank, a securities broker-dealer or an insurance company, provided that the risk committee member’s risk management experience is relevant to the particular risks facing the IHC.
 - The Federal Reserve expects that the risk committee member’s experience in risk management would be commensurate with the IHC’s structure, risk profile, complexity, activities and size, and the IHC should be able to demonstrate that an individual’s experience is relevant to the particular risks facing the company.
 - The EPS final rule does not specify which type of experience in risk management is required (e.g., front-line risk management vs. supervisory role)
 - While the EPS final rule requires only one member of the risk committee to have risk management experience, the Federal Reserve expects all risk committee members generally to have an understanding of risk management principles and practices relevant to the IHC.
 - The risk committee of an IHC that poses more systemic risk should have more risk committee members with commensurately greater understandings of risk management principles and practices.

IHC Risk Committee *(cont.)*

- **Independence Requirement:** The IHC's risk committee must include **at least one member** who:
 - Is **not** an officer or employee of the Foreign Bank or its affiliates and has not been an officer or employee of the Foreign Bank or its affiliates during the previous three years; and
 - Is **not** a member of the immediate family (as defined in Section 225.41(b)(3) of the Federal Reserve's Regulation Y) of a person who is, or has been within the last three years, an executive officer (as defined in section 215.2(e)(1) of the Federal Reserve's Regulation O) of the Foreign Bank or its affiliates.
- **Additional Independent Directors Optional:** In the context of U.S. BHCs, the Federal Reserve stated in the preamble to the EPS final rule that:
 - Firms are encouraged to consider including additional independent directors as members of their risk committees because active involvement of independent directors can be vital to robust oversight of risk management.
 - At the same time, involvement of directors affiliated with the firm on the risk committee may complement the involvement of independent directors.
- **Other IHC Board Committees:** As a practical matter, an IHC will need to consider the allocation of oversight responsibilities among the risk committee and other committees of its board of directors.

U.S. Chief Risk Officer

- A Foreign Bank or its IHC must appoint a U.S. chief risk officer (CRO) with experience in identifying, assessing and managing risk exposures of large, complex financial firms.
 - The Federal Reserve expects a Foreign Bank to be able to demonstrate that the U.S. CRO's experience is relevant to the particular risks facing it and commensurate with its structure, risk profile, complexity, activities and size.
- **Responsibilities:** The U.S. CRO is responsible for:
 - Overseeing the measurement, aggregation and monitoring of risks undertaken by the combined U.S. operations;
 - Overseeing the implementation of and ongoing compliance with the risk management policies and procedures for the combined U.S. operations and the development and implementation of related processes and systems;
 - Overseeing the management of risks and risk controls within the parameters of the risk control framework for the combined U.S. operations, and the monitoring and testing of such risk controls;
 - Reporting risks and risk management deficiencies of the combined U.S. operations and resolving such risk management deficiencies in a timely manner; and
 - Carrying out certain liquidity risk management responsibilities. See [page 54](#).
- **Reporting:** The U.S. CRO must:
 - Report directly to the U.S. risk committee and the Foreign Bank's global CRO, unless the Federal Reserve approves an alternative structure;
 - Regularly provide information to the U.S. risk committee, global CRO and the Federal Reserve regarding the nature of and changes to material risks undertaken by the combined U.S. operations, including risk management deficiencies and emerging risks, and how such risks relate to the Foreign Bank's global operations; and
 - Meet regularly and as needed with the Federal Reserve to assess compliance with the EPS final rule's risk management requirements.

U.S. Chief Risk Officer *(cont.)*

- **Single Point of Contact:** The U.S. CRO must serve as a single point of contact that is required to oversee risk management within the combined U.S. operations.
 - According to the Federal Reserve, such a structure ensures accountability and facilitates communication between the Foreign Bank and U.S. supervisors.
- **No Other Roles within Foreign Bank:** According to the Federal Reserve, in order to ensure that the U.S. CRO is primarily focused on the risk management oversight of the combined U.S. operations, the U.S. CRO should not fulfill other roles within the Foreign Bank.
 - *E.g.*, the U.S. CRO should not also serve as the Foreign Bank's global CRO.
 - This is to prevent the CRO's risk oversight function from being compromised by devoting attention to other matters within the Foreign Bank.
- **Location:** The U.S. CRO must be employed by and located in the Foreign Bank's U.S. branch/agency, IHC or other U.S. subsidiary.
- **Compensation:** The U.S. CRO must receive compensation and other incentives consistent with providing an objective assessment of the risks taken by the combined U.S. operations.

IHC Board and Senior Management Responsibilities for Capital Planning and Dodd-Frank Stress Testing

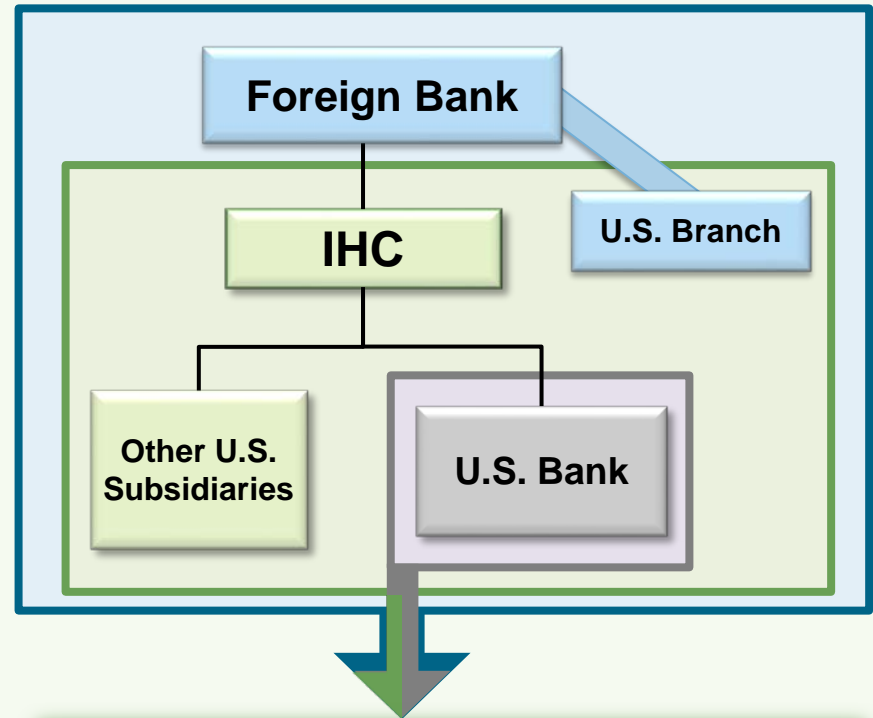
- **Capital Planning:** An IHC's board of directors and senior management have primary responsibility for developing, implementing and monitoring its capital planning strategies and internal capital adequacy process.
 - Includes periodic review of capital goals, assessment of the appropriateness of adverse scenarios considered in capital planning and regular review of any limitations and uncertainties in the process.
 - At least annually, the IHC's board of directors (or a designated committee) must:
 - Review the robustness of the IHC's process for assessing capital adequacy and ensure that any deficiencies are appropriately remedied; and
 - Approve the IHC's capital plan and any proposals for planned capital actions.
- **Dodd-Frank Stress Testing:** An IHC's board of directors (or a designated committee) must review and approve policies and procedures relating to its stress testing processes as frequently as economic conditions or the IHC's condition warrant, but no less than annually.
 - The IHC's board and senior management must consider the results of Dodd-Frank stress tests:
 - As part of its capital plan and capital planning processes, assessment of capital adequacy and risk management practices;
 - When assessing IHC's exposures, concentrations and risk positions; and
 - In the development or implementation of any plans of the IHC for recovery or resolution.

Liquidity Risk Management Responsibilities

- **U.S. Risk Committee:** The EPS final rule's qualitative liquidity framework imposes liquidity risk management responsibilities on the U.S. risk committee (or a subcommittee thereof) with respect to, among other things:
 - Liquidity risk tolerance of the Foreign Bank's combined U.S. operations;
 - Contingency funding plan for the combined U.S. operations; and
 - Receiving reports from the independent review function regarding material liquidity risk management issues.
- **U.S. CRO:** The qualitative liquidity framework imposes liquidity risk management responsibilities on the U.S. CRO with respect to, among other things:
 - Reviewing liquidity risk management strategies and policies and procedures established by the senior management of the combined U.S. operations;
 - Whether the combined U.S. operations are operating in accordance with the established liquidity risk tolerance;
 - Liquidity risks of business lines and products offered, managed or sold through the combined U.S. operations;
 - Liquidity risk limits for the combined U.S. operations; and
 - Cash flow projections, liquidity stress testing and liquidity buffers for the combined U.S. operations.

Interaction Among Different Risk Governance Frameworks

- A Foreign Bank will need to consider the interaction among:
 - The risk governance framework required by the EPS final rule for Foreign Banks and IHCs;
 - Risk governance expectations or guidelines applicable to any U.S. depository institution subsidiaries (e.g., the OCC's proposed risk governance guidelines); and
 - Home country risk governance requirements.



Integration: A Foreign Bank's Dodd-Frank risk governance framework should be integrated with its U.S. bank subsidiary's risk governance framework and home country risk governance requirements

Other U.S. Prudential Regulatory Developments Relevant for IHCs

Already Finalized	To Be Finalized	To Be Proposed
<ul style="list-style-type: none"> ▪ U.S. Basel III capital rules ▪ Capital planning and CCAR ▪ Dodd-Frank supervisory and company-run stress tests ▪ Qualitative liquidity standards ▪ Risk management standards 	<ul style="list-style-type: none"> ▪ Leverage capital surcharge for U.S. G-SIBs ▪ Single counterparty credit limits ▪ U.S. Basel III liquidity coverage ratio ▪ Early remediation framework ▪ Risk governance standards for large depository institutions 	<ul style="list-style-type: none"> ▪ Risk-based capital surcharge for U.S. G-SIBs ▪ Minimum long-term debt requirement ▪ U.S. Basel III net stable funding ratio ▪ Measures to address certain risks related to short-term wholesale funding ▪ Additional Pillar 3 disclosure requirements ▪ Rules to implement Basel Committee's on-going revisions to the Basel capital framework, including: <ul style="list-style-type: none"> ▪ Revisions to Basel III leverage ratio ▪ Fundamental review of trading book capital rules ▪ Non-internal-model-based method (SA-CCR) for calculating derivatives exposures ▪ Exposures to central counterparties ▪ Equity exposures to investment funds ▪ Securitization exposures ▪ Review of standardized approach for credit risk and operational risk

Bottom line: More prudential standards to come in 2014 and beyond

Appendix: A Closer Look at U.S. Basel III Issues for IHCs

U.S. Basel III vs. Basel Committee's Basel III Framework

- U.S. Basel III differs from the Basel Committee's Basel III framework and the Basel III regimes in other jurisdictions.
- These differences can give rise to business, operational, systems and compliance challenges for IHCs and Foreign Banks.

Topic	U.S. Basel III	Basel Committee's Basel III Framework
Additional Tier 1 capital eligibility criteria	<ul style="list-style-type: none"> Only instruments classified as equity under U.S. GAAP may qualify as Additional Tier 1 capital This would generally prevent contingent capital instruments, which are typically classified as liabilities, from qualifying as Additional Tier 1 capital 	<ul style="list-style-type: none"> Instruments classified as liabilities for accounting purposes can be included in Additional Tier 1 capital if they have a principal loss absorption feature
Reliance on external credit ratings	<ul style="list-style-type: none"> Dodd-Frank Act prohibits references to external credit ratings in federal regulations U.S. Basel III standardized approach uses non-ratings-based alternatives to determine standardized risk weights 	<ul style="list-style-type: none"> Standardized approach relies extensively on external credit ratings Basel Committee may review such reliance
Derivatives exposures	<ul style="list-style-type: none"> U.S. Basel III standardized approach does not permit use of the internal models methodology (IMM) to determine derivatives exposures 	<ul style="list-style-type: none"> The standardized approach permits use of IMM, subject to supervisory approval Basel Committee has established a non-internal-model-based standardized approach for calculating counterparty credit risk exposure arising from derivatives (SA-CCR). Davis Polk summary here.

U.S. Basel III vs. Basel Committee's Basel III Framework

(cont.)

Topic	U.S. Basel III	Basel Committee's Basel III Framework
Securities financing transactions	<ul style="list-style-type: none"> U.S. Basel III standardized approach does not permit use of the simple value-at-risk (VaR) approach 	<ul style="list-style-type: none"> Standardized approach permits use of the simple VaR approach, subject to supervisory approval
Securitization exposures	<ul style="list-style-type: none"> Dodd-Frank Act prohibits references to external credit ratings in federal regulations U.S. Basel III removes ratings-based approach from hierarchy of approaches for calculating RWAs for securitization 	<ul style="list-style-type: none"> Permits use of the ratings-based approach Basel Committee has proposed significant changes to the securitization framework (related Davis Polk materials here)
Operational risk capital charge	<ul style="list-style-type: none"> No specific operational risk capital charge under the U.S. Basel III standardized approach 	<ul style="list-style-type: none"> Contains 3 methods for calculating operational risk capital charge: <ol style="list-style-type: none"> (1) the Basic Indicator Approach; (2) the Standardized Approach; and (3) the Advanced Measurement Approaches (AMA)

Issuing U.S. Basel III-Compliant Capital Instruments from IHC

- Capital instruments issued by the IHC to **(1)** its parent company or **(2)** third-party investors must meet the eligibility criteria under U.S. Basel III.
 - Keepwell agreements, senior debt or parent guarantees do **not** qualify as regulatory capital under U.S. Basel III.
- Important differences may exist between U.S. and home country eligibility criteria for regulatory capital instruments. *E.g.*, U.S. Basel III:
 - Provides that only instruments classified as **equity under U.S. GAAP** may qualify as Additional Tier 1 capital; and
 - Permits Additional Tier 1 capital instruments to have certain dividend stoppers.

U.S. Basel III Capital Instruments

Common Equity Tier 1 Capital

- Common stock (plus related surplus) and retained earnings
- Qualifying minority interests (issued by consolidated depository institution or foreign bank subsidiaries)

Additional Tier 1 Capital

- Non-cumulative perpetual preferred stock
- Qualifying minority interests

Tier 2 Capital

- Subordinated debt
- Qualifying minority interests

Issuing U.S. Basel III-Compliant Capital Instruments from IHC *(cont.)*

■ Home Country Basel III Minority Interest

Rules: Home country Basel III rules may place qualitative and quantitative limits on the ability of a Foreign Bank to count minority interests in the IHC towards the Foreign Bank's consolidated regulatory capital.

- The amount of an IHC's surplus capital that is attributable to third-party investors can be large because U.S. leverage ratio requirements, Dodd-Frank stress testing and capital planning effectively require IHCs to maintain a large surplus.

U.S. Basel III Capital Instruments

Common Equity Tier 1 Capital

- Common stock (plus related surplus) and retained earnings
- Qualifying minority interests (issued by consolidated depository institution or foreign bank subsidiaries)

Additional Tier 1 Capital

- Non-cumulative perpetual preferred stock
- Qualifying minority interests

Tier 2 Capital

- Subordinated debt
- Qualifying minority interests

Overview of U.S. Basel III Eligibility Criteria for Regulatory Capital Instruments

Common Equity Tier 1	Additional Tier 1	Tier 2
<ul style="list-style-type: none"> ▪ Paid-in amount is classified as equity under U.S. GAAP ▪ Represents most subordinated claim in a receivership, insolvency, liquidation or similar proceeding of IHC ▪ Entitles holder to a proportional claim on IHC's residual assets after all senior claims have been satisfied ▪ No maturity date; can only be redeemed with prior Federal Reserve approval and does not create an incentive to redeem ▪ Cash dividend payments are paid out of IHC's net income, retained earnings or surplus related to common stock ▪ IHC has full dividend discretion ▪ Dividend payments and other distributions may be paid only after all legal and contractual obligations of IHC have been satisfied ▪ Not secured or guaranteed by IHC or an affiliate thereof 	<ul style="list-style-type: none"> ▪ Paid-in amount is classified as equity under U.S. GAAP ▪ Subordinated to IHC's general creditors and subordinated debt holders ▪ No maturity date and no dividend step-up or any other feature that creates an incentive to redeem ▪ Instrument may be redeemed by IHC <u>only</u> after a minimum of 5 years following issuance unless there is a regulatory capital event, tax event or investment company event ▪ Redemption requires Federal Reserve approval ▪ IHC has full dividend discretion – dividend stopper with respect to common stock and <i>pari passu</i> instruments is permitted ▪ No credit-sensitive feature ▪ No features that limit or discourage additional issuance of capital ▪ Not secured or guaranteed by IHC or an affiliate thereof ▪ Additional requirements apply if instrument is <u>not</u> issued by IHC or an operating subsidiary thereof ▪ Additional disclosure requirements apply if issued by an IHC that has ≥ \$250 billion in total assets or ≥ \$10 billion of on-balance sheet foreign exposures 	<ul style="list-style-type: none"> ▪ Subordinated to IHC's general creditors ▪ Minimum original maturity of ≥ 5 years. At the beginning of each of the last 5 years of instrument's life, amount eligible for inclusion in Tier 2 capital is reduced by 20% of the original amount ▪ No feature that creates an incentive to redeem ▪ Instrument may be redeemed by IHC <u>only</u> after a minimum of 5 years following issuance unless there is a regulatory capital event, tax event or investment company event ▪ Redemption requires Federal Reserve approval ▪ Holder of instrument must have no contractual right to accelerate payment of principal or interest <u>except</u> in the event of a receivership, insolvency, liquidation or similar proceeding of IHC ▪ No credit-sensitive feature ▪ Not secured or guaranteed by IHC or an affiliate thereof ▪ Additional requirements apply if instrument is <u>not</u> issued by IHC or an operating subsidiary thereof ▪ Additional disclosure requirements apply if issued by an IHC that has ≥ \$250 billion in total assets or ≥ \$10 billion of on-balance sheet foreign exposures

Balancing Risk-Based Capital, Leverage Capital, Liquidity and Funding Requirements

The following comparison chart illustrates the different incentives and burdens created by the U.S. risk-based capital, leverage capital and liquidity requirements applicable to IHCs.

Type of asset or exposure	U.S. Basel III standardized approach	U.S. leverage ratio (Tier 1 capital to average on-balance sheet assets)	Basel III leverage ratio (based on Basel Committee's Jan. 2014 revisions)	U.S. liquidity buffer requirement for IHC	U.S. Basel III LCR proposal (Oct. 2013)
Vault cash	0% risk weight	Treated the same as any other asset	Treated the same as any other asset	Automatically considered a highly liquid asset	Not high-quality liquid asset (HQLA)
Securities issued or guaranteed by the U.S. government	0% risk weight	Treated the same as any other asset	Treated the same as any other asset	Automatically considered a highly liquid asset	Level 1 HQLA
Securities issued or guaranteed by non-U.S. sovereigns	0% risk weight for OECD member countries	Treated the same as any other asset	Treated the same as any other asset	To qualify as a highly liquid asset, must demonstrate liquidity characteristics to Federal Reserve	OECD securities may qualify as Level 1 HQLA
Securities issued or guaranteed by the U.S. GSEs (e.g., Fannie Mae and Freddie Mac)	20% risk weight	Treated the same as any other asset	Treated the same as any other asset	Automatically considered a highly liquid asset	May qualify as Level 2A HQLA, subject to cap and haircut

Related Resources: Davis Polk's: **(1)** U.S. Basel III standardized risk weights tool (available [here](#)); **(2)** visual memo on Basel Committee's revised Basel III leverage ratio (available [here](#)); **(3)** visual memo and calculator on U.S. liquidity buffer for IHCs (available [here](#)); and **(4)** visual memo on U.S. Basel III LCR proposal (available [here](#)).

Balancing Risk-Based Capital, Leverage Capital, Liquidity and Funding Requirements *(cont.)*

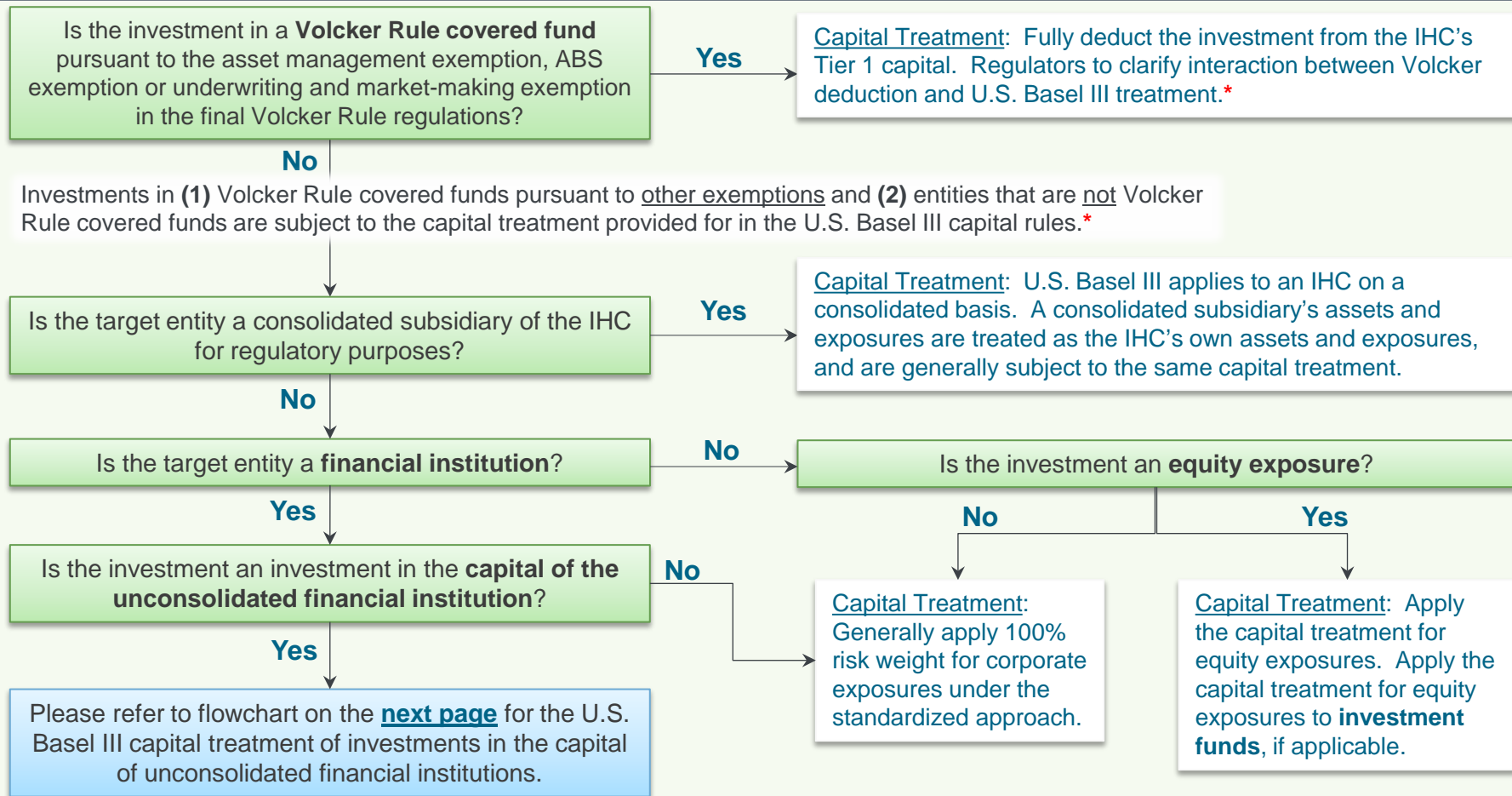
Type of asset or exposure	U.S. Basel III standardized approach	U.S. leverage ratio (Tier 1 capital to average on-balance sheet assets)	Basel III leverage ratio (based on Basel Committee's Jan. 2014 revisions)	U.S. liquidity buffer requirement for IHC	U.S. Basel III LCR proposal (Oct. 2013)
General corporate debt securities or loans	100% risk weight	Treated the same as any other asset	Treated the same as any other asset	To qualify as a highly liquid asset, must demonstrate liquidity characteristics to Federal Reserve	May qualify as Level 2B HQLA, subject to cap and haircut
Guarantees, commitments and other contingent items	Apply credit conversion factor (ranging from 0% to 100%) and then apply counterparty risk weight	Only on-balance sheet portion taken into account	Multiply notional amount by credit conversion factors ranging from 10% to 100%	Taken into account in cash flow projections and internal liquidity stress tests, which inform size of U.S. liquidity buffer	Taken into account in prescribed cash flow calculations
OTC derivatives	Apply standardized counterparty risk weight to exposure amount determined using current exposure method (CEM) and collateral haircut approach	Only on-balance sheet portion taken into account	Both on- and off-balance sheet portions taken into account Limited recognition of netting and certain cash variation margin	Taken into account in cash flow projections and internal liquidity stress tests, which inform size of U.S. liquidity buffer	Taken into account in prescribed cash flow calculations

Balancing Risk-Based Capital, Leverage Capital, Liquidity and Funding Requirements *(cont.)*

Type of asset or exposure	U.S. Basel III standardized approach	U.S. leverage ratio (Tier 1 capital to average on-balance sheet assets)	Basel III leverage ratio (based on Basel Committee's Jan. 2014 revisions)	U.S. liquidity buffer requirement for IHC	U.S. Basel III LCR proposal (Oct. 2013)
Centrally cleared derivatives	Apply 2% or 4% risk weight to exposure amount determined using modified CEM and collateral haircut approach	Only on-balance sheet portion taken into account	Both on- and off-balance sheet portions taken into account CCP-facing leg in a client clearing arrangement may be excluded under certain circumstances	Taken into account in cash flow projections and internal liquidity stress tests, which inform size of U.S. liquidity buffer	Taken into account in prescribed cash flow calculations
Securities financing transactions (SFTs)	Apply standardized counterparty risk weight to exposure amount determined using collateral haircut approach	Only on-balance sheet portion taken into account	Both on- and off-balance sheet portions taken into account SFT cash payables and cash receivables with same counterparty may be netted under certain circumstances	Taken into account in cash flow projections and internal liquidity stress tests, which inform size of U.S. liquidity buffer	Taken into account in prescribed cash flow calculations

U.S. Capital Treatment of IHC's Investments in Consolidated and Unconsolidated Entities

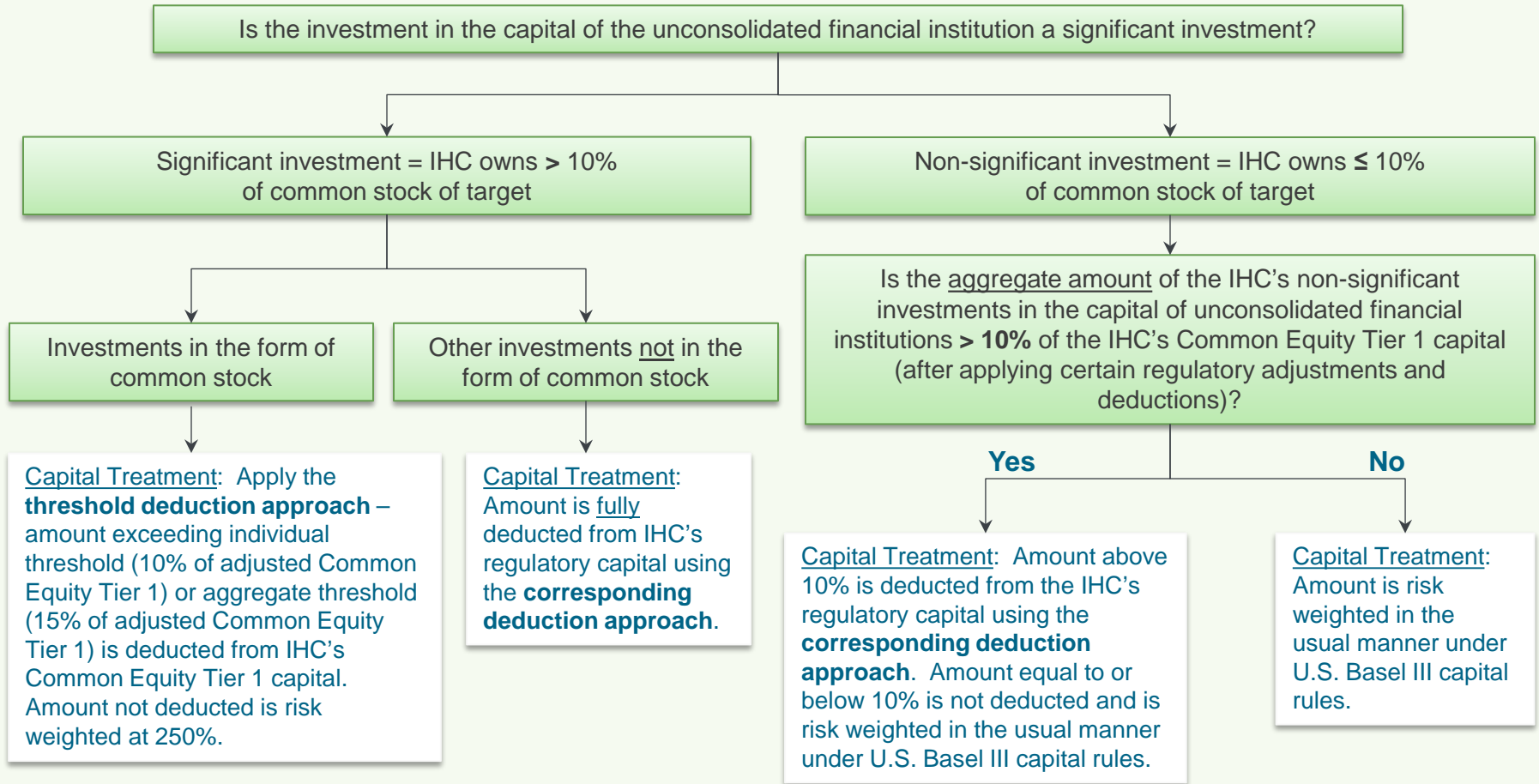
Terms in **bold** are defined on [pages 68-71](#). Flowchart assumes U.S. Basel III has fully phased in and Volcker Rule conformance period has ended.



* The U.S. banking agencies recognize that U.S. Basel III imposes risk weights and deductions that “do not correspond” to the deduction for covered fund investments imposed by the Volcker Rule. They intend to review the interaction between the capital requirements in the final Volcker Rule regulations and U.S. Basel III and expect to propose steps to reconcile the two rules.

U.S. Basel III Treatment of IHC's Investments in the Capital of Unconsolidated Financial Institutions


Terms in **bold** are defined on [pages 68-71](#). Flowchart assumes U.S. Basel III has fully phased in.



U.S. Capital Treatment of IHC's Investments in Entities: Key Definitions

Term	Definition
Volcker Rule covered fund	<ul style="list-style-type: none"> ▪ An entity that falls within the definition of “covered fund” in the final Volcker Rule regulations. <ul style="list-style-type: none"> ▪ Davis Polk’s flowcharts on the covered funds portion of the final Volcker Rule regulations are available here. ▪ Tier 1 Capital Deduction: A banking entity’s investments in Volcker Rule covered funds pursuant to the asset management exemption, ABS exemption or underwriting and market-making exemption in the final Volcker Rule regulations must be deducted from the banking entity’s Tier 1 capital. <ul style="list-style-type: none"> ▪ The amount of the investment (<i>i.e.</i>, amount that must be deducted) is generally measured as the greater of: <ul style="list-style-type: none"> ▪ Historical cost basis plus any earnings received; and ▪ Fair market value, if the banking entity accounts for the profits (or losses) of the investment in its financial statements. ▪ Certain aspects of the Volcker capital deduction remain unclear, <i>e.g.</i>: <ul style="list-style-type: none"> ▪ Measure of Tier 1 capital from which deduction is made ▪ Definition of “earnings received” ▪ Foreign Banks: The preamble to the final Volcker Rule regulations clarified that a foreign banking entity that makes a Volcker Rule covered fund investment in the United States, either directly or through a U.S. branch or agency, will <u>not</u> be required to deduct the investment from the foreign bank’s Tier 1 capital calculated under applicable home country standards. <ul style="list-style-type: none"> ▪ However, any U.S. subsidiary of a foreign banking entity that is required to calculate Tier 1 capital under U.S. capital regulations (<i>e.g.</i>, a U.S. IDI, U.S. BHC or IHC) must deduct the aggregate value of investment held through that subsidiary from its Tier 1 capital. ▪ The U.S. banking agencies stated that they may revisit this approach in light of the IHC requirement. The EPS final rule does not address the interaction between U.S. Basel III and the Volcker capital deduction for IHCs.

U.S. Capital Treatment of IHC's Investments in Entities: Key Definitions *(cont.)*

Term	Definition
Financial institution 	<ul style="list-style-type: none"> ▪ BHC, SLHC, nonbank SIFI, depository institution, foreign bank, credit union, industrial loan company, industrial bank, insurance company, securities holding company, SEC-registered broker-dealer, futures commission merchant, swap dealer, security-based swap dealer, designated financial market utility. ▪ Any non-U.S. entity that is supervised and regulated in a manner similar to the entities described above. ▪ Any other company of which the IHC owns (A) an investment in GAAP equity instruments of the company with an adjusted carrying value or exposure amount \geq \$10 million; or (B) >10% of the company's issued and outstanding common shares (or similar equity interest) which is "predominantly engaged" (85% or more of consolidated annual gross revenues or consolidated total assets for either of two most recent calendar quarters) in any of the following activities: <ul style="list-style-type: none"> ▪ Lending money, securities or other financial instruments, including servicing loans; ▪ Insuring, guaranteeing, indemnifying against loss, harm, damage, illness, disability, or death, or issuing annuities; ▪ Underwriting, dealing in, making a market in, or investing as principal in securities or other financial instruments; or ▪ Asset management activities (not including investment or financial advisory activities). ▪ Any other company that the Federal Reserve determines is a financial institution based on activities similar in scope, nature or operation to the entities described above. <p>Exclusions</p> <ul style="list-style-type: none"> ▪ GSEs, small business investment companies, community development financial institutions, entities the investment in which would qualify as a community development investment, employee benefit plans. ▪ Entities registered with the SEC under the Investment Company Act of 1940 or foreign equivalents. ▪ Investment or financial advisers (whether they provide discretionary or non-discretionary advisory services).

U.S. Capital Treatment of IHC's Investments in Entities: Key Definitions *(cont.)*

Term	Definition
Capital of an unconsolidated financial institution	<ul style="list-style-type: none"> ▪ An investment in the capital of an unconsolidated financial institution means a net long position: <ul style="list-style-type: none"> ▪ In an instrument that is recognized as capital for regulatory purposes by the primary supervisor of an unconsolidated regulated financial institution; or ▪ In an instrument that is part of the GAAP equity of an unconsolidated unregulated financial institution. ▪ An investment in the capital of an unconsolidated financial institution includes direct, indirect and synthetic exposures to such instruments, but excludes underwriting positions held by the IHC for 5 business days or less. <ul style="list-style-type: none"> ▪ Indirect exposure means an exposure that arises from the IHC's investment in an investment fund which holds investment in the capital of an unconsolidated financial institution. ▪ A synthetic exposure results from an IHC's investment in an instrument where the value of such instrument is linked to the value of a capital instrument of an unconsolidated financial institution. ▪ Where an IHC has an investment in an unconsolidated financial institution (Institution A) and Institution A has an investment in another unconsolidated financial institution (Institution B), the IHC would <u>not</u> be deemed to have an indirect investment in Institution B because its investment in Institution A is already subject to capital thresholds and deductions. ▪ Net long position = gross long position in the underlying instrument (including trading book positions subject to the U.S. market risk capital rule) net of short positions in the same instrument where the maturity of the short position either matches the maturity of the long position or has a residual maturity of at least one year. Special maturity matching rules apply to positions that are reported as trading assets or trading liabilities.
Investment fund	<ul style="list-style-type: none"> ▪ A company (corporation, partnership, LLC, business trust, SPE, association or similar organization): <ol style="list-style-type: none"> (1) where all or substantially all of the assets of the company are financial assets; <u>and</u> (2) that has no material liabilities.*

* The "no material liabilities" aspect of the U.S. Basel III definition of "investment fund" may change in the future if the U.S. implements the Basel Committee's December 2013 revisions to the capital treatment for equity exposures to investment funds, which take into account a fund's leverage. See related Davis Polk materials [here](#).

U.S. Capital Treatment of IHC's Investments in Entities: Key Definitions *(cont.)*

Term	Definition
Equity exposure	<ul style="list-style-type: none"> ▪ An equity exposure includes, among other things, a security or instrument (whether voting or non-voting) that represents a direct or an indirect ownership interest in, and is a residual claim on, the assets and income of an unconsolidated company, provided that the ownership interest is not a securitization exposure.
Corresponding deduction approach	<ul style="list-style-type: none"> ▪ Under the corresponding deduction approach, an IHC must make deductions from the component of capital (<i>i.e.</i>, Common Equity Tier 1, Additional Tier 1, Tier 2) for which the underlying instrument would qualify if it were issued by the IHC itself.
Threshold deduction approach	<ul style="list-style-type: none"> ▪ The threshold deduction treatment provides for limited recognition as Common Equity Tier 1 capital of the following 3 items, subject to a 10% individual limit and a 15% aggregate limit based on the IHC's Common Equity Tier 1 capital (after applying certain regulatory adjustments): <ul style="list-style-type: none"> ▪ DTAs arising from temporary differences that could not be realized through net operating loss carrybacks, net of any related valuation allowances and net of DTLs; ▪ MSAs net of associated DTLs; and ▪ Significant investments in unconsolidated financial institutions in the form of common stock, net of associated DTLs. ▪ If an item exceeds the 10% individual limit, the excess is fully deducted from Common Equity Tier 1. If the 3 items combined (excluding amounts deducted after applying the individual 10% limit) exceeds the 15% aggregate limit, the excess is deducted from Common Equity Tier 1. ▪ The amount of the 3 items not deducted from Common Equity Tier 1 is risk weighted at 250%. ▪ DTAs that arise from temporary differences that an IHC may realize through net operating loss carrybacks are not subject to the deduction thresholds and are subject to a 100% risk weight.

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