

## **Randal K Quarles: The Federal Reserve's regulatory agenda for foreign banking organizations – what lies ahead for enhanced prudential standards and the Volcker rule**

Speech by Mr Randal K Quarles, Vice Chairman for Supervision of the Board of Governors of the Federal Reserve System, at the Institute of International Bankers Annual Washington Conference, Washington DC, 5 March 2018.

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Thank you very much to the Institute of International Bankers for inviting me to speak here today. Among my first areas of focus when I was a very young lawyer starting out in my career well over 30 years ago was providing advice to foreign banks and financial firms operating in the United States, and I learned then just how integral, essential, and welcome a part your firms play in our domestic financial sector. Non-U.S. firms serve as an important source of credit to U.S. households and businesses and contribute materially to the strength and liquidity of U.S. financial markets, so it is critical—not just as a matter of fairness but as a matter of our domestic interest—that we as regulators ensure that they operate in a fair and open financial services sector. I view that as an important part of my job.

So today I want to share my perspective on the appropriate regulatory environment for foreign banks operating in the United States, as well as some thoughts on specific elements of that regime. Before doing that though, we should take stock of the pre-crisis history of foreign firms operating in the United States.

First, the financial crisis revealed that in times of stress, international banking firms with large and complex local operations can contribute to instability in those local markets and can require extraordinary support from local authorities. Second, a number of foreign financial institutions expanded the size and complexity of their U.S. operations at a rousing pace and scale prior to the crisis, and we did not adjust our local regulatory and supervisory approaches to address the increased risk associated with this expansion. As a result, the difficulties faced by the U.S. operations of non-U.S. banks during the crisis mirrored that of their similarly sized domestic counterparts, underscoring a need for increased resiliency of both domestic firms and the U.S. operations of foreign banks.

To bolster that resiliency, the environment for foreign banks operating in the United States underwent a number of changes. While there are important differences, those changes for foreign firms broadly parallel many of the changes instituted for domestic firms. My Federal Reserve colleagues and I have termed these the core post-crisis regulatory reforms: capital, liquidity, stress testing, and resolution planning.<sup>1</sup> Of course, the obvious and most prominent difference for foreign firms—as attendees of this conference certainly know—was the introduction of the intermediate holding company (IHC) structure, to which the post-crisis regulatory reforms apply.

In my estimation, these reforms have gone a long way toward meeting our goal of a more resilient financial system. That said, we are now at a point—with ten years of experience in setting up and living with the body of post-crisis regulation—where it is both relevant and timely to examine the post-crisis reforms and identify what is working well and what can be improved. If none of the regulatory measures implemented up to now were capable of improvement, this would be the first project of this scale and complexity conducted that had been done exactly right the first pass through. If there was still work to be done after Hammurabi, there is probably still some work to be done now after Dodd and Frank. In particular, as I have said elsewhere, we should be looking to see where we can achieve our regulatory objectives in ways that maintain our measures' effectiveness, but improve their efficiency, transparency, and simplicity. As part of

that effort, we will consider additional tailoring and flexibility of our regulations in light of their impact on foreign banking organizations (FBOs) based on lessons learned over the past several years.

To illustrate how I am thinking about these issues, I want to focus in my remarks today on two specific regulatory examples. These are, of course, not an exhaustive list of work to be done in the regulation of FBOs, but they tend to be near the top of the feedback list from both the industry and supervisors. First, I will discuss the application of enhanced prudential standards to FBOs, including our flexibility in implementing certain aspects of these standards. I will also offer some initial thoughts on opportunities for further tailoring that regime for FBOs. Second is the Volcker rule. I will provide some of my initial thinking on how we might be able to improve the Volcker rule, both generally and in its application to FBOs in particular.

## **Enhanced Prudential Standards**

In implementing enhanced prudential standards for foreign banks with a large U.S. presence, we sought to ensure that firms hold sufficient local capital and liquidity—and have a risk management infrastructure—that is commensurate with the risks in their U.S. operations.<sup>2</sup> And in general, that approach is meeting many of the broad goals the Federal Reserve set out to achieve. Today, foreign banks with large U.S. operations are less fragmented, maintain local capital and liquidity buffers that align to the size and riskiness of their U.S. footprint, and operate on equal footing with their domestic counterparts.

Our current approach aligns with other jurisdictions that host a large and complex foreign bank presence. For example, the European subsidiaries of U.S. banking firms have long been subject to Basel-based standards imposed by the European Union and the United Kingdom as host regulators. In addition, European regulators are contemplating a holding company structure for the local operations of foreign banks to reduce fragmentation and ensure effective local supervision, similar in many ways to Federal Reserve rules.

In adopting the enhanced prudential standards, however, the Board has acknowledged both the uniqueness of FBOs—as the U.S. operations are a small part of a larger firm—and the diversity of foreign bank operations in the United States. The Board contemplated from the outset that circumstances may require application of the rule's requirements to be adjusted in light of an individual firm's structure or risk profile. The Board has exercised this authority in the past, and I want to stress that we will continue to provide flexibility where appropriate to accommodate these differences.

For instance, in implementing enhanced risk management standards, we have focused on outcomes—a strong control environment for foreign bank operations in the United States—while providing some flexibility in how those outcomes are achieved. We have allowed the global risk committee to serve as the risk committee for the U.S. operations rather than require the creation of a standalone committee. Further, for foreign banks with large U.S. branches but no IHC, the Board has acknowledged the challenges associated with the location of the risk committee. The Board has accordingly allowed risk committees at U.S. holding companies as well as managerial committees located in the United States, provided that the global board provided appropriate oversight.<sup>3</sup> We are committed to continuing this outcomes-focused approach and to refining it where needed.

Further, we recognize that effective stress testing regimes can take many different forms, specifically when interpreting the home-country stress testing requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Board has acknowledged, for example, that a foreign bank's internal capital adequacy assessment process (ICAAP) may meet the minimum standards, provided that the firm's ICAAP is on a consolidated basis and reviewed by the home country regulator.

In addition, while we believe that the IHC requirement serves a valuable role in ensuring consistency of regulation across U.S. operations of an FBO, the Board has reserved authority to approve multiple IHCs if circumstances warrant based on the FBO's activities, scope of operations, structure, home country regulatory framework, or similar considerations. For example, the Board's enhanced prudential standards rule contemplates allowing multiple IHCs in cases where home country legal requirements inhibit the combination of certain bank and nonbank operations.

In practice, and in several instances, the Board has permitted a foreign bank to maintain certain U.S. subsidiaries outside of its IHC, so long as the foreign bank did not have practical control over that subsidiary.<sup>4</sup> In addition, the Board recently approved an application by a foreign bank for a second IHC. Part of our rationale for approving the dual IHC structure was the enhancement of recovery and resolution options of the global firm. In granting the exception, the Board applied enhanced prudential standards to the two IHCs in the same manner that would apply to a single IHC, to maintain a level playing field and align incentives for the safe and sound operation of both IHCs. This approach allows us more flexibility in addressing firm-specific structure needs, while maintaining the goals of the enhanced prudential standards more generally. We will continue to consider future applications based on the merits of the case.

Finally, to the extent that foreign banks have decided to reduce the scope of their U.S. operations to reduce the application of some of the enhanced prudential standards, the Board has accommodated requests for extended transition periods, so as to avoid unnecessary investments in infrastructure that ultimately would not be required by regulation.

We are committed to tailoring our regulatory and supervisory regimes to align with the risk posed by financial institutions to the U.S. financial system. We are also continuing to evaluate whether our rules are sensitive to changes in the risk profile of banking organizations. We want our rules both to increase in stringency as firms' risks grow and, just as important, to decrease in stringency when firms have actively reduced their risk profiles.

## **The Volcker Rule**

Let me turn now to the Volcker rule. Not to put too fine a point on it, but I believe the regulation implementing the Volcker rule is an example of a complex regulation that is not working well.

The fundamental premise of the Volcker rule is simple: banks with access to the federal safety net—Federal Deposit Insurance Corporation insurance and the Federal Reserve discount window—should not engage in risky, speculative trading for their own account. Whatever one's view of this basic premise, it is the law of the land. Taking that premise as a given, we have to ask how to improve the framework of the implementing regulation to make it more workable and less burdensome in practice from both a compliance and supervisory perspective.

I think we all can agree that the implementing regulation is exceedingly complex. As one example of specifics, among many, the statute and implementing regulation's approach to defining "market making-related activities" rests on a number of complex requirements that are difficult or impossible to verify objectively in real time. As a result, banks spend far too much time and energy contemplating whether particular transactions or positions are consistent with the Volcker rule.

Some of you may quite sensibly be asking, "If the deficiencies of the regulation are so apparent, how did we get here?" Despite the best of intentions in crafting the regulations, no one seems to be happy with the complex rule we wound up with. This has a very positive consequence: I have heard nothing but support from all of my regulatory colleagues for the proposition that the regulation is overly complex and would benefit from streamlining and simplifying to improve its workability in practice.

We are actively working with our fellow regulators in seeking ways to further tailor and to reduce burden, particularly for firms that do not have large trading operations and do not engage in the sorts of activities that may give rise to proprietary trading. We also appreciate the broad extraterritorial impact of the rule in its current form for foreign banks' operations outside of the United States. To that end, we have, with the full cooperation of all five Volcker regulatory agencies, picked back up the process that was begun last fall to engage in a rulemaking process subject to the Administrative Procedures Act and develop a proposal for public comment that would make material changes to the Volcker rule regulations. In that process we will take account of our own experience with the regulations since implementation, and we also want to take account of the views of market participants and other interested parties with views on the Volcker rule, including what is working and what is not. We expect this process will proceed with dispatch.

We must also work within the confines of the statute. For example, a number of my current and former Federal Reserve Board colleagues have expressed support for Congress providing an exemption from the Volcker rule for community banks, which is something I also support.<sup>5</sup> Short of a statutory exemption, we can only do our best to mitigate burden on community banks that generally do not engage in the types of activities the Volcker rule was intended to cover.<sup>6</sup> Statutory changes likely would make our work of streamlining more straightforward and complete, but we have a fair bit that we can accomplish even absent such changes.

What are some of the improvements that we are thinking about that would be possible within the regulation itself? As an initial matter, it should be clearer and more transparent what is subject to the Volcker rule's implementing regulation and what is not. The definition of key terms like "proprietary trading" and "covered fund" should be as simple and clear as possible. It should not be a guessing game or require hours of legal analysis of complex banking and securities regulations to determine if a particular entity is a covered fund. It should not happen—although it *has* happened—that our supervised firms come to us and ask questions about whether a particular derivative trade is subject to the rule, and we cannot give them our own answer or a consistent answer across the five responsible agencies. Supervisors need to be able to provide clear and transparent guidance on what is covered by the Volcker rule and what is not. This would benefit not only the firms, but the supervisors at the agencies as well.

Again, a good example is the exemption for market making-related activities, which is one of the key exemptions from the prohibition on proprietary trading. The rule contains a gaggle of complex regulatory requirements, but the statute contains merely one—that the market making-related activities are designed not to exceed the reasonably expected near-term demands of clients, customers, or counterparties, otherwise known as RENT'D.<sup>7</sup> We are considering different ways to use a clearer test for RENT'D. We want banks to be able to engage in market making and provide liquidity to financial markets with less fasting and prayer about their compliance with the Volcker rule.

As I noted earlier, we also understand that the Volcker rule has had an extraterritorial impact on FBOs. With respect to foreign banks, there are at least a few places where we would like to revisit the application of the final rule based on concerns raised by market participants and others over the past four years of implementation.

In particular, there are certain foreign funds—funds that are organized outside the United States by foreign banks in foreign jurisdictions and offered solely to foreign investors—that are subject to the Volcker rule due to Bank Holding Company Act control principles. Last summer, the banking agencies, in consultation with the Securities and Exchange Commission and the Commodity Futures Trading Commission, issued guidance that effectively stayed enforcement of the Volcker rule to these foreign funds in light of the technical and complex issues they raise.<sup>8</sup> I expect we would continue this period of stay while we continue to consider these important issues.



The statute also contains exemptions for FBOs to allow foreign banks to continue trading and engaging in covered fund activities solely outside the United States. The regulation again has a complex series of requirements that a foreign bank must meet to make use of these exemptions. We have heard from a number of foreign banks that complying with these requirements is unworkable in practice, and we are considering ways to address this impracticality. One possibility that has been suggested by market participants is a simple approach that focuses on the risk of the booking location. Of course, we would have to consider whether this is possible in light of the language of the statute and principles of competitive equity, but the suggestion is illustrative of the possibility of a more workable approach.

As a final but no less important matter, we are considering broad revisions to the Volcker rule compliance regime. We would like Volcker rule compliance to be similar to compliance in other areas of our supervisory regime. As I noted earlier, we appreciate the broad extraterritorial impact of the rule in its current form on foreign banks' operations outside of the United States. Accordingly, we will be looking for ways to reduce the compliance burden of the Volcker rule for foreign banks with limited U.S. operations and small U.S. trading books.

## Conclusion

As I have described previously, the Federal Reserve is actively reviewing post-crisis financial reforms in an effort to better understand which reforms are working well and which ones can be improved to reduce regulatory burden and improve the efficiency, transparency, and simplicity of the regulatory framework without compromising a safe and sound financial system. In that effort, we recognize the importance of foreign banks to the U.S. economy and have a strong interest in ensuring our regulations are appropriately tailored to their U.S. footprint and risks to U.S. financial stability. Our goal is to maintain a regulatory framework that helps to ensure a strong and stable banking system in an efficient manner that does not result in excessively burdensome costs to the banking industry or the economy as a whole.

The areas I have discussed today are important components of the exercise of improving our regulations as they apply to FBOs, and are part of a larger overall agenda to critically evaluate and improve our regulations to promote financial stability while fostering the conditions for solid economic activity. Some of these exercises will require more effort and time than others, but each one of them is a high priority for us at the Federal Reserve. I look forward to hearing your views as we make progress toward these improvements.

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<sup>1</sup> See Randal K. Quarles, "[Early Observations on Improving the Effectiveness of Post-Crisis Regulation \(PDF\)](#)," (speech at the American Bar Association Banking Law Committee Annual Meeting, Washington, January 19, 2018).

<sup>2</sup> The U.S. intermediate holding company structure provided for consistent application of capital, liquidity, and other prudential requirements and consistent supervision across the U.S. subsidiary operations of an FBO. See 12 USC 5365; Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17,240 (March 27, 2014).

<sup>3</sup> See 12 CFR 252.155(a)(3) (requiring an FBO with U.S. branches and agencies and combined U.S. assets of \$50 billion or more to maintain its risk committee as a committee of the board of directors of its U.S. intermediate holding company (as applicable) or as a committee or the global board of directors (or equivalent thereof)); see also General Counsel opinion letters to Cooperatieve Rabobank U.A. and Sumitomo Mitsui Financial Group, Inc., each dated October 19, 2016, related to the risk committee requirement.

<sup>4</sup> For instance, if the subsidiary was wholly owned by a joint venture between the foreign bank and the third party.

<sup>5</sup> See, e.g., Jerome H. Powell, "[Regulation and Supervision of Community Banks](#)," (speech at the Annual Community Bankers Conference, New York, NY, May 14, 2015). ("I believe community banks should not face significant burdens from complying with these requirements, so I support raising the asset threshold for both the Volcker rule and incentive compensation rules, perhaps to \$10 billion. In the event where the actions of a

community bank might raise concerns in either of these areas, that could be addressed through our normal examination process.”); see also Daniel K. Tarullo, “[Departing Thoughts](#),” (speech at The Woodrow Wilson School, Princeton University, Princeton, NJ, April 4, 2017). (“The third problem, also in the statute, is that the Volcker rule applies to a much broader group of banks than is necessary to achieve its purpose. As I have said before, the concerns underlying the Volcker rule are simply not an issue at community banks.”)

- <sup>6</sup> See Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, “[The Volcker Rule: Community Bank Applicability \(PDF\)](#),” news release. December 10, 2013.
- <sup>7</sup> See 12 U.S.C. 1851(d)(1)(B); 12 CFR 248.4(b).
- <sup>8</sup> See Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, “[Statement regarding Treatment of Certain Foreign Funds under the Rules Implementing Section 13 of the Bank Holding Company Act \(PDF\)](#),” July 21, 2017.