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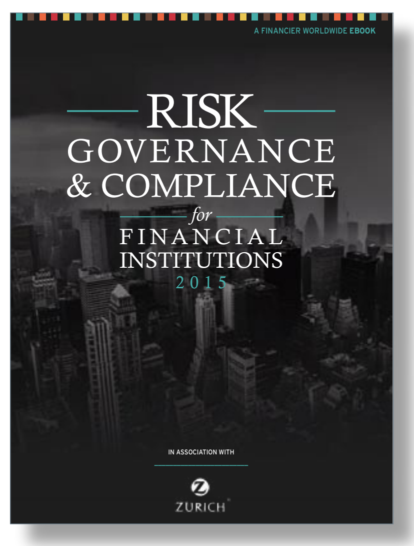

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THE NEW CORPORATE GOVERNANCE RULES FOR SIGNIFICANT FOREIGN BANKS OPERATING IN THE UNITED STATES

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In 2014, the Board of Governors of the Federal Reserve System (Federal Reserve) and the Office of the Comptroller of the Currency (OCC) finalised rules that will revolutionise the corporate governance structures of non-US banks with significant US operations. Although the most important of the Federal Reserve rules will be effective in 2016, the OCC rules will be effective for certain institutions this May, and, in any event, corporate governance at regulated banks is clearly a US supervisory priority. The new rules require the development of extensive internal governance frameworks and processes that must withstand regulatory scrutiny; as such, they will contribute to the trend of de facto subsidiarisation, or 'ring fencing', of US operations.

The new requirements flow out of the Dodd-Frank Act and the regulators' supervisory experience during the financial crisis. Prior to the financial crisis, although many non-US banks had established, in addition to US branch or agency operations, US bank and broker-dealer subsidiaries, there was not a one-size-fits-all approach to US corporate governance or organisational structure. As a result, just as a non-US bank could take a global approach to capital and liquidity regulation, it could take a global approach to governance, with business lines being structured on a global basis, and reporting lines not being required to give wholesale precedence to US oversight.

For non-US banks that are viewed as systemically significant, regulatory implementation of the Dodd-Frank Act will change this prior practice dramatically. Section 165 of the Dodd-Frank Act authorises the Federal Reserve to establish enhanced prudential standards for significant non-US banks with US operations: under this authority, the Federal Reserve has required, for the first time, all non-US banks with $50bn or more in US non-branch/agency assets to form an intermediate holding company (IHC) for their US operations and has imposed granular corporate governance requirements at the IHC level.

Governance in the US is thus being highly – and universally – centralised. Under the Federal Reserve rules, an IHC must be a US legal entity governed by a board operating in the same manner as other US corporations. The IHC board must have a risk committee, charged with approving and periodically reviewing the risk management framework and policies of the IHC; the IHC Risk Committee may also serve as the US risk committee that is required for the foreign bank's combined US operations (the IHC and all branches and agencies). The risk committee must include a director who is independent of the foreign bank and its affiliates, as well as a director who is experienced in managing the risk exposures of large complex financial firms. There must also be a designated chief risk officer for the US operations.

The IHC risk management framework must include policies and procedures establishing risk-management governance and risk control infrastructure, as well as processes and systems for monitoring compliance, identifying risk-management deficiencies, and establishing managerial and employee responsibility for risk management, including, significantly, through their compensation. The Section 165 rule also requires significant interaction between the non-US bank's IHC board and risk committee, especially on capital and liquidity risk management issues.

Acting on a parallel track, the OCC, which regulates all national banks, including those owned by non-US institutions, finalised new guidelines imposing 'Heightened Expectations' for enhanced risk governance, applicable to any national bank with $50bn or more in total assets. The guidelines require that a national bank subject to the guidelines include at least two directors on its board that are independent of management and the management of its parents under traditional independence standards, and they impose substantial duties on the bank's board of directors and risk committee. These obligations include the approval of a risk management framework of the bank; an IHC framework may be substituted only if the assets of the national bank comprise 95 percent or more of the assets of the IHC, although relevant aspects of the IHC framework may be borrowed. In addition, the bank board is required to approve a strategic plan developed by the bank's chief executive, and, at least annually, evaluate management's efforts to implement the strategic plan.

A significant national bank is also required to develop a risk appetite statement, to include qualitative and quantitative components, that articulates the bank's risk appetite and serves as the basis for the risk governance framework, with the quantitative limits incorporating sound stress testing processes and addressing risks to the bank's earnings, capital and liquidity. Like an IHC, a significant national bank must have a chief risk officer responsible for implementing the risk management framework who must report frequently to the bank board or its risk committee with respect to specified areas.

The prescriptive nature of these heightened governance standards has three principal implications. First, the required frameworks for the US operations of significant non-US banks will be far more formalised than before the financial crisis and will be subject to far more frequent review. The significance attributed to the US IHC Risk Committee in the final Section 165 rules, for example, will require that the risk committee have a formal charter and that it regularly receive specified reports from the chief risk officer and the IHC's independent risk management function. Because the Federal Reserve will look to the board of directors of the IHC for ensuring overall compliance with the enhanced prudential standards, IHC boards will need to mandate additional formalised reporting functions and delegate clearly to US senior management its responsibilities for business lines and the risks that those lines create. When an IHC has a national bank subsidiary, such frameworks and processes will be required to be replicated at the bank level as well, with an eye to ensuring the sound and prudent operation of the bank. When the same persons serve as independent directors of the IHC and a bank subsidiary, for example, the OCC believes that such directors should consider the safety and soundness of the bank in decisions made by the IHC that affect the bank's risk profile.

Second, because corporate governance expectations have now been formalised in specific regulations and guidelines, there are greater consequences if institutions fail to meet those expectations than when governance was subject to more principles-based regulation. Failure to live up to the letter of the Federal Reserve's Section 165 governance requirements, as well as their spirit, may lead to ratings downgrades and possible supervisory or enforcement action. Similarly, the OCC's Guidelines permit the OCC to require a national bank to submit a compliance plan to remedy failures to meet one or more of the heighted expectations contained in the OCC's Guidelines.

Finally, similar to the capital and liquidity requirements of the Federal Reserve's Section 165 rule, the rule's new governance requirements for US IHCs will increase the de facto subsidiarisation of the US operations of significant non-US banks, and, when a national bank is owned, this effect will be increased by the OCC's Guidelines. Just as the Federal Reserve is now requiring that non-US bank IHCs stand alone, independent from their non-US parent, as a capital and liquidity matter, so too IHCs will be required to stand alone as a corporate and risk governance matter, and the same is true for any national bank.

Home country management will obviously continue to decide the overall business objectives and strategy for operations outside the home country and how generally to allocate overall capital. But the effect of the new governance standards, reinforced by the greater consequences of failing to live up to them, is that US directors, senior line management, and senior risk management now very clearly 'own' US risk. Although IHCs and national bank subsidiaries are usually wholly-owned, and therefore, as a matter of US corporate law, will be managed in the best interests of the non-US bank and its shareholders, US boards and senior managers are now much more clearly responsible to US regulators for governance failings.

2015, therefore, is a very important year for the overall management and governance of the US operations of significant non-US banks. Developing a US corporate governance and risk oversight structure that meets the heightened governance expectations of the Federal Reserve and OCC is critical if such significant global players are to derive full benefit from their US operations. At the same time, however, directors and management for the US operations will have every incentive to focus on the US, and not globally, in carrying out their increased responsibilities.

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