FBO Tailoring Proposal Tightens Liquidity Requirements for IHCs

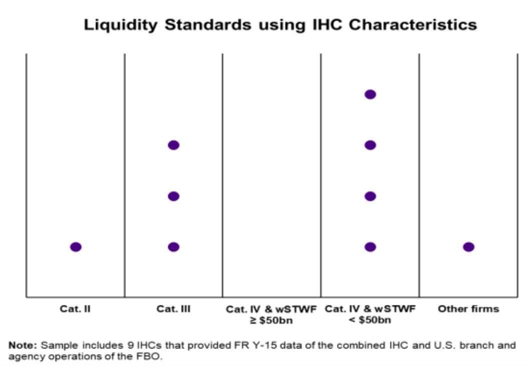
June 20, 2019

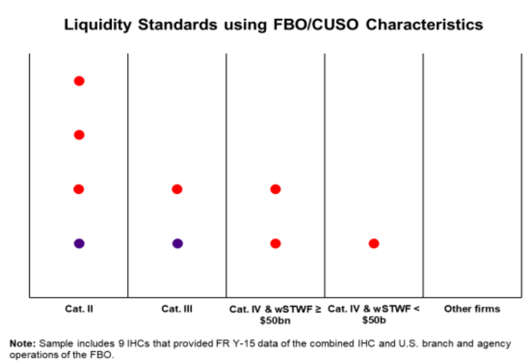
In April of this year, the agencies issued a proposal to tailor regulatory capital and liquidity standards to foreign banking organizations (FBOs) that have significant U.S. operations. This post shows that the proposal contains two components that artificially inflate the risk characteristics of an FBO's U.S. operations, resulting in overly stringent liquidity requirements imposed on the FBO's U.S. intermediate holding company (IHC).

- First, the proposal applies liquidity requirements to an IHC based on the characteristics of the FBO's combined IHC and U.S. branch and agency operations (CUSO). This post shows that by using the characteristics of the CUSO instead of the characteristics of the IHC, the proposal increases liquidity requirements for the majority of IHCs operating in the U.S.
- Second the proposal includes many intercompany transactions when calculating an FBO's risk-based indicators, something that is not done for domestic bank holding companies (BHCs) because those kinds of transactions are eliminated through consolidation. This post shows that including these intercompany transactions results in a meaningful increase in liquidity requirements for some IHCs, especially when those standards are imposed using the characteristics of the CUSO.

The fact that the FBO tailoring proposal results in increased liquidity requirements for IHCs is particularly surprising when one considers that similarly-sized domestic BHCs enjoy significant liquidity relief under the tailoring proposal for U.S. firms. This disparate treatment is even more surprising given other FBO attributes like the strong history of parental support, comprehensive and consolidated home country regulation (including liquidity requirements on all global operations), and (in many cases) specific additional financial support like internal TLAC. All of this matters because increased bank liquidity requirements can have important costs for the U.S. economy in terms of both reduced credit availability and less liquid capital markets.

PROBLEMATIC IMPACTS OF USING CUSO FOR IHC REQUIREMENTS



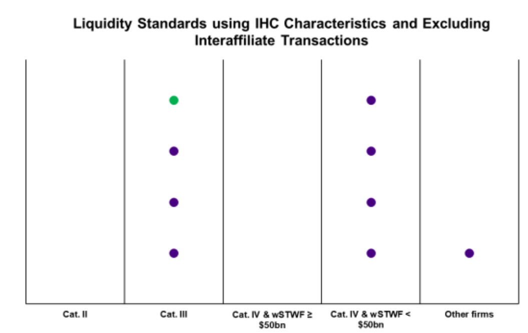


Determining the stringency of an IHC's liquidity requirements based on the characteristics of the FBO's CUSO is inappropriate because it results in liquidity requirements that are misaligned with the IHC's activities, organizational structure, business model and risk profile. To show the outsize impact of using CUSO, BPI undertook an analysis using data supplied by nine FBOs with IHCs. The figure on the left displays the nine IHCs in our sample across the various liquidity standards categories using the characteristics of the IHC only.[1] One IHC would be subject to Category II liquidity standards, which would include full daily LCR and NSFR requirements and the daily submission of the liquidity monitoring report (FR 2052a). Next, three IHCs would be subject to Category III liquidity standards, which would include reduced daily LCR and NSFR requirements and the monthly submission of the liquidity monitoring report. Four IHCs would be subject to Category IV liquidity standards, which would include monthly submission of the liquidity monitoring report. Moreover, IHCs with more than $50 billion in weighted short-term wholesale funding (wSTWF) would be subject to reduced monthly LCR and NSFR requirements, but none of the IHCs in our sample fall in this subcategory. Lastly, one IHC would be subject to the "Other firms" category and thereby exempted from liquidity requirements altogether.

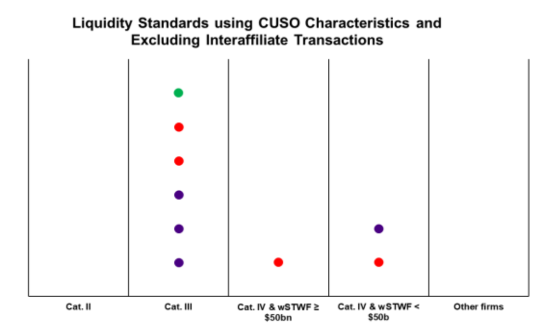
The figure on the right displays the application of liquidity standards based on the characteristics of the FBO's CUSO (i.e., on the basis of characteristics of entities and operations beyond those of the IHC itself), as advanced in the FBO proposal. The red dots represent the cases in which the liquidity standards applied to an IHC are more stringent using the characteristics of the CUSO. Thus, the proposal increases the liquidity requirements for 7 of the 9 IHCs included in our sample. As noted above, the use of CUSO characteristics to determine IHC liquidity requirements creates inappropriate outcomes because it is misaligned with the IHC's activities, organizational structure, business model and risk profile.

PROBLEMATIC IMPACTS OF INCLUDING INTERAFFILIATE TRANSACTIONS IN THE RISK-BASED INDICATORS

The proposal includes most intercompany transactions in the risk-based indicators, including claims on foreign affiliates in the cross-jurisdictional activity (CJA) indicator (except those secured by eligible financial collateral) as well as the nonbank asset indicator, and funding from non-U.S. affiliates in the wSTWF indicator. Excluding these kinds of intercompany transactions would be more consistent with the domestic tailoring proposal, which eliminates all transactions between a BHC and its consolidated subsidiaries.



Note: Sample includes 9 IHCs that provided FR Y-15 data of the combined IHC and U.S. branch and agency operations of the FBO. Excludes intercompany claims from cross-jurisdictional activity and nonbank assets and funding from affiliates from weighted short-term wholesale funding.



Note: Sample includes 9 IHCs that provided FR Y-15 data of the combined IHC and U.S. branch and agency operations of the FBO. Excludes intercompany claims from cross-jurisdictional activity and nonbank assets and funding from affiliates from weighted short-term wholesale funding.

The chart on the left displays the application of liquidity standards using IHC characteristics and excluding *all* intercompany claims from the CJA indicator and nonbank assets indicator as well as funding from non-U.S. affiliates from the wSTWF indicator. The color of the dots represents the change relative to the case in which the application of liquidity standards is based on the characteristics of the IHC *including* intercompany transactions. Overall, 8 IHCs would be subject to the same liquidity requirements (purple dots) and 1 IHC would be subject to less stringent liquidity requirements (green dot). Although most of the IHCs remain in the same category, the impact of excluding intercompany transactions is still important because those IHCs

[1] These measures include all intercompany transactions, except that, as provided for in the proposal, it excludes cross-jurisdictional claims on non-U.S. affiliates that are secured by eligible financial collateral.

would have a greater flexibility to adjust their activities in the U.S. without becoming subject to stricter liquidity requirements.

The chart on the right displays the application of liquidity standards using CUSO characteristics and excluding the same intercompany transactions as in the IHC panel. The color of the dots represents the change relative to the case in which the application of liquidity standards is based on the characteristics of the IHC *excluding* intercompany transactions. Overall, 4 IHCs would be subject to the same liquidity requirements (purple dots), 4 IHCs would be subject to tighter requirements (red dots) and 1 IHC would be subject to less stringent liquidity requirements (green dot). Thus, using CUSO assets and risk-based indicators would still yield more stringent liquidity requirements relative to using only the IHC characteristics. While not fully representing equal treatment with respect to domestic BHCs, excluding all intercompany transactions would partially account for some of the structural differences between FBOs' operations in the U.S. and domestic bank holding companies.

ECONOMIC COSTS OF IMPOSING INCREASED LIQUIDITY REQUIREMENTS

Liquidity regulations are costly because they require banks to hold more liquid assets, like Treasury bills or deposits at the Federal Reserve, and fewer illiquid assets, like loans to households and businesses as well as private securities. A compilation of the literature on the costs and benefits of liquidity requirements conducted by the Basel Committee on Banking Supervision in 2016 concluded that the imposition of liquidity requirements would lead to at least a 3 percent permanent reduction in lending.

In considering whether to impose more stringent liquidity requirements on FBOs operating in the United States, the agencies should weigh the costs of such liquidity requirements against their potential benefits. Since FBOs in the United States are an important source of credit to U.S. households and businesses and contribute materially to the strength and liquidity of U.S. capital markets, the Federal Reserve should demonstrate that the benefits of increasing liquidity requirements for IHCs operating in the U.S. exceed the costs of such requirements in terms of reduced credit availability and lower market liquidity. Of course, these costs would be lower if the proposal were adjusted to treat FBOs' U.S. banking activities in a manner more consistent with equal treatment of U.S. BHCs.