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INTERNATIONAL BANKING

Expert Analysis

International Guidelines On Addressing Bank Weakness

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The Basel Committee of the Bank for International Settlements recently issued "Guidelines for identifying and dealing with weak banks," which discusses the supervisory tools that should be available to banking supervisors to help them identify and deal with weakness at banking organizations, including the ultimate weapon of closure and resolution.[1] This column will compare the general supervisory tools U.S. bank regulators have to identify and address weakness at U.S. banking offices of non-U.S. banks (branches and agencies) to the guidelines.[2]

The Guidelines

The guidelines are aimed at providing practical advice in dealing with "weak banks" and replace a 2002 publication on the same topic. The guidelines define a "weak bank" as "one whose liquidity or solvency is impaired or will soon be impaired unless there is a major improvement in its financial resources, risk profile, business model, risk management systems and controls, and/or quality of governance and management in a timely manner." The guidelines emphasize early identification and intervention to prevent escalation of problems that could ultimately result in the closure and liquidation of the bank.

What are the signs of a weak bank, aside from a deteriorating financial condition? They include poor governance or management, inadequate capital and liquidity, a non-viable business model or strategy, weak asset quality and poor systems and controls. Bank supervisors must implement a risk-based supervisory approach that includes on-site bank examinations coupled with off-site reviews, regular financial reporting by banks and ongoing assessments of a bank's business models, corporate governance, risk management, information systems, stress testing and resolution plans. Additionally, supervisors should be interacting on a regular basis with senior bank management and board members, external auditors, and international supervisors. Any supervisory rating system on the safety and soundness of the banks under their supervision should result in a report highlighting a comprehensive forward-looking picture of the bank, and its principal strengths, weaknesses and risks.

While supervisors focus as expected on the condition of individual banks in their respective jurisdictions, the guidelines discuss the importance of supervisory review of the stability of the entire financial system on a macroprudential level, which can provide early warning indicators of problems that may begin to affect individual banks.

The guidelines then shift into a discussion of what corrective action can be taken by a bank regulator after it identifies weakness at a bank under its supervision, including corrective actions aimed at enhancement of governance, internal controls and risk management; requiring cash injections by shareholders or new investors; suspending payment of dividends; and restricting activities or requiring downsizing of operations.

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The guidelines discuss the need for incentives for banks to promptly address problems before they get worse, noting that the most basic cause for inaction is hope by both the bank and the regulator that problems will resolve themselves. Supervisors must have the necessary tools to intervene early to addresses weaknesses at a bank with a series of required corrective actions to be taken by the bank, and the authority to close and liquidate the institution.

In taking the ultimate step of closure and resolution, bank supervisors should attempt to minimize disruption of banking services, use private sector solutions if possible such as an acquisition of the weak bank by a stronger bank and avoid "moral hazard" by making sure that shareholders and uninsured creditors are not compensated beyond what would have been received if there had been a complete insolvency. Cross-border bank supervisor cooperation and coordination are critical for large multinational banking organizations, even if closure and resolution cannot be conducted solely by the home country regulator.

Sizing Up the United States

The United States holds up well when its system of bank supervision is compared with the guidelines, even with a layer of complexity (e.g., the dual banking system of regulation at the federal and state level) that may not be indicative of the bank supervisory systems in other countries.

The guidelines focus on identification of weakness while it is already in operation. In addition to the tools mentioned in the guidelines, the United States has taken steps to evaluate an entering non-U.S. bank's operations in an effort to prevent weak banks from even establishing a foothold in the United States.

FRB as Gatekeeper

Since 1991, in the United States, the Board of Governors of the Federal Reserve System (FRB) has been the gatekeeper for non-U.S. banks that wished to establish U.S. direct banking offices. A critical determination for the FRB and the non-U.S. bank in question is whether the home country regulator exercises comprehensive supervision on a consolidated basis, or CCS.[3]

CCS is a two part test. Part 1 is whether the non-U.S. bank's home country maintains a CCS supervisory process. Part 2 is whether the non-U.S. bank is subject to that home country's CCS.

In determining whether a non-U.S. bank is subject to CCS, the FRB will take into account, among other factors, the extent to which the home country supervisor: (i) ensures that the non-U.S. bank has adequate procedures for monitoring and controlling its activities worldwide; (ii) obtains information on the condition of the non-U.S. bank and its subsidiaries and offices outside the home country through regular reports of examination, audit reports, consolidated financial reports or otherwise; and (iii) evaluates prudential standards, such as capital adequacy and risk asset exposure, on a worldwide basis.[4]

If the FRB cannot make a CCS determination,

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the FRB nonetheless could approve an application if it determines that the home country supervisor is actively working to establish arrangements for the consolidated supervision of such bank, and all other factors are consistent with approval. One of those factors is a review of the relevant anti-money laundering laws in the home country, including whether the home country supervisor is developing a legal regime to address money laundering or is participating in multilateral efforts to combat money laundering.

In addition to the CCS determination (or "actively working towards CCS" determination), the FRB may take into account additional factors such as the financial resources of the non-U.S. bank (including the capital, profitability, level of indebtedness, and future prospects) and the condition of any U.S. office of the non-U.S. bank; the managerial resources of the non-U.S. bank, including the competence, experience, and integrity of its officers and directors; and whether the non-U.S. bank's home country supervisors share material information regarding the bank's operations with other supervisory authorities.

Finding a License

Once getting past the FRB gatekeeper, a non-U.S. bank must find a regulator to issue the non-U.S. bank a license to establish a direct banking office in the United States. The non-U.S. bank has the option of getting a branch or agency license from a state banking regulator ("state-licensed branches"), or, since 1978, a license from the U.S. Treasury Department's Office of the Comptroller of the Currency (OCC) which issues licenses for direct branches and limited branches of non-U.S. banks ("federal branches").[5]

The OCC and the individual state banking regulators have their own criteria for the non-U.S. bank to meet prior to being granted a license. In many instances, the criteria are similar to the FRB's standards for approval, including CCS and acceptable financial and managerial resources.

Joint Supervision

Jointly with the FRB, the licensing authority also exercises ongoing jurisdiction over the U.S. branch or agency of a non-U.S. bank. This includes, as recommended in the guidelines, on-site examinations of the office resulting in issuance of an examination report discussing the safety and soundness of the office, off-site reviews, regular communications with U.S. office and head office management, and ongoing consultation with home country regulators.

Assets in Place

As part of its ability to operate in the United States, branches and agencies of non-U.S. banks usually must establish accounts pledging liquid assets to the regulator that can be used to cover the initial costs of a liquidation of the branch or agency. Generally referred to as asset pledge or capital equivalency accounts, the amount of pledged liquid assets is calculated as a fraction of the total third-party assets held at the office.[6]

In addition to the pledged assets account, the regulators also may have the ability to require additional good assets to be maintained in the jurisdiction if the regulators determine that there is weakness at the non-U.S. bank. Called asset maintenance, it is a discretionary supervisory tool for the licensing authorities, and can be imposed non-publically on an institution-by-institution basis, or to a group of non-U.S. banks from the same jurisdiction because of economic issues in that country. Generally, calculation of asset maintenance starts at 108 percent of third-party assets. If necessary, the amounts held can be folded into the asset pledge account, thus locking up the assets for the regulator's benefit.

The FRB also has the authority to withdraw its permission for the non-U.S. bank to operate in the United States, including a lack of CCS by the home country regulator or the non-U.S. bank office has engaged in an unsafe and unsound banking practice, such as financial trouble.

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Avoiding Liquidation

Under the guidelines, banking supervisors should have several alternatives to address weakness at a bank that gradually escalate to closure and resolution. If a U.S. banking supervisor perceives a non-U.S. bank and/or its U.S. branch or agency beginning to weaken, it has a variety of tools that it can use to avoid involuntary liquidation. In addition to asset maintenance (whether or not rolled into the pledged asset account), the licensing authority and the FRB can issue administrative enforcement orders to terminate certain activities, replace management or even to undertake a voluntary liquidation under the on-site eye of the regulators.

The licensing authority also could move to suspend or revoke the license of the non-U.S. bank, preventing any activities taking place while liquidating the office or while the bank complied with a remedial plan.

Shutting It down

Generally speaking, should a licensed branch or agency of a non-U.S. bank be closed by the U.S. regulator, (whether federally licensed or state-licensed), the U.S. office is "ring-fenced" and is liquidated by the particular U.S. regulator as if it were a separate entity. Only claims against the branch/agency would be considered, usually with exclusions for claims from other offices of the non-U.S. bank.

Generally, assets of the licensed office, and more importantly, assets of the non-U.S. bank itself within the jurisdiction of the regulator, will become the property of the regulator to use in the liquidation. For example, for a New York state-licensed branch of a non-U.S. bank, title to all the assets of the licensed office wherever located, and all the assets of the non-U.S. bank itself located in New York vests in the Superintendent of Financial Services when he or she closes the New York licensed office.[7]

Given New York City's position as a financial center, the non-U.S. bank and some of its non-U.S. branches may well have U.S. dollar deposit accounts at New York banks. That can result in a large windfall for the Superintendent of Financial Services. If a federal branch or federal limited branch is closed and liquidated by the OCC, the OCC will consolidate all the U.S. assets of the non-U.S. bank and conduct one consolidated U.S. liquidation.

Any funds left over after the approved creditor claims and the costs of the liquidation have been paid will be returned to the head office (or the liquidator of the head office). Some jurisdictions (such as New York) require that excess funds first be shared with the liquidator of any other U.S. office of the non-U.S. bank that might need them prior to sending the funds to the home country.

While branches and agencies of non-U.S. banks can be closed for all of the usual reasons one might close a separately chartered bank (e.g., insolvency, illiquidity), there are often ways through a series of regulatory actions such as those noted above, to keep the licensed office open under supervision while it is voluntarily liquidating. However, if the non-U.S. bank is closed at the head office, then the U.S. regulator is forced to act accordingly. Most of the recent liquidations of U.S. branches and agencies of non-U.S. banks have resulted from the closure of the bank at the head office.

Conclusion

The United States has put into place a number of measures seeking to identify and address weakness in a U.S. branch or agency of a non-U.S. bank. While the guidelines are targeted primarily at bank supervisors on a global basis, non-U.S. banks may want to review them, particularly the recommendations for action, which may result in additional laws and regulations being imposed in their home countries, if they are not already in place.

1. Bank for International Settlements, "Guidelines for identifying and dealing with weak banks," July 15, 2015, available at http://www.bis.org/bcbs/publ/d330.pdf.
2. This column will not discuss the U.S. bank subsidiaries of non-U.S. banks or the enhanced supervisory authority over systemically significant non-U.S. financial institutions with U.S. banking operations.
3. 12 USC 3105.
4. 12 CFR 211.24.
5. The activities of agencies of state-licensed non-U.S. banks and limited branches of federally licensed non-U.S. banks are more limited than those of branches, usually with respect to domestic deposit-taking.
6. 12 USC 3102; NY Banking Law, 202-b.
7. N.Y. Banking Law, 606(4).