U.S. Banking System and Foreign Banking Organization Supervisory Structure

Office of the Comptroller of the Currency Exam Process

December 14, 2017

Agenda

1. International Banking Supervision Overview

2. Federal Branch Supervision

3. Supervisory Tools

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1. **International Banking Supervision Overview**

2. Federal Branch Supervision

3. Supervisory Tools

Legal Vehicles Available to FBOs to Create a Presence in the United States

OCC Supervised

- **Federal Branch** – Offices of foreign banks that can engage in a commercial banking business in the U.S. including the acceptance of domestic wholesale deposits

- **Limited Federal Branch** – A federal branch that accepts only those deposits permissible for an Edge Act corporation to receive

- **Federal Agency** – Offices of foreign banks that can engage in a commercial banking business in the U.S. but cannot generally accept domestic deposits or exercise fiduciary powers

- **Foreign Bank Subsidiary** – Companies owned 25% or more by a bank holding company or foreign bank

Legal Framework

International Banking Act, 1978

- Substantially equalized treatment ("national treatment") of U.S. operations of foreign and U.S. banks
  - Made federal license, issued by OCC, available for foreign banks, in addition to the existing state license option

Foreign Bank Supervision Enhancement Act (FBSEA), 1991

- Expanded oversight role of the Federal Reserve including power to approve and terminate U.S. operations of FBOs, including federal branches/agencies
  - Approval of FBO presence – application process and Comprehensive Consolidated Supervision (CCS) determination
- Prohibited foreign branches from applying for deposit insurance

Legal Framework

Riegle-Neal Interstate Banking and Branching Efficiency Act, 1994.

- Essentially created national treatment for FBOs in interstate banking and branching

Gramm-Leach-Bliley Act (GLBA), 1999

- Removed barriers between the banking, securities, and insurance industries
    - Authorized Financial Holding Companies (FHC)

Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA), 2010

- Focuses on strengthening the financial stability of the U.S. and includes:
    - Heightened supervisory expectations for FBOs > $50 billion in total U.S. assets
    - Includes enhanced prudential standards for large banking organizations
        - Section 165 Enhanced Prudential Standards (EPS) for FBOs finalized in February 2014

Pre-DFA Approach to FBOs

- FBOs allowed to structure U.S. operations in a manner that they find most efficient with appropriate restrictions
- Reliance on home country supervision of the FBOs worldwide operations
- Reliance on state and federal functional regulators to supervise the relevant entities operated by FBOs in the U.S.
- Significant reliance on the parent bank to support its U.S. operations

Post-DFA – Section 165 (Regulation YY) Enhanced Prudential Standards for FBOs

- Certain FBOs required to establish an intermediate holding company (IHC)
- Enhanced risk-based capital and leverage requirements
- Enhanced liquidity requirements
- Enhanced risk management and risk committee requirements
- Stress test requirements
- Requires enhanced prudential standards to increase in stringency based on the size and complexity of the FBO
  - Rules generally apply to FBOs with a U.S. banking presence and total global consolidated assets greater than $50 billion
  - Standards increase in stringency for FBOs with combined U.S. assets greater than $50 billion due to the increased risk they may pose to the U.S. financial system

Interagency FBO Supervision Program

Began in 1995 as a result of Bank of Credit and Commerce International (BCCI)

- Covers all foreign banks operating in the U.S.

Focus is on understanding the head office and its ability to support U.S. operations

- Home Country Financial System
- Accounting Analysis
- Institutional Overview
- Strength of Support Assessment (SOSA) and SOSA rating

Communication of results to head office management and home country supervisor

Unique Factors in FBO Supervision

FBOs are different: management from a different country—may lack knowledge of U.S. customs, culture, laws & regulations.

Host Country vs. Home Country Supervisor – Shared communications.

Role of Host Country

- Evaluate the overall ability of FBO to support its U.S. operations
- Maintain an understanding of global risk management and control systems as applied to U.S. operations
- Provide access to information concerning U.S. operations of FBOs
- Exchange information with home supervisor and coordinate when supervisory follow-up is necessary

Communications and Coordination with Home Country Supervisors

Ways in which information is shared:

- Ad hoc meetings/conversations
- Bilateral meetings/discussions
- Supervisory colleges
- Participation in examinations
- Annual summary of condition letter including SOSA rating
- Sharing of examination reports

Information Sharing Arrangements

- In place with bank supervisors in many jurisdictions globally
- May not be required legally—and usually has no legal effect—but generally serves to expedite the process

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2. **Federal Branch Supervision**

3. Supervisory Tools

Foreign Owned Subsidiaries and Branches

Foreign Owned Banking Subsidiaries	Branches
• Separate legal entity	• Not standalone entities
• Local Board of Directors and President	• Dependent on Head Office Board or Committee; Local General Manager
• Separate capital	• Capital equivalency deposit (CED)
• Traditional bank funding sources	• Primarily head office funding
• FDIC insured	• No deposit insurance
• FDIC is resolution/receiver	• OCC is resolution authority
• File Call Report Form 031 or 041	• File Call Report Form 002
• Rated using CAMELS	• Rated using ROCA

Foreign Owned Subsidiaries and Branches

Subject to OCC's supervision-by-risk philosophy.

Bank supervisory cycle and activities:

- A full-scope, on-site examination, will occur at least once during each 12-month period. The OCC may extend this requirement to 18 months if:
  - The bank has total assets of less than $500 million
  - The bank is well capitalized as defined in 12 CFR 6
  - At its most recent examination, Risk Management was rated 1 or 2, and the Composite rating was a 1 or 2.
  - Other factors specified in the Bank Supervision Process Comptroller's Handbook
- Quarterly offsite monitoring
- Targets and follow-up (if necessary)

Foreign Owned Subsidiaries and Branches

OCC Exam Teams:

- Evaluate the overall integrity and effectiveness of risk management systems.
- Communicate findings to local management. For federal branches, also communicate with head office and home regulators.
- Assess regulations, policies, and procedures that apply to national banks.

Rating System

R: Risk Management
O: Operational
Controls
C: Compliance
A: Asset Quality

- Applies to individual FBO branches and agencies
- 1-5 scale
- Appendix F of the "Bank Supervision Process" Comptroller's Handbook: https://occ.gov/publications/publications-by-type/comptrollers-handbook/banksupervisionprocess.pdf

Risk Management

- Determine the extent that risk management systems are adequate to:
  - Control risk exposures that result from branch activities
  - Ensure effective oversight by HO and branch management of branch activities
    - Includes 3rd party relationships such as IT servicing and outsourcing arrangements
    - Determine compliance with risk management and capital stress testing requirements of the FBO Enhanced Prudential Standards rules
    - Conclusion on BSA/AML risk management systems
    - Conclusion on credit administration systems

Operational Controls

- Assess the effectiveness of:
  - Internal controls, including accounting and financial controls
  - Internal and external audit function
  - Information technology

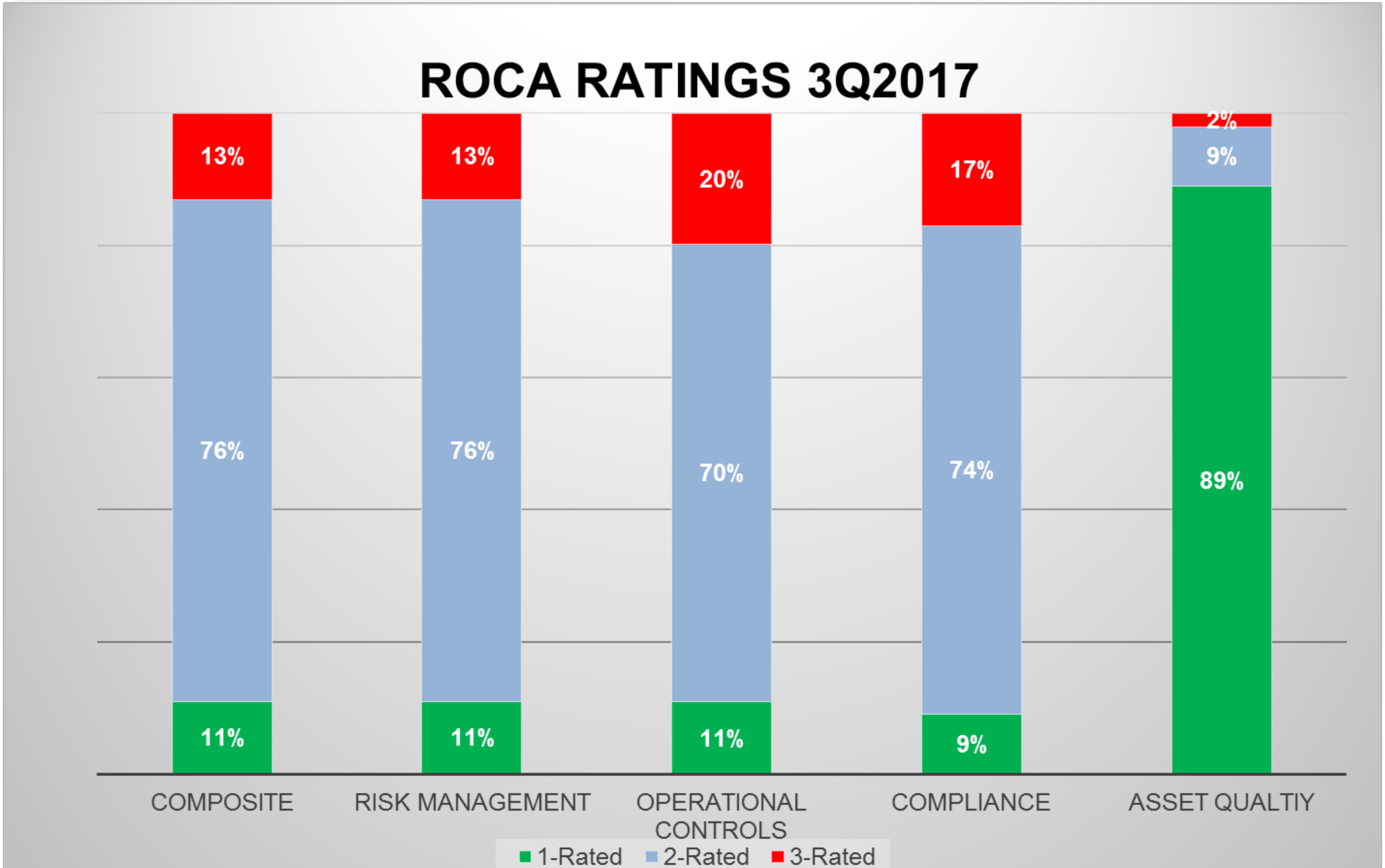
Compliance

- Assess compliance with:
  - Safety and soundness regulations applicable to the branch activities
  - BSA/AML requirements
  - Consumer regulations, if the branch offers products governed by consumer laws
  - Regulatory reporting
  - CED requirements

Asset Quality

- Rating is based on the level of problems assets
  - All loan documentation and analyses should be in English
  - Credit risk definitions and regulatory classifications apply
  - No ALLL required
  - Legal lending limit is based on HO capital

ROCA Ratings for IBS Portfolio



Risk Assessment System

RISK CATEGORY	Aggregate Risk (High, Moderate, Low)	Quantity of Risk (High, Moderate, Low)	Quality of Risk Management (Weak, Insufficient, Satisfactory, Strong)	Direction (Increasing, Stable, Decreasing)
Credit				
Interest Rate				
Liquidity				
Price				
Operational				
Compliance				
Strategic				
Reputation				

Risk Assessment System

Communicates the **quantity** of risk, the **quality** of risk management, the level of supervisory concern (measured as **aggregate** risk), and the **direction** of risk for eight risk categories.

- Quantity of Risk: Reflects the level of risk assumed in the course of doing business.
- Quality of Risk Management: Assesses whether the bank's risk management systems are capable of identifying, measuring, monitoring and controlling that amount of risk.
- Aggregate Risk: Assess the current risk profile.
- Direction of Risk: Speaks to the prospective view of the risk profile.

Risk Assessment System

The Quality of Risk Management assesses how well risks are identified, measured, controlled, and monitored.

- <u>Strong</u>: Qualified personnel, effective risk identification and analysis, clear designation and appropriate separation of responsibilities, accurate and timely information flow, and established monitoring and follow-up processes.

- <u>Satisfactory</u>: Overall risk management practices are satisfactory relative to the institution's size, complexity, and risk profile.

- <u>Insufficient</u>: Reflects the presence of concerns that may adversely affect a bank's condition if not corrected. These concerns preclude a satisfactory assessment, but do not support a finding that risk management is weak.

- <u>Weak</u>: Risk management practices are less than satisfactory relative to the institution's size, complexity, and risk profile.

Risk Assessment System

- Used in conjunction with ROCA to evaluate a bank’s financial condition and resilience.
- Includes information on the foreign banking organization and its home country’s political, economic, and banking sector environments.
- Allows examiners to identify and take action on emerging risks in a timely manner, before such risks materialize in a bank’s financial performance.
- Risk is defined as “the potential that events will have an adverse effect on a bank’s current or projected financial condition and resilience.”

Risk Assessment System

- Enables the OCC to measure and assess existing and emerging risks in a bank.
- Drives OCC's scope of examination and supervisory strategy.
- Helps the bank and the OCC reach a common understanding of the risks, focus on the strengths and weaknesses of risk management, and ensure that supervisory objectives are achieved.

Capital Equivalency Deposit (CED)

- Required because federal branches and agencies are not separately capitalized

- Form of capital cushion to cover costs of any liquidation and deposit liabilities and maintained in a depository bank in the U.S.

- Two types of CED agreements:
  – A formal CED agreement
  – A CED "letter-agreement"

Appendix B: Capital Equivalency Deposit Adequacy Worksheet

Capital Equivalency Deposit Worksheet		
Note: This worksheet tests compliance with 12 CFR 28.15. Answers to all of the following questions should be "yes"; a "no" answer indicates a violation of 12 CFR 28.15. Please refer to the regulation if any questions arise in its completion.		
Basic requirements		
	Yes	No
1. Is the CED held in a member bank located in the same state as the federal branch?		
2. Is the CED in the form of a dollar deposit? (If yes, skip the next two questions.)		
3. Is the CED in the form of securities that can be held by any national bank for its own account?		
4. Are the securities A. segregated on the books of the depository bank? B. pledged to the Comptroller of the Currency?		
5. Does the branch maintain a CED ledger/account that records the amount of liabilities?		
6. Is a 30-day average of the applicable liabilities calculated at the end of each month?		
7. If necessary, is the CED increased to maintain the ratio of 5% of applicable liabilities within the first two business days of the following month?		

Date:	**Test calculation**	**Prior month branch ledger 30-day average**
Total dollar amount of the CED (if securities, use the lower of principal or market value)	(a)	(a)
Total liabilities of the branch	(b)	(b)
LESS:		
(1) accrued expenses	(1)	(1)
(2) amount due and other liabilities to branches, offices, agencies and subsidiaries of the foreign bank	(2)	(2)
Applicable liabilities	(c)	(c)
Calculate:		
Test: Line (a) divided by line (c) (must be 5% or more)	= %	
Branch ledger: Line (a) divided by line (c) (must be 5% or more)	%	
Verify that these numbers match the numbers in the branch's ledger for this date, then use the prior month's 30-day average figure to test CED adequacy.		
	Maker:	Checker:
	Officer:	

Due-To and Due-From Head Office Accounts

- Due-to HO balance reflects borrowing from HO
- Due-from HO balance reflects lending to HO, posing credit and transfer risk
- Balances netted for reporting and examination purposes
  - Fed branches operate at either net due-from (NDF) or net due-to (NDT) positions
  - IBS – NY closely monitors branches' liquidity positions – particularly those with NDF positions
- For branches intending to operate in NDF positon, OCC expects them to have NDF policy covering the following:
  - Unique risks posed by raising funds in U.S. to fund affiliates, including HO
  - Recognition of branch's ability to operate in NDF position depends on HO's financial strength and home country conditions
  - NDF limits and appropriate metrics to monitor NDF position
    - Limit NDF to dollar amounts or percent of balance sheet
    - Dashboard of Early Warning Indicators (EWIs)
    - EWIs trigger discussion that can lead to reduced NDF limit

Net Due-From Head Office Accounts

(cont.)

- Identification of scenarios and monitoring variables to measure and identify undue NDF exposures
- Appropriate linkage to contingency funding plan (CFP) and implementation of liquidity stress test ensuring HO would have sufficient unencumbered liquid assets to support branch and eliminate NDF position

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1. International Banking Supervision

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3. **Supervisory Tools**

Matters Requiring Attention

- Matters Requiring Attention (MRA) describe practices that:
  - Deviate from sound governance, internal control, and risk management principles, and have the potential to adversely affect the bank's condition, including its financial performance or risk profile, if not addressed; or
  - Result in substantive noncompliance with laws and regulations, enforcement actions, supervisory guidance, or conditions imposed in writing in connection with the approval of any application or other request by the bank.
- Concerns are communicated to the Board when discovered, and are not deferred pending bank management's efforts to address the concern.
- Failure to address an MRA could lead to enforcement actions.

Matters Requiring Attention

- An MRA addresses deficient practices, including a lack of practices, which could adversely affect the bank's condition. The deficient practices may be unsafe or unsound.
- Timely detection enables the board and management to address deficient practices before they affect the bank's condition.
- The OCC expects the bank's board of directors to ensure timely and effective correction of the practices described in an MRA.
- Examiners will engage in timely follow-up activities.

Matters Requiring Attention

MRAs are written in the "Five C's" format to facilitate timely and effective corrective action by the bank's board and management.

1. Description of the **concern(s)**.
2. Identification of the root **cause(s)** of the concern and contributing factors.
3. Description of potential **consequence(s)** or effects on the bank from inaction.
4. Description of supervisory expectations for **corrective action(s)**.
5. Documentation of management's **commitment(s)** to corrective action, and the timeframe(s) and the person(s) responsible for corrective action.

Matters Requiring Attention

MRAs are **not** used to

- Recommend best practices.
- Require enhancements to bank practices that already meet acceptable standards.
- Report adverse conditions unless the MRA includes actionable items to address the practices that contributed to the conditions, or required to remedy those conditions.

Enforcement Actions

Actions used to correct problems, concerns, weaknesses, or deficiencies noted in a national bank.

- **Informal Enforcement Actions**
  - Give a bank more explicit guidance and direction than an ROE
  - Require a written commitment from the bank's board members
  - <u>Examples</u>: commitment letters, memoranda of understanding, and approved safety and soundness plans

- **Formal Enforcement Actions**
  - Used when informal actions are ineffective in influencing bank management and board members to correct identified problems and concerns in the bank's operations
  - Public document
  - <u>Examples</u>: formal written agreements, consent orders, cease and desist orders, capital directives, PCA directives, and safety and soundness orders, and decisions to place a bank into conservatorship or receivership

Enforcement Actions

- Additional enforcement tools are available to address concerns with federal branches and agencies
- Weak home country supervision and support, increasing country risk, and weak internal controls can diminish FBO’s ability to support its U.S. operations
- OCC may opt to “Ring Fence” U.S. operations by imposing certain measures such as:
  - Asset maintenance requirements
  - Net due-from limits
  - Minimum liquidity positions
  - Higher CED requirements
  - Limits on balance sheet growth and related party transactions

Recovery and Resolution Planning

- Recovery planning should provide a road map of actions and the triggers for those actions
- Need to understand how U.S. branch ties to HO recovery and resolution plan
- OCC is the Resolution Authority for the U.S. operations of federal branches
  - OCC determines who is the receiver
  - FDIC not required to be the receiver

International Banking Supervision

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