# Regulating foreign banks

The role of foreign banks in the U.S. economy has been a point of practical concern historically (Do foreign banks have a competitive advantage over U.S. banks?) and recently (Do foreign banks expose U.S. taxpayers to risks originating in foreign economies?) While the role of foreign banks in emerging and developing economies has attracted the attention of policymakers and academics, reports that the Federal Reserve channeled billions in loans to foreign banks generated national news headlines in 2011 and triggered a (brief) push for greater scrutiny of foreign banks in the United States. What accounts for major changes in U.S. regulation of foreign banks? How have these rules changed as anxiety about financial crisis has been replaced with an appetite for global capital? What can the US case tell us more generally how internationally active banks impact and are impacted by domestic politics? The only conditions that seem to favor regulatory scrutiny are a rare combination of crisis or scandal (high public attention), outflows of capital from US markets, and a broader government commitment to regulatory reform.

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## Foreign banks in the U.S. economy: who cares and why?

Foreign banks are highly integrated in the American financial sector, as competitors for retail deposits and important sources of capital for domestic and foreign borrowers. The growth of this segment of the financial sector was rapid and large. The Board of Governors of the Federal Reserve System routinely monitors and reports the level of "foreign banking operations" in the U.S. In 1980, foreign-owned banks and U.S. branches and agencies of foreign banks accounted for 11 percent of total bank assets in the U.S. or about $216 billion. By 2020, this number had grown to and stabilized at about 20 percent of total bank assets or about $4.3 trillion in total assets (FRS, 2019b). Much of this growth took place in short window, from 2003-2007, when foreign bank assets doubled from $1.5 trillion to nearly $3 trillion.

While risks associated with foreign bank operations are not new, the 2008 financial crisis highlighted the particular challenges of a large and growing foreign presence in the banking sector. Financial distress can spread from a foreign parent company to a local U.S. subsidiary or branch (importing crisis) and U.S. resources – lending or other subsidies – can flow out of the U.S. economy to a foreign parent company (exporting relief). The scope of Federal Reserve lending to foreign banks was revealed in a widely-publicized 2011 data release and leaders at the Federal Reserve offered a series of reforms to contain risks associated with foreign banks.

After reviewing the general policy challenges and questions posed by foreign banks, I identify key choices about the supervision of foreign banks made in the U.S. in 1978, 1992 and 2001. These choices ultimately set the stage for the spectacular growth of foreign banking operations leading up to the 2008 financial crisis. Rules regarding the operation of foreign banks seem to mirror the treatment of other innovations in banking activity, encouraging innovation and experimentation during periods of growth, but cracking down on risky practices after a shock or a crisis. Rule-making by the US regulators also seems to mirror choices made in transnational governing organizations, what Newman and Poser (2016) label the "new politics of bank regulation." Key rules adopted by the Federal Reserve in 2019 clearly reflect the dominant position of internationally active banks and the advocacy organizations lobbying on their behalf.

## What are foreign banking operations?

The foreign presence in the U.S. banking sector is large – about 170 foreign banks operate in the U.S, mostly as uninsured state bank branches or representative offices (FRS, 2019). Many of these institutions followed customers – businesses – into the U.S. market, just as U.S. banks followed U.S. customers into global markets. In many cases the links between foreign owners and domestically-chartered banks is not obvious – one of the largest mid-Atlantic banks, Sovereign Bank, operated under that name from 2006-13, but was partially and later wholly owned by the large Spanish bank, Santander Bank (McGeer, 2013). The complexity of the corporate relationships can be remarkable – for example, the largest German financial institution that participated in the Federal Reserve's extraordinary lending programs during the financial crisis was Hypo Real Estate Bank AG ("HRE"). This company was actually a Munich–based holding company parent of an Irish-based subsidiary, DEPFA BANK plc, with a branch in New York State (HRE, 2013). At the peak of the crisis (November, 2008), HRE had over $28 billion in loans from the Federal Reserve, a combination of Term Auction Facility and discount window borrowing (Kuntz and Ivery, 2012). Despite receiving nearly $140 billion in state support from the German government, HRE ultimately failed and was completely nationalized by October, 2009 (Maushagen, 2009).

Foreign banks operating in the United States are organized in one of two basic ways. Foreign-owned US-chartered subsidiary banks, which account for about 1/3 of the foreign presence, are banks that accept retail deposits and function just like a domestic bank. Foreign "branches and agencies" do not accept retail deposits, but focus on wholesale deposits from financial and nonfinancial firms and, in the period immediately before the financial crisis, increasingly relied on borrowing to finance operations. These forms of financing are much less stable than retail deposits, making these foreign operations more risky that U.S. domestic banking operations. (For an overview, see Goulding and Nolle, 2012). The Federal Reserve publishes quarterly data on the assets and organizational form of foreign banking operations - the "Share and Structure Data" (FRS, 2019). Beginning in 1997, the structure data included the name and charter type for each foreign banking entity, as well as the foreign bank name and home country, and, in some cases, a name and home country of a "top tier" parent company. The nations with the largest presence in U.S. markets are identified in Table 1. The largest individual foreign firms currently operating banks in the United States are identified in Table 2. Toronto Dominion Bank, the largest actor today, has over $350 billion in assets in the U.S and is the 10$^{th}$ largest bank holding company in the entire U.S. banking sector. (FFIEC, 2020) Japan, Canada, and the France currently (and typically) account for more than half of the U.S. assets of foreign banking offices. (While China is home to four of the largest banks in the world and three of the four have a presence in the United States, the total amount of assets associated with Chinese entities operating in the US is about $150 billion, barely 3% of foreign bank assets). Important changes in the legal structure of foreign banks, implemented in 2016, require that any bank with in excess of $50 billion in assets organize as an Intermediate Holding Company – a corporate form that facilitates enforcement of capital requirements and orderly resolution. The motivation for and impact of these rules will be treated in more detail below.

**[Tables 1 and 2 about here]**

## Liberalization, globalization, and cross-border banking: benefits and risks

What explains the emergence, persistence, and majors changes in regulatory arrangements governing foreign banks in the United States or other developed economies? There is an extensive literature on capital markets and financial liberalization broadly defined, covering how and why countries relax controls on cross-border flow of capital (Simmons and Elkins, 2004) and the proliferation of bilateral investment treaties (Elkins et al, 2006). There is also an extensive literature on the entrance of foreign banks into developing economies. Since developing economies are competing for scarce foreign capital, the presence and growth of foreign banking operations is vital for economic growth. Recent scholarship has also advanced our understanding of the specific role and implications of foreign banks in developed economies, the EU, in particular. The combination of the 2008-13 financial crises, efforts to harmonize bank regulation in the EU. and Brexit drew attention to the risks and political influence of foreign banks. Epstein (2014) highlighted the stabilizing role of foreign bank subsidiaries anchored in the Central and Eastern European State during the European debt crisis. Spendzharova (2014) identified the link between the presence and structure of foreign banking activity and member-state preferences over the form of integrated EU bank regulation and supervision. Howarth and Quaglia (2016) reveal that negotiations related to Brexit triggered competition between national financial centers more than cooperation to liberalize cross-border banking. The relatively late development of the literature on cross-border expansion of banks in advanced or developed economies is surprising given that the vast majority of cross-border capital flows have long been between developed economies, particularly, between the U.S. and the E.U (see Milesi-Ferretti and Tille, 2011).

Economies require capital; large and growing economies require highly developed and well-functioning capital markets. The size and scope of a national capital markets - "depth and liquidity" – are important indicators of national economic performance and international capital inflows can supplement domestic capital to fund critical local borrowing needs. Sobel (2012) sketches out the positive case for international financial integration– investors have a wide variety of choices, competition across financial services firms stimulates innovation and reduces costs. Wider distribution of risk and access to capital is linked to both stability and growth. To see how the case for European financial integration rests on these claims, see Baele et al, 2004. Unfortunately, empirical support for benefits of this type is underwhelming – for example, Coeurdacier, Rey, and Winant (2015) conclude that existing work only suggests "we can safely say that the evidence is mixed." They develop a model of financial integration that captures this sentiment – predicting net costs associated with financial integration for some types of nations and net benefits for other types of nations. Political science literature has been sensitive to these types of distributive implications of integration, recognizing that internationalization can offer resources to some actors, redistribute political economic and political power, and even trigger crises in governance and legitimacy (see, for example, Milner and Keohane, 1996).

Banking across borders, especially extending bank operations into a competitive and complex financial sector like the U.S. or the E.U., raise some puzzling questions. Banking is in many ways inherently local. First, depositors know banks and banks know borrowers. This local and particular information is difficult for new entrants to acquire. Second, local norms and practices shape the business. The costs associated with acquiring information about customers and norms is a liability for potential foreign entrants to a market. A comprehensive and widely cited review of the relative efficiency of foreign and domestic banks concluded that foreign banks are more costly and less efficient than domestic banks (Berger et al, 2000). The single exception was U.S. banks – U.S. banks operating abroad were more efficient than host country competitors. Tschoegl (2002) directly tackles this paradox – why would banks extend operations into the US, especially to compete for retail deposits, given the local and global efficiency of US-based competitors? He finds that the entrants to U.S. markets are the largest banks in the home markets, with capacity to purchase and expand across borders. So, in some ways, the growing presence of foreign banking operations in the U.S. reflects a long-term trend toward consolidation in the banking sector more generally. Large global operations treat local and remote acquisition opportunities as relatively similar. The creation of large cross-border networks create opportunities to move funds internationally within an organization (to exploit internal capital markets). Given the rapidly expanding cross-border flow of funds within banking networks, there must be compelling benefits attached to these foreign activities.

In this context – global financial markets populated by large global banks with large cross-border capital flows – national regulators confront a challenge – a local branch or subsidiary of foreign parent may fail – as a result of poor local planning or as a result of global shocks that cripple the parent. Either type of failure could result in rapid – immediate - transfers of large amounts of capital out of an economy and possibly introduce a crippling shock to domestic borrowers. But Epstein (2014) concludes that, while this type of cut-and-run was anticipated in the Eurozone crisis, foreign banks actually made choices that stabilized host economies, or at least did not permit subsidiaries to fail in any spectacular ways. The growth of the network of globally-active bank also has political implications. The transnational organizations that are created or steered to support these banks – trade associations and quasi-official rulemaking institutions – marshal support in both international and domestic contexts for friendly regulation (for a description of this mechanism, see Newman and Posner 2016). While the mechanisms of this exercise of power are not transparent and the outcomes are not always consistent with bank objectives, the experience in both the EU and broader international forums has directed attention at outsize bank power (Macartney, Howarth and James, 2020).

Decisions related to managing and containing risks are notoriously challenging the area of bank regulation. For at least seventy years, economists have recognized that financial innovation will subvert narrowly tailored regulations that define permissible forms of lending and borrowing. As Henry Simons observed in 1936, we experience "the reappearance of prohibited practices in new and un-prohibited forms" (quoted in Minsky 1980). Minsky, drawing on the work of Keynes, emphasized the psychology of expectations: euphoric sentiment leads investors to seek out higher and higher levels of risk and to seek leverage to realize what, over the course of the business cycle, are lower and lower returns on this risk-seeking. This dynamic makes financial markets inherently unstable. Entrepreneurs in the financial services sector have powerful incentives to create novel instruments that appeal to investors; the potential financial returns for these innovations are enormous. Public sector experts, operating with fewer resources and without similar immediate financial incentives to adapt or update regulations, are at a disadvantage. The budget, expertise, and technology of the regulators cannot keep pace with private sector innovation. Foreign banking operations represent exactly this type of challenge – foreign firms enter the market in new forms, introducing new technology, ideas, and practices. As the financial sector grows and risks appear to be manageable or low, regulators accept novel forms and activities. Only a crisis or scandal triggers skepticism or scrutiny.

The Federal Reserve and other bank supervisors have grappled with the challenges of foreign banks since the relaxation of capital controls and other elements of financial market liberalization expanded the movement of capital across national borders. Losses in foreign exchange markets and the visible failure of two banks - Franklin National Bank in the U.S. and the German bank Bankhaus Herstatt – ultimately led to both an international framework for supervision of banking across borders (the Basel Concordat of 1975) and to changes in U.S. law that placed foreign banking activity under the scrutiny of the Federal Reserve (the International Banking Act of 1978.) The regulatory treatment of foreign banks has since evolved in three phases – a period of growing foreign bank activity from 1975 to 1991 as banks received "national treatment" under federal supervision, a period of stricter oversight and declining foreign bank activity after the forced closure of the Bank of Credit and Commerce International (BCCI) in 1991, and rebound and plateau after the passage of Gramm Leach Bliley and an important (critical) supervisory choice made by the Federal Reserve in 2001. The financial crisis did little to undo these global ties. While the rules – both statutory and administrative – have changed in important ways – in efforts to both contain and promote the operations of foreign banks, the size of foreign banking operations and group of nations that account for that activity has remained relatively stable. The foreign bank share of total bank assets has moved between lows near 19% to highs near 22% since 2001.

**The International Banking Act: bringing foreign institutions under federal supervision**

Prior to the 1960s, most states enacted restrictive legislation that barred foreign banks from operating in the U.S. These laws, dating to the 1920s, confined foreign bank operations to a handful of states, principally New York. The immediate trigger for foreign bank activity in the US was actually growing international activity of US-chartered firms. Part of this international expansion of US banks was specifically to make sure that key multinational corporate clients could be served abroad, but banks also attempted to benefit from varying regulatory and other factors that a foreign location could bring (Klopstock, 1973). At the same time that U.S. banks worked to establish a presence in other countries, foreign banks worked to establish a presence in the U.S, particularly in New York. Two features of the U.S. – the huge securities market in New York City and the status of the dollar as an international reserve currency, especially after the relaxation of capital controls in 1974 – drove foreign banks to open U.S. branches or subsidiaries (see Terrell and Key, 1977). As U.S. banks expanded operations in overseas markets, foreign governments were unlikely to permit access if a bank's home state denied reciprocal access to foreign firms. This constraint motivated large international banks in Illinois (Continental Trust) and California (Bank of America) to push for lower barriers to access (Zwick, 1966).

Between 1965 and 1974, the assets of foreign banking organizations grew from $7 billion to $56 billion. At the time, foreign banking activity was largely concentrated in New York, Illinois and California and the state regulations governing these banks were perceived as relatively weak (The asset data and much of the discussion below draw on Auerbach, 1975). The reactions of state governments to this foreign expansion were quite mixed. The California legislature considered action to directly target and limit the growth of Japanese banks. The California bill split small banks (that preferred restrictions) and large banks (that feared retaliation in Japan), and led the Federal Reserve to propose legislation to bring foreign banking operations under national supervision. The Illinois legislature moved in the opposite direction, granting charters to 18 foreign banks in 1974, with the primary aim to position the City of Chicago as an international financial center.

Until the passage of the International Banking Act in 1978, all foreign bank branches and offices were regulated by state governments. The absence of federal regulation gave these banks important competitive advantages, a considerable source of concern for Fed leadership even before the intense scrutiny of foreign banking activity in 1974 (Papers of Arthur Burns, 1972). Foreign banks voluntarily complied with a number of federal regulations, but neither U.S. banks nor foreign banks perceived U.S. banking as a level playing field – some states expressly prohibited foreign banks (ranging from Texas to Minnesota), and some state rules clearly benefited foreign banks compared to domestic banks supervised by a federal regulator. Foreign banks were not subject to Glass-Steagall restrictions, and a dozen or more foreign banks acquired broker-dealer affiliates in the early 1970s. Foreign banks could operate interstate branch networks, an opportunity that was possible for U.S. banks only after major deregulation of banking in 1980 (DIDMCA). On the other hand, foreign banks had no access to the Federal Reserve discount window for last-resort borrowing. D'Rista (1976:763) identified the implications of state government supervision of large globally active banks: "The result has been a substantial erosion of U.S. regulatory standards as applied to the largest U.S. banks with extensive foreign operations and certain foreign banks operating here as well."

Despite a number of studies and calls for actions, the U.S. Congress failed to pass legislation to respond to increased foreign bank activity in the 1960s. Wright Patman (D-TX) sponsored very restrictive regulatory reform in 1973 – rules that would have required foreign banks to sell securities affiliates, cease multistate activities, and participate in the FDIC as fully capitalized subsidiaries. The bill did not pass and, ultimately, the Congress included international banking questions in a broad review of financial regulation – Financial Institutions and the Nation's Economy or FINE. In the 1976 report Jane D'Rista concluded:

> "Not all unregulated international banking operations take place in London, Nassau and the Cayman Islands. They also take place in Panama, Hong Kong, Singapore and, more important, in New York, Chicago, Los Angeles and San Francisco. In these four U.S. cities, agencies and branches of foreign banks controlling some $50 billion in assets conduct an international business which differs very little from that of their parent banks' London branches or the London or Nassau branches of U.S. banks."

It was not until the collapse of the Bretton Woods arrangement that international banking moved squarely on to the policy agenda. In 1974, disruptions in foreign exchange markets and the failure of a large German bank, Bankhaus Herstatt, and a large American bank, Franklin National Bank, focused attention on the risks of international financial trading and markets (Auerbach, 1975). Franklin, for instance, had a discount window loan balance exceeding $1 billon when it was closed. These failures motivated national regulators to develop international partnerships to manage these risks, most notably in the form of the Basel Committee on Bank Supervision and, in the U.S, to move toward more direct federal supervision of foreign banks. The failure of Herstatt was particularly revealing for U.S. regulators – timing of the closure of Herstatt piled up losses on U.S. banks while minimizing losses for large German banks, an outcome that the Federal Reserve staff described as "arbitrary and highly prejudicial" in a memo to Chairman Arthur Burns (Papers of Arthur Burns, 1974).

The Federal Reserve System established a System Steering Committee on International Bank Regulation which eventually developed the regulatory reforms that were packaged and passed by the U.S. Congress as the International Banking Act of 1978. The System Steering Committee endorsed the principle of equitable or national treatment, reinforcing the idea that indigenous and foreign banking institutions should face the same regulatory burdens or costs. The IBA adopted the principle of national treatment but did not include evaluation of reciprocity – so even banks from nations that restricted the presence of U.S. banks would be permitted to operate in the U.S. (Burand, 1992). The twin norms of national treatment and equality of competitive opportunity have persisted as fundamental principles in the design of US rules and appeared directly in Dodd-Frank provisions regarding foreign banking operations (see FRS 2014). The IBA gave foreign banks the option to seek a federal charter, but most foreign banking operations remained under the regulation of state supervisors. The Federal Reserve did receive authority to examine banks operations across states. In addition, foreign banks were required to participate in FDIC insurance programs.

In addition to the new federal rules, the 1974 crisis triggered an internationally coordinated effort to increase cooperation between regulators in host and parent countries. This effort, headquartered in the Bank for International Settlements, led to the formation of the Basel Committee in on Banking Supervision. The Committee published the 1975 Basel Concordat, a 1983 Statement of Principles, and, ultimately, became the focal point for efforts to establish uniform capital requirements for banks (see Kapstein, 1994, for links between international financial crisis in the 1970s and the establishment of the Basel Committee). The Basel Concordat spelled out the responsibilities of home country supervisors of a parent firm and the responsibilities of the host country supervisors of a subsidiary. This form of coordinated home-host supervision is a durable feature of the Basel Accords. The 1983 Statement of Principles formally endorsed the concept of consolidated supervision, the idea that regulators need to see a complete picture of the global business of a bank in order to understand local risks. For a pre-crisis overview of the global financial regulatory architecture that the Basel Committee inspired, see Alexander et al 2006.

The new rules were clearly favorable to the expansion of foreign banking operations in the United States. Between 1978 and 1991, foreign banks grew spectacularly in number and in size, taking a larger and larger share of the domestic market. The growth of foreign bank assets is summarized in Figure 1. (*See the October, 1982 Federal Reserve Bulletin for a description of the legal forms of the early growth*).

**[Figure 1 about here]**

Evaluating the microeconomic impact of the IBA, Mahajan, Dubofsky, and Fraser (1991) found that the Act had a modest net positive impact on foreign bank valuations –so investors perceived the new rules as favorable to foreign banks. But, before 1992, Federal Reserve officials in Washington DC seemed relatively unconcerned about potential erosion of US market share. At a 1991 hearing, Alan Greenspan described the largely positive effects of foreign banking operations on U.S. financial markets, noting the role of foreign banks as lenders and as an indicator of the prominent role of the United States in international financial markets (Greenspan, 1991).

## Responding to regulatory failure: BCCI and the push to limit foreign bank access to U.S. markets

By 1990, the rapidly expanding foreign bank share of U.S. wholesale bank lending activity (commercial and industrial loans, in particular) led to some soul-searching in the banking industry. Why was the U.S. banking sector so vulnerable to foreign competition? Answers varied – from the relative novelty of competition (prior to 1980, U.S. banks could not even compete across state lines), the competitive disadvantage of robust federal regulation (a disadvantage relative to foreign subsidiaries (most still state-regulated) and foreign branches (most home-country regulated), to the weak capital position of U.S. banks (buffeted by a series of crises, including the LDC debt crisis and the S&L crisis). For an overview, see Baer 1990.

One action that responded to this problem was the introduction of global guidelines for capital requirements – the 1988 Basel Accords. The Basel Accords were largely a response of representatives of globally competitive financial sectors—from the United States and the United Kingdom in particular—to diminishing capital positions of Japanese banks in the late 1980s. The claim was that Japanese banks were moving into markets without the same types of capital requirements required of local financial institutions, —placing the local institutions at a competitive disadvantage (see Barth, Caprio, and Levine, 2008). The Basel Accords reinforced and broadened international cooperation in the area of bank supervision and evaluation, building on the 1975 and 1983 efforts to establish norms and practices for cross-border oversight of financial institutions.

But it was a bank failure and scandal that triggered changes in the regulation of foreign banks in the in the U.S. The activity and risks associated with foreign banks captured the attention of the public with the spectacular failure of BCCI. In July of 1991, an international crackdown led to the closure of BCCI branches in a number of countries. Although BCCI did not operate in the United States, there were in fact direct corporate and financial ties between BCCI subsidiaries and insured US firms. A GAO summary of investigations by the Federal Reserve and other regulators described how BCCI secretly took control of U.S. bank holding companies, specifically to avoid the licensing and supervisory requirements of the International Banking Act. BCCI senior management apparently knew that an application for a banking relationship in the United States was unlikely to be approved by the Federal Reserve (GAO 1992), The Federal Reserve and the New York District Attorney pursued criminal charges and civil action related to the failure, but, after an acquittal on the criminal charges in 1993, the principal targets of the investigation settled the civil case in 1998, agreeing to a $5 million fine (Truell, 1998). Before the BCCI scandal captured the public's imagination it was reported that the Atlanta branch of Banca Nazionale del Lavoro evaded federal and state rules to loan $4 billion to Iraq. The BNL scandal, later dubbed "Iraqgate" was also an inspiration for the 1991 rules.

The BCCI failure highlighted the risks associated with globally active banks that lack comprehensive supervision on a consolidated basis – a home country regulator that examines the entire portfolio of a firm's business holdings, rather than limiting scrutiny to only the activities of the firm inside of a particular country. U.S. regulators advocated consolidated supervision for foreign parents of U.S. foreign banking operations, as a way to both identify potential risks and minimize costs of disruption (see, for instance, Greenspan, 1997) The U.S. Congress passed a major reform initiative, the Foreign Bank Supervision Enhancement Act or FSBEA, in 1991.

FSBEA gave the Fed broad authority to review the applications of foreign banks seeking U.S. charters (state or federal), required the Fed to assess the capacity of home country supervisors and reporting requirements, and restricted business activities of foreign-owned bank to activities permitted by federal charters (Burand, 1992). The Act also required a study of capital requirements. (*See notice and comment related to Regulation K updates*). The effects of FSBEA were unambiguous The GAO reported that foreign bank management viewed the 1991 rules as formidable barrier to entry to the U.S. market (GAO 1996, 56). Foreign banks were also required to set up subsidiaries in order to accept deposits and access deposit insurance (52 branches were grandfathered, meaning access without subsidiary) (GAO 1996). There were still important distinctions that between U.S. and foreign firms that persisted after 1991 -- foreign bank branches could be tied to a parent with substantial commercial or industrial business activity, exempt from similar restrictions imposed on U.S. banks (GAO 1996, p.46) Burand (1992) reports that Congress considered, but rejected, proposals from the U.S. Treasury to require foreign banks to establish US subsidiaries. Domestic banking interests, foreign banking interests, and leadership at the Federal Reserve objected, claiming that requirements to establish subsidiaries would undermine the norm of national treatment. A congressionally mandated "Subsidiary Requirement Study" performed jointly by Federal Reserve and Treasury also concluded that the subsidiary requirements were not necessary.

By 1995 the Federal Reserve had implemented the new legislation as the Foreign Banking Operation (FBO) program. FBO combined enhanced supervision of US operations (including information sharing across regulators) with a review of the home country financial sector, accounting policies. (GAO, 1997). The net effect of the rules was a decade-long contraction of foreign bank presence in the United States – foreign bank share of total assets contracted from 22% to 18% during a period of rapid expansion of the financial sector.

**Gramm Leach Bliley and the 2001 foreign parent exemption**

After only a few years of experience with the 1991 rules, Fed leadership concluded that the home country consolidated supervision requirements were too onerous, particularly for financial institutions from the developing economies (Philips, 1995). As a consequence, the Federal Reserve broadened exemptions for foreign banks, removing restrictions on the activities of bank holding companies and parent firms. The exemptions were intended to relax restrictions on foreign banks that limited the ability of bank holding companies to package banking and other nonbank services for clients (Philips, 1997). (*Verify the scope of this exemption*)

The Financial Modernization Act of 1999 or Gramm Leach Bliley was a notable innovation in the treatment of U.S. financial institutions. Emulating the European model of universal banking, Gramm Leach Bliley removed barriers between depository institutions and investment banks, the so-called Glass-Steagall Wall. U.S. firms could register as Financial Holding Companies to combine a variety of retail and investment banking activities. Recognizing the "principle of national treatment and equality of competitive opportunity," Gramm Leach Bliley brought exempted foreign banking operations under the FHC designation, broadening the scope of Fed authority "to avoid any significant risk to the safety and soundness of depository institutions or any Federal deposit insurance fund or other adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices." Alexander et al (2006, 146/262) describe how this provisions of Gramm Leach Bliley gave the Fed new discretion to restrict access to markets if a home country supervisor was deemed to be inadequate.

Consistent with the exemptions given to foreign banks in the mid-1990s, implementation of this component of Gramm Leach Bliley did not have the effect of restricting foreign banking activity. In fact, a critical rule opened the door for major foreign bank expansion in the U.S. in 2001. The text of the supervisory letter seems innocuous:

> "In cases in which the Board has determined that a foreign bank operating a U.S. branch, agency, or commercial lending company is well-capitalized and well-managed under standards that are comparable to those of U.S. banks controlled by FHCs, the presumption will be that the foreign bank has sufficient financial strength and resources to support its banking activities in the United States. Thus, as a general matter, a U.S. BHC that is owned and controlled by a foreign bank that is an FHC that the Board has determined to be well-capitalized and well-managed will not be required to comply with the Board's capital adequacy guidelines." (FRS, 2001)

This rule change clearly created an operating environment that advantaged foreign firms who were "well-capitalized" by home country supervisors, even if that capital was inadequate by US standards.

Between December of 2003 and December of 2007, assets of domestic-owned banks grew by 45 percent, from $7 trillion to $10.3 trillion. In the same period, assets of foreign-owned banking organizations grew from $1.5 trillion to $2.9 trillion, an increase of over 80 percent! The exemptions described in the "01-01 Letter" clearly triggered, or at minimum permitted banks to increase the level of banking activity at US branches, using the US branches to tap in to US markets. Much of this expansion was fueled by credit extended **to** a foreign parent – the "Net Due to Foreign" item in the Federal Reserve's H.8 statistical release reports the amount of credit extended to or from a foreign parent to a U.S. bank. The data are reported along with other liabilities – a positive number represents an amount owed to a foreign parent – a negative number indicates that the foreign parent is receiving funds and this is treated as an asset. The H.8 item is summarized in Figure 3, below. The run-up in credit extended to the parents after 1999 is clear – a trend that accelerated up to and during the 2008 financial crisis (see Goulding and Nolle, 2012 for details).

**[Figure 3 about here]**

**Foreign banks and the financial crisis.**

<u>How did foreign banks import risks?</u>

The pace of global financial integration accelerated in 2000-7, driven principally by cross border bank lending and, in particular, expansion of European banks in U.S. markets and U.S. banks in European markets (Milesi-Ferretti and Tille, 2011) U.S. and foreign banks used creative accounting strategies to expand and grow under the constraint of capital requirements adopted under the Basel Accords. One particular strategy involved a highly specialized type of financial entity, an Asset Backed Commercial Paper (ABCP) conduit. These conduits are created to sell short-term debt to investors (commercial paper) to finance the purchase of longer maturity asset-backed securities (like subprime mortgage-backed securities or related collateralized debt obligations). This portfolio exploits the difference between the low cost of high-quality short-term debt and the high returns on low-quality long-term debt. By creating an ABCP conduit, large financial institutions could remove lower-quality long-term obligations from their balance sheet, freeing up capital to make new loans, and generate income from sponsored ABCP conduit profits.  Before the financial crisis, Federal Reserve leadership recognized that, even in the absence of explicit credit guarantees, sponsoring bank reputations were linked to the performance of ABCP conduit.  If the conduit failed, the sponsored bank would be expected to make investors whole (see Krozner 2008).  Although IFRS rules (the accounting standard in Europe) do not recognize conduits as off balance sheet, EU capital requirements do not count conduits in asset risk weights (the balance sheet reflects the size of the firm, but capital requirements do not).  In the US, bank regulators also elected – in a decision in 2004 - to exclude ABCP conduits from risk-weighted assets used to calculate capital charges.

Acharya, Schnabl, and Suarez, 2010 provide a comprehensive account of the role of ABCP conduits in the 2008 financial crisis.  Of the ten largest pre-crisis ABCP conduit sponsors identified by Suarez et al, three were large U.S. banks and seven were U.S. foreign bank operations or parents of U.S. foreign banking operations. These seven firms alone accounted for 30 percent of foreign bank assets in the U.S at the time.  Overall, foreign firms accounted for nearly 60 percent of all ABCP conduits.  As the ABCP market collapsed in 2007, the balance sheets of these foreign parent banks deteriorated and these firms extracted capital from U.S. branches.  On average, credit extended to parents expanded from a quarterly average of $270 billion before the crisis (2006:2-2007:2) to $340 billion during the crisis (2008:3-2009:4).  As the U.S. assets of these banks declined, lending activity and other financial activity also declined in the U.S., so risky behavior by foreign bank parents translated into a contraction in lending to U.S. borrowers.  Ceterolli and Goldberg identify the specific firms associated with this outflow of capital – large banks with large ABCP conduit exposure were more likely to send capital to parents and contract domestic lending.  This transmission of risk via foreign banking operations is not entirely novel.  When Japanese equity prices collapsed in the early 1990s, U.S. branches of Japanese banks reduced lending and other financial service in the U.S. (Peek and Rosengren, 1997).  Risky activity by a foreign parent, regulated by a foreign nation, can result in lending shocks and financial distress in host country economies, even large host country economies like the U.S.

A second aspect of foreign bank risk is related to funding sources.  After the crisis, Fed staff learned that foreign banking operations had been relying on short-term borrowed funds and wholesale deposits to fund operations, rather than more stable sources of funding, like retail deposits (see Tarullo, 2014b).  Federal Reserve leadership characterized this change as a "significant and rapid transformation" in the business activities of foreign bank operations (BoG, 2012, page 3). As the U.S. commercial paper market deteriorated in 2008, foreign banks sought out alternative sources for dollars, mainly foreign exchange markets and asset sales.  Foreign exchange markets turned out to be very expensive since many firms needed dollars.  As many firms tried to sell assets, the crisis intensified as sales of dollar-denominated assets pushed down the values of these assets.  This pathway of financial distress – from U.S. short-term funding markets to U.S. foreign banking operations to foreign parents – was a surprise – one of many at the time - for US regulators.

<u>How did foreign banks export relief?</u>

In a second and distinct way the financial crisis revealed a policy challenge presented by foreign banks.  If the Federal Reserve establishes lending and credit facilities to deliver funds to distressed financial institutions, what if the funds borrowed by distressed institutions are used to shore up capital for a distressed foreign parent or even meet funding needs of a foreign branch in another host country, rather than used to make loans to U.S. borrowers? After a lawsuit brought against the Federal Reserve System by Bloomberg News, the Federal Reserve released firm-level data on daily borrowing exposures related to the variety of extraordinary lending programs established by the Federal Reserve as the crisis unfolded in 2008 and 2009. The data revealed that nearly 2/3 of all borrowed funds were directed to firms with a foreign parent or foreign top tier holding company. Table 3 reports the proportion of funds that went to firms identified with each of nine countries that accounted for over 95% of all borrowing from the Federal Reserve.

**[Table 3 about here]**

Federal Reserve Governor Daniel Tarullo later explained the implications in clear language: "the funding vulnerabilities of numerous foreign banks and the absence of adequate support from their parents made them disproportionate users of the emergency facilities established by the Federal Reserve."(Tarullo, 2014a)

## What happened after the crisis?

<u>Phase 1. Cracking down on foreign bank risks</u>

The major legislative response to the financial crisis, Dodd-Frank, contains two provisions that fundamentally change the way foreign banks can operate in the U.S. Section 165 of the Act requires that systemically risky (large) financial institutions be subject to closer regulatory scrutiny, enhanced capital requirements, routine company-run stress-tests, and new liquidity requirements. In order to apply these new requirements to foreign banks, the Federal Reserve required that any foreign banking operations with consolidated assets exceeding $50 billion and US non-branch assets of $50 billion or more must establish an Intermediate Holding Company in the United States (see FRS 2014). This threshold ensures that foreign bank holding companies are subject to the same capital and liquidity management requirements and risk management protocols that govern U.S. bank holding companies. Section 171, known as the "Collins Amendment," specifies more restrictive capital requirements for all bank holding companies in the United States, specifically excluding certain types of capital (trust-preferred securities) from Tier 1 or high quality capital. The interaction of these two sections would require several large foreign banking operations that operate U.S.-chartered subsidiaries to move large amounts of capital into the United States.

Two reactions to the proposed rules were notable – from internationally active banks and foreign regulators. Even before the proposed rules were introduced, major foreign banks moved to restructure to avoid new capital charges. Barclays Group U.S., for instance, de-registered as a bank holding company, splitting operations into two firms, a credit card issuer regulated by the FDIC and a trading unit regulated by the SEC (Enrich, 2011). But, since Barclays non-branch assets exceeds the $50 billion threshold, the firm is subject to the intermediate holding company requirement under the final rule. The comment period on the proposed rule also revealed substantial reservations about the costs of compliance and potential disadvantages for foreign firms. A presentation by Barclays, a document released by the Federal Reserve during the notice and comment period, raised a specific objection related to national treatment, involving the definition of permissible funding sources to respond to financial distress. A U.S. bank holding company may rely on capital and funding from foreign sources or subsidiaries to meet U.S. leverage requirements. A U.S. intermediate holding company cannot rely on foreign capital (from the parent) to meet U.S. leverage requirements. The Barclays presentation outlined specific impacts on US credit markets, notably reduced foreign participation in the US Treasury markets (BoG, 2013).

A second notable response came from European regulators. In a widely publicized letter from EU Financial Services Commissioner Michael Barnier to Board Chairman Ben Bernanke, the EU position is made clear (see Brunsden, 2013). Barnier argues that the Fed's choice to abandon a long-standing practice of deferring to home country regulators will invite retaliation by EU regulators in the form of higher geographically defined capital requirements for US banks operating in the EU and, overall, undermine efforts to ensure global convergence in regulation and supervision. The U.S. labor advocacy group Unite Here indicates that large EU firms were lobbying to fold financial regulation into the EU US Transatlantic Trade and Investment Partnership, a controversial step that would invoke the force of negotiated trade agreements to force US regulators to lower capital requirements to meet EU levels (Leary and Schafer, 2014).The final rule that implemented Section 165 did respond to several objections related to "international regulatory cooperation" which emerged during the notice and comment period in 2013. The comments revealed concerns about fragmentation in international standards, erosion of the norm of home country consolidated supervision, and problems for cross-border resolution of failing firms. The trade-off that this rules navigates is US financial stability versus cross-border cooperation. The final rule commentary clarifies the tension:

> "[w]hile foreign banks have strong business and reputational incentives to support their U.S. operations, to the extent that the U.S. operations of a foreign banking organization depend on parent support and the parent foreign banking organization experiences financial or other stress, foreign banking organizations and their home-country supervisors may be forced to choose between the costs involved in supporting U.S. operations and the implications for home country operations." (FRS, 2014 Final rule)

In other words, international regulatory cooperation may sound nice, but nations will use supervisory authorities to protect domestic financial stability – even if this jeopardizes stability in a host nation.

<u>Phase II. Relaxing the post-crisis reforms</u>

As the financial crisis receded from memory and the political environment in the US became more hostile to regulation in any form, the Federal Reserve revisited the Dodd-Frank rules. The Fed published a proposed rule that would tailor supervision to the risk profile of the bank, placing the major foreign banking operations into one of four categories, with the highest level of capital requirements and supervision reserved for the largest and most systemically risks firms (BoG, 2019). Board documents describing the level of scrutiny and the banks in each category are reproduced as Figures 4 and 5.

**[Figures 4 and 5 about here]**

The reaction of financial community was swift and unified. There were 28 published comments on the proposed rule in 2019 – all pushing for a set of revisions that would ultimately be incorporated in the final rule – about ½ of the comments were directly from the large foreign banks, another ¼ from trade associations representing foreign banks, and the remaining ¼ from US associations and thinks tanks – the ABA, Bank Policy Institute, Chamber of Commerce and others. The comments reinforce the dominant perspective in the United States – foreign banks are vital and in order to attract and retain these organizations we need to defer, in most instances, to home country supervisors – or else risk a cascade of "global ring-fencing" that would threaten global financial integration (ABA/BPI, 2019). The seemingly arcane but substantively significant change hinged one question – should a foreign bank's risk profile be based on the assets of the intermediate holding company or the entire set of entities (including branches and agencies), or "Combined U.S. Operations" (CUSO). The proposed rule used CUSO for one critical rule – the Single Counter Party Credit Limit and final rule relied on the size of the holding company. This change, coupled with other changes, resulted in a decrease of required capital of more than $3 billion for foreign banks. Federal Reserve documents indicate that four institutions were the beneficiaries: Deutsche Bank, MFUG, Barclays and Credit Suisse. (See Figure 5).

The Fed's action on the final rule reveals the power of the truly transnational coalition that acts in order to preserve cross-border capital flows. Newman and Posner (2016) described a set of empirical findings on the notice-and-comment process for revisions to the Basel Accords:

> "Analysis of these comments demonstrates that the voices of big international banks comprised the greatest portion of perspectives to engage the process…These interests were frequently introduced through multiple channels. Banks like Barclays, Citigroup and BNP Paribas submitted individual comments. Their aggregated position was presented the International Institute of Finance. These comments universally supported positions that advanced market-friendly measures…"

Substitute the Bank Policy Institute for International Institute of Finance and this description captures exactly what happened in 2019 as the Board revised prudential regulation of foreign banks.

While the exercise of bank power may not always work and may rarely be so overtly obvious, the new U.S. prudential standards show how banks can be decisive when public attention is low, regulators are sympathetic, and the flow of capital into the host nation is net positive. The H.8 data reported in Figure 3 reveals the relatively constant level of foreign assets supporting US borrowing. Rules to restrict foreign bank presence were attractive in 2010 since it appeared that foreign banks were drawing away U.S. capital. Today, with the situation reversed, advocacy groups don't simply make a case for cross-border openness based on ideas about liberalization and globalization, they point the sustained high volume of lending by foreign banks to support American business. Soon after the proposed rule was announced the Chamber of Commerce published "Here's Why U.S. Businesses Need Foreign Banks to Thrive, " describing the vital role of foreign banks as sources of funds for small business, source of funds for infrastructure projects, and participation in the market for Treasury securities (Hulse, 2019).

## Conclusions

There is an obvious trade-off at the core of choices about the regulatory arrangements governing foreign bank operations. Liberal or unrestrictive rules encourage foreign banks to operate, attract foreign capital, broaden opportunities for U.S. investors and, indirectly, permit broader international activity for U.S. banks. But restrictive rules also bring benefits – foreign banking operations are compelled to conform to the same regulatory or other rules imposed on domestic banks, subsidiary corporate forms concentrate taxpayer-funded subsidies or relief in U.S. markets, and lower levels of foreign activity reduce the volatility of cross-border flows of capital. As with other forms of bank regulation, infatuation with innovation, growth, and novelty leads to relaxation of restrictions when financial markets are booming; financial crisis leads to retrenchment, restriction, and a skepticism about the unfamiliar. After the Great Recession, U.S. regulators initially appeared to embrace a reform agenda that would reduce foreign bank activity in the U.S., invite foreign retaliation which will ultimately limit U.S. bank activities abroad, and, reduce the flow of capital across borders. But the appetite for these types of restrictions proved to be short-lived for a couple of reasons. Lobbying and advocacy by large banks and related transnational associations – in the U.S. and in the E.U. – obstructed or delayed implementation. As we observed on several occasions in the 1990s and 2000s, the Fed and other regulators chose to use their substantial discretion to relax restrictions on foreign banking operations. The persistent flow of capital from foreign parents into U.S. markets expanded the coalition of supportive actors and, without a scandal or crisis to focus public attention on the risks, the narrow set of actors with high stakes in the outcome successfully steered the decision to their benefit. The US experience can help us understand under what conditions bank power will matter: when there is no crisis or scandal, when capital flows are moving inward, and when the government in power has a broader deregulatory agenda. All three conditions applied in 2019 and none in 2010.

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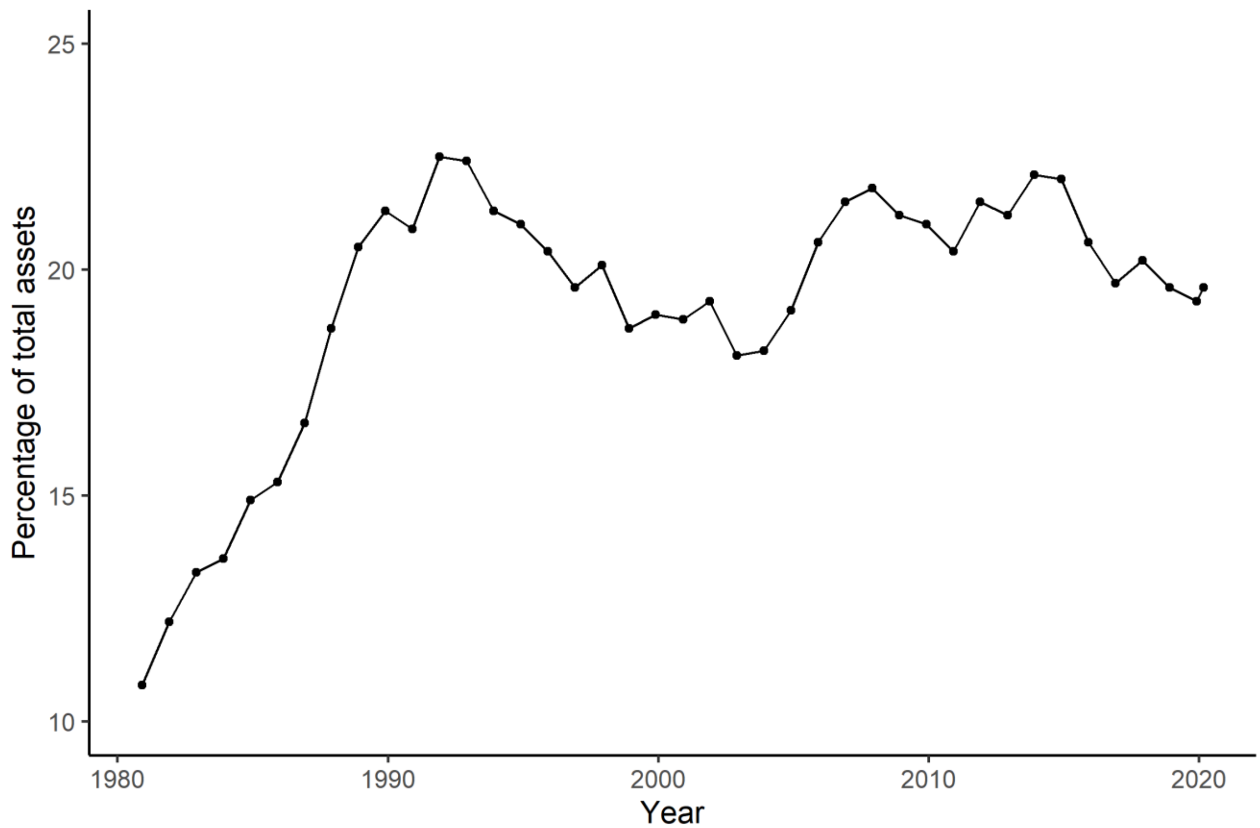
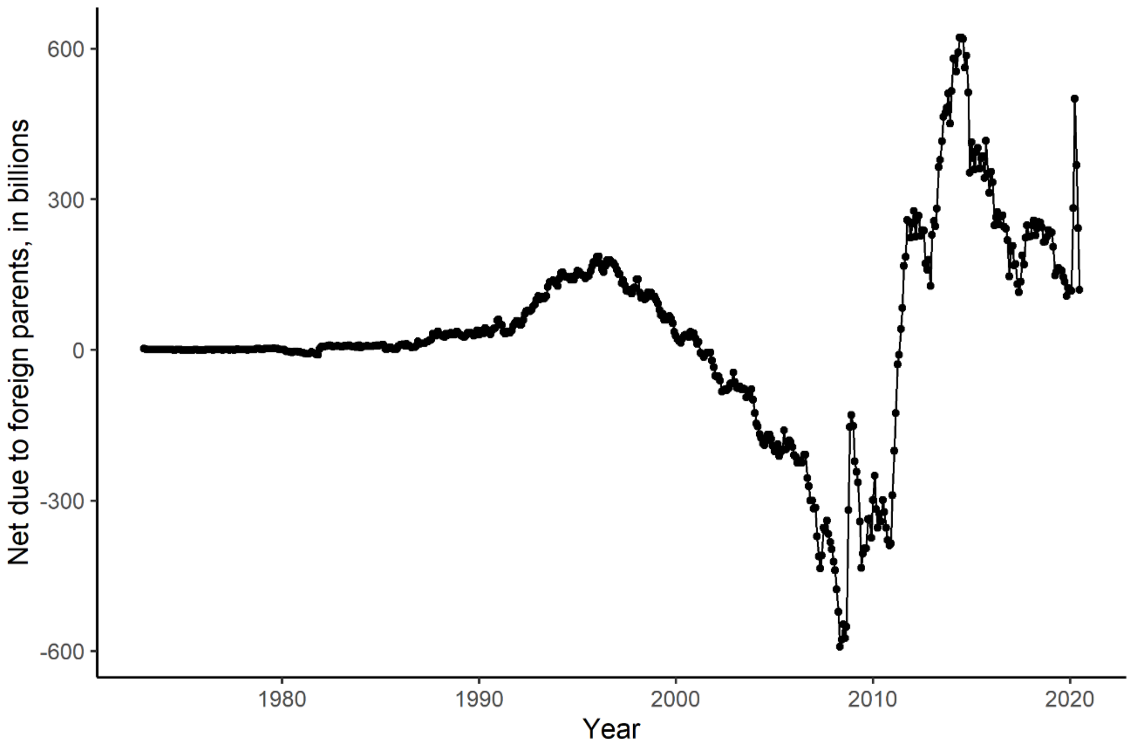
**Figure 1.**

**Foreign presence in the banking sector grew dramatically between 1980 and 1990, contracted between 1990 and 2002, but has since varied in a narrow range from 19% to 22% of total US bank assets. The OECD average is 20%.**



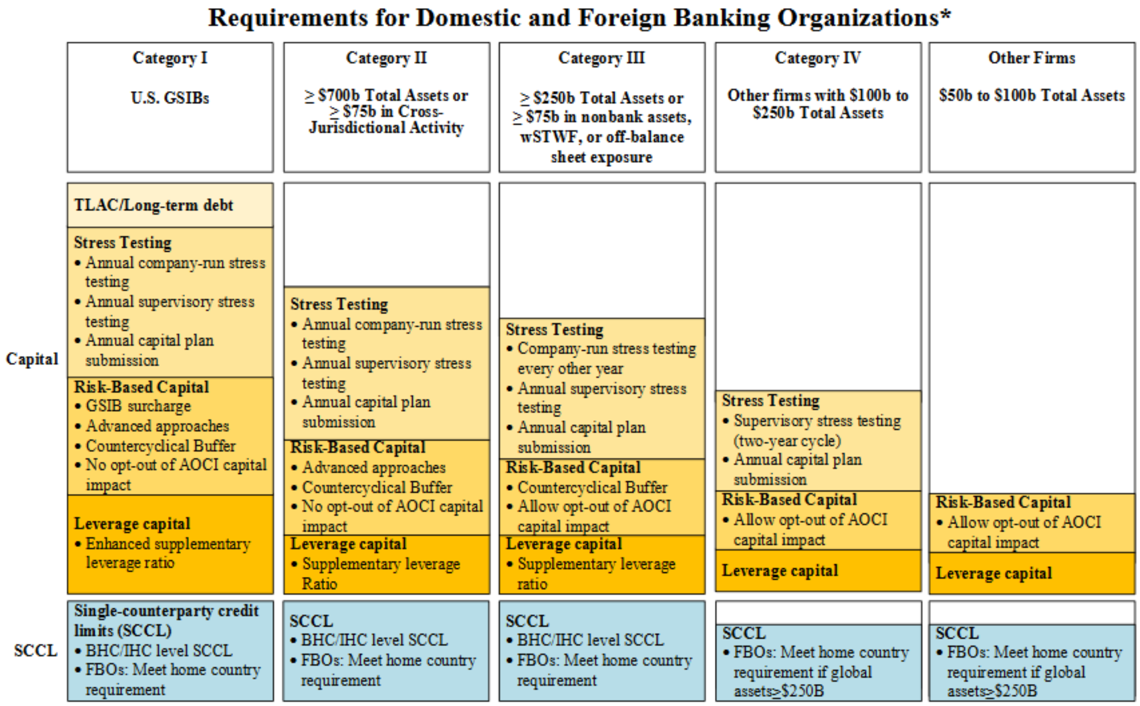

*Source: Board of Governors of the Federal Reserve System, Share and Structure Data. Assets of foreign banks and branches, as share of total U.S. bank assets*

**Figure 2.**
**While foreign banks moved money from the US during the financial crisis, for over ten years, foreign-owned banks have moved money into the United Sates banking system**




*Source: Board of Governors of the Federal Reserve System, H.8 statistical release. Foreign banking entities, liabilities, net due to foreign parent. Positive numbers indicate a net inflow from parents to US-based entities*

**Figure 3. The Federal Reserve approved tailored capital requirements for foreign banking operations in 2019, with less demanding requirements than US global systemically-important banks.**




*Source: Board of Governors of the Federal Reserve System. Press Release. Federal Reserve Board finalizes rules that tailor its regulations for domestic and foreign banks to more closely match their risk profiles. 10 October 2019. [BoG, 2019]*

**Figure 4. By using the holding company, rather than combined U.S. operations, to tailor some requirements, notably Single Counterparty Credit Limits, several firms move to less restrictive categories, notably Barclays, Credit Suisse, Deutsche Bank and MUFG.**

| | Category I<br>U.S. GSIBs | Category II<br>≥ \$700b Total Assets or ≥ \$75b in Cross-Jurisdictional Activity | Category III<br>≥ \$250b Total Assets or ≥ \$75b in NBA, wSTWF, or Off-balance sheet exposure | Category IV<br>Other firms with \$100b to \$250b Total Assets | Other firms<br>\$50b to \$100b Total Assets |
|---|---|---|---|---|---|
| Intermediate Holding Company | | | Barclays*<br>Credit Suisse<br>Deutsche Bank<br>HSBC<br>Toronto-Dominion<br>UBS | Bank of Montreal<br>BNP Paribas<br>MUFG<br>Royal Bank of Canada<br>Santander | BBVA |
| Combined U.S. Operations | | Barclays<br>Credit Suisse<br>Deutsche Bank<br>MUFG | HSBC<br>Mizuho<br>Royal Bank of Canada<br>Toronto-Dominion<br>UBS | Banco Santander<br>Bank of Nova Scotia<br>Bank of Montreal<br>BBVA<br>BNP Paribas<br>BPCE<br>Société Genéralé<br>Sumitomo Mitsui | Canadian Imperial<br>Crédit Agricole<br>I & C bank of China<br>Norinchukin<br>Rabobank |

*Source: Board of Governors of the Federal Reserve System. Press Release. Federal Reserve Board finalizes rules that tailor its regulations for domestic and foreign banks to more closely match their risk profiles. 10 October 2019.[BoG, 2019]*

**Table 1.**
**Largest U.S. foreign banking presence (percent of foreign total)**

| | |
|---|---|
| 1997 (n=840). | Japan (28%), France, Germany, Canada, Netherlands |
| 2007 (n=491). | United Kingdom (23%), Germany, France, Canada, Japan |
| 2019 (n=354). | Canada (28%), Japan, France, United Kingdom, Germany |

Source: FRS, 2019.

**Table 2.**
**Largest foreign banking entities in the United States, selected years**

| | |
|---|---|
| **1997 (before Gramm Leach Bliley)** | |
| STICHTING PRIORITEIT ABN AMRO HOLDING | Netherlands |
| BANK OF TOKYO-MITSUBISHI UFJ LTD. THE | Japan |
| SOCIETE GENERALE | France |
| SABAN S.A. | Gibraltar |
| | |
| **2007 (before the financial crisis)** | |
| ROYAL BANK OF SCOTLAND GROUP PLC | United Kingdom |
| DEUTSCHE BANK AKTIENGESELLSCHAFT | Germany |
| HSBC HOLDINGS PLC | United Kingdom |
| BNP PARIBAS | France |
| | |
| **2019 (most recent data)** | |
| TORONTO-DOMINION BANK THE | Canada |
| MITSUBISHI UFJ FINANCIAL GROUP INC. | Japan |
| BANK OF MONTREAL | Canada |
| DEUTSCHE BANK AKTIENGESELLSCHAFT | Germany |

Source: FRS, 2020. Some foreign bank operations may have more than one U.S. office and multiple foreign bank operations may be controlled by a top tier parent. The annual rank reflects total U.S. office assets for each top tier parent or foreign bank operation without a top tier parent. By 2007, ABN AMRO (Netherlands) is part of the Royal Bank of Scotland Group (United Kingdom). The Royal Bank of Scotland is now controlled by top tier parent United Kingdom Financial Investments (state-owned). Saban S.A. (Gibraltar) is part of HSBC (United Kingdom) by 2003.

**Table 3.**

**U.S. and foreign bank participation in extraordinary Fed lending programs**

(weighted by total borrowing from the Fed - average daily balance x number of days in debt)

| Nation | Percent of total | Largest borrower |
|---|---|---|
| United States | 35.6 | Citigroup |
| Britain | 17.5 | Royal Bank of Scotland |
| Germany | 14.9 | Hypo Real Estate Holding AG |
| Belgium | 7.9 | Dexia |
| France | 6.3 | BNP Paribas |
| Japan | 5.5 | Norinchukin Bank |
| Switzerland | 5.4 | UBS AG |
| Canada | 2.1 | Toronto Dominion Bank |
| Italy | 1.4 | UniCredit SpA |
| All other nations | 3.0 | Arab Banking Corp./Bahrain |

Source: Kuntz and Ivery, 2011. "1b_Company_Index_1.csv"