Regulation of Foreign Banking Organizations

Remarks by

Daniel K. Tarullo

Member

Board of Governors of the Federal Reserve System

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In the aftermath of the financial crisis, regulators around the world continue to implement reforms designed to limit the incidence and severity of future crises. My subject today pertains to an area in which reforms have yet to be made—the regulation of the U.S. operations of large foreign banks.\(^1\) Applicable regulation has changed relatively little in the last decade, despite a significant and rapid transformation of those operations, as foreign banks moved beyond their traditional lending activities to engage in substantial, and often complex, capital market activities. The crisis revealed the resulting risks to U.S. financial stability.

In taking a fresh look at regulation of foreign banks in the United States, I by no means want to imply that the United States should revoke its welcome to foreign banks. On the contrary, this reconsideration reflects the important role foreign banks have played. The presence of foreign banks can bring particular competitive and countercyclical benefits because foreign banks often expand lending in the United States when U.S. banking firms labor under common domestic strains. But just as we are adapting our regulatory approach to U.S. banks, so we need to incorporate important lessons learned from the crisis into our oversight program for foreign banks.

The question of how best to regulate foreign banks is hardly a new one, either here or in other countries. Debates over the relative merits of territorial versus global or mutual recognition approaches, the difficulties in achieving strictly equal terms of competition between banks with different home regulatory systems, and the degree to which harmonization of international standards and supervisory consultations can mitigate the resulting inconsistencies and frictions are all familiar topics to academics, banking lawyers, and supervisory authorities.

\(^1\) Molly Mahar of the Board’s staff contributed substantially to these remarks.
While I do not aim to resolve this afternoon the complicated interaction among these perspectives and considerations, I will try to outline a practical and reasonable way forward.

To be effective, a new approach must address the vulnerabilities that have been created by the shift in foreign bank activities, in keeping with sound prudential policy and congressional mandates in the Dodd-Frank Wall Street Reform and Consumer Protection Act. At the same time, a modified regulatory system should maintain the principle of national treatment and allow foreign banks to continue to operate here on an equal competitive footing, to the benefit of the U.S. banking system and the U.S. economy generally.²

**Foreign Bank Regulation in the United States**

Regulating the U.S. operations of foreign banks presents unique challenges. Although U.S. supervisors have full authority over the local operations of foreign banks, we see only a portion of a foreign bank’s worldwide activities, and regular access to information on its global activities can be limited. Foreign banks operate under a wide variety of business models and structures that reflect the legal, regulatory, and business climates in the home and host jurisdictions in which they operate.

Despite these difficulties, the United States has traditionally accorded foreign banks the same national treatment as domestic banks, and U.S. regulators generally have allowed foreign banks to choose among structures that they believe promote maximum efficiency at the consolidated level. Under the statutory scheme established by Congress, permissible U.S. structures include cross-border branching and direct and indirect subsidiaries, provided that they

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² The principle of “national treatment” in the context of financial and other services is that a host country should treat a foreign-owned service provider no less favorably than like domestic service providers. Of course, differences in business organization, domestic regulatory systems, and other factors mean that there must sometimes be determinations whether foreign and domestic firms are “like” one another in relevant respects.
operate in a safe and sound manner.\(^3\) U.S. law also allows well-managed and well-capitalized foreign banks to conduct a wide range of bank and nonbank activities in the United States under conditions comparable to those applied to U.S. banking organizations.

Still, it is worth noting that even as there has been continuity in this basic policy, U.S. regulation of foreign banks has evolved over the years in response to changes in the extent and nature of foreign bank activities. Let me mention two examples.

Before 1978, foreign bank branches in the United States were licensed and regulated by individual states, with little in the way of federal regulation or restrictions. They were not subject to the full panoply of limitations on interstate banking, equity investments, or affiliations with securities firms that were applicable to domestic banks. The rapid growth of foreign banking in the 1970s, particularly branching, prompted an end to this lighter regulatory regime.\(^4\) The International Banking Act of 1978 gave the Federal Reserve Board regulatory authority over the domestic operations of foreign banks and significantly equalized regulatory treatment of foreign and domestic firms.\(^5\) Congress maintained this approach of basic competitive equality in the 1999 Gramm-Leach-Bliley Act.\(^6\) That law substantially removed restrictions on affiliations between commercial banks and other kinds of financial firms for both domestic and foreign

\(^3\) Cross-border branches of foreign banks operate in the United States as a direct branch of the foreign parent and are not separately capitalized entities. Federal foreign branches and agencies are authorized by 12 U.S.C. §3102, which recognizes that states may also authorize branches of foreign banks to operate within their territory. The Board of Governors of the Federal Reserve System must approve all foreign branches and agencies, whether state or federal (see 12 U.S.C.§3105(d)). A good survey of the considerations for both firms and policymakers in the choice between subsidiaries and branches for foreign banks is provided in Jonathan Fiechter, Inci Otker-Robe, Anna Ilyina, Michael Hsu, Andre Santos, and Jay Surti (2011), “Subsidiaries or Branches: Does One Size Fit All?” Staff Discussion Note 11/04 (Washington: International Monetary Fund, March 7), www.imf.org/external/pubs/ft/sdn/2011/sdn1104.pdf.

\(^4\) Between 1972 and 1977, the number of foreign banking institutions in the United States roughly doubled, while the total assets of those institutions roughly tripled in absolute terms and doubled as a proportion of all banking assets in the United States, reaching nearly 13 percent. Henry Terrell and Sydney Key (1977), “The Growth of Foreign Banking in the United States: An Analytical Survey,” in *Key Issues in International Banking*, Conference Series No. 18 (Boston: Federal Reserve Bank of Boston, October).


institutions operating in the United States. Moreover, in light of provisions in Gramm-Leach-Bliley that permitted a foreign bank to be a financial holding company (FHC), the Federal Reserve announced in 2001 that a bank holding company (BHC) in the United States that was owned and controlled by a well-capitalized and well-managed foreign bank generally would not be required to meet the Board’s capital requirements normally applicable to BHCs.7

My second example relates to the massive fraud uncovered at the Bank of Credit and Commerce International (BCCI) and its subsequent collapse in 1991, which highlighted the need for more effective supervision of banks operating in multiple countries. The Foreign Bank Supervision Enhancement Act of 1991 (FBSEA) required foreign banks to receive approval from the Board before establishing a branch or agency in the United States.8 The law required the Federal Reserve, in turn, to determine that the foreign bank is subject to “comprehensive supervision or regulation on a consolidated basis” in its home country before approving an application either to open a branch or to acquire a U.S. subsidiary bank.

It is further worth noting that changes in U.S. law and regulatory practice affecting foreign banking organizations have often corresponded to changes in international regulatory agreements. For example, FBSEA was enacted at the same time as the Basel Committee on Banking Supervision was working to address the problems revealed by BCCI—an effort that bore fruit the next year in changes to the so-called Basel Concordat, which established minimum standards for the supervision of international banking groups.9 Another instance was the

substantial reduction or removal of remaining asset-pledge and asset-maintenance requirements for most U.S. branches of foreign banks, prompted in part by implementation of the new international capital standards included in the 1988 Basel Accord.

**The Shift in Foreign Bank Activities**

Although foreign banks expanded steadily in the United States during the 1970s, 1980s, and 1990s, their activities here posed limited risks to overall U.S. financial stability. Throughout this period, the U.S. operations of foreign banks were largely net recipients of funding from their parents and generally engaged in traditional lending to home-country and U.S. clients.\(^{10}\) U.S. branches and agencies of foreign banks held large amounts of cash during the 1980s and '90s, in part to meet asset-maintenance and asset-pledge requirements put in place by regulators. Their cash-to-third-party liability ratio from the mid-1980s through the late 1990s generally ranged between 25 percent and 30 percent.

The U.S. branches and agencies of foreign banks that borrowed from their parents and lent those funds in the United States (“lending branches”) held roughly 60 percent of all foreign bank branch and agency assets in the United States during the 1980s and '90s. Commercial and industrial lending continued to account for a large part of foreign bank branch and agency balance sheets through the 1990s.\(^{11}\)

This profile of foreign bank operations in the United States changed in the run-up to the financial crisis. Reliance on less stable, short-term wholesale funding increased significantly. Many foreign banks shifted from the “lending branch” model to a “funding branch” model, in which U.S. branches of foreign banks were borrowing large amounts of U.S. dollars to upstream to their parents. These “funding branches” went from holding 40 percent of foreign bank branch

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\(^{10}\) FFIEC 002, various years.

\(^{11}\) FFIEC 002, various years.
assets in the mid-1990s to holding 75 percent of foreign bank branch assets by 2009. Foreign banks as a group moved from a position of receiving funding from their parents on a net basis in 1999 to providing significant funding to non-U.S. affiliates by the mid-2000s--more than $700 billion on a net basis by 2008.\textsuperscript{12}

A good bit of this short-term funding was used to finance long-term, U.S. dollar-denominated project and trade finance around the world. There is also evidence that a significant portion of the dollars raised by European banks in the pre-crisis period ultimately returned to the United States in the form of investments in U.S. securities. Indeed, the amount of U.S. dollar-denominated asset-backed securities and other securities held by Europeans increased significantly between 2003 and 2007, much of it financed by the short-term, dollar-denominated liabilities of European banks.\textsuperscript{13} Meanwhile, commercial and industrial lending originated by U.S. branches and agencies as a share of their third-party liabilities fell significantly after 2003.\textsuperscript{14} In contrast, U.S. broker-dealer assets of the top-10 foreign banks increased rapidly during the past 15 years, rising from 13 percent of all foreign bank third-party assets in 1995 to 50 percent in 2011.\textsuperscript{15}

**Lessons from the Recent Financial Crisis**

The 2007–2008 financial crisis and the continuing financial stress in Europe have revealed financial stability risks associated with the foreign banking model as it has evolved in the United States. To some extent the concerns associated with foreign banking operations track the more general shortcomings of pre-crisis financial regulation. Internationally agreed

\textsuperscript{12} FFIEC 002, various years.


\textsuperscript{14} FFIEC 002, various years.

\textsuperscript{15} FR Y-9C, FFIEC 002, FR Y-7, FR 2886b, FFIEC 031/041, FR Y-7N/S, X-17A-5 Part II (SEC Form 1695), and X-17A-5 Part IIA (SEC Form 1696).
minimum capital levels were too low, the quality standards for required capital were too weak, the risk weights assigned to certain asset classes did not reflect their actual risk, and the potential for liquidity strains was seriously underappreciated.

But some risks are more closely tied to the specifically international character of certain global banks, both here and in some other parts of the world. The location of capital and liquidity proved critical in the resolution of some firms that failed during the financial crisis. Capital and liquidity were in some cases trapped at the home entity, as in the case of the Icelandic banks and, in our own country, Lehman Brothers. Actions by home-country authorities during this period showed that while a foreign bank regulatory regime designed to accommodate centralized management of capital and liquidity can promote efficiency during good times, it also increases the chances of ring-fencing by home and host jurisdictions at the moment of a crisis, as local operations come under severe strain and repayment of local creditors is called into question. Resolution regimes and powers remain nationally based, complicating the resolution of firms with large cross-border operations.

The large intra-firm, cross-border flows that grew rapidly in the years leading up to the crisis also created vulnerabilities. To be fair, the ability to move liquidity freely throughout a banking group may have provided some financial stability benefits during the crisis by enabling banks to respond to localized balance-sheet shocks and dysfunctional markets in some areas (such as the interbank and foreign exchange swap markets) and by transferring resources from healthier parts of the group. Nevertheless, this model also created a degree of cross-currency funding risk and heavy reliance on swap markets that proved destabilizing.  

Moreover, foreign banks that relied heavily on short-term, U.S. dollar liabilities were forced to sell U.S. dollar

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assets and reduce lending rapidly when that funding source evaporated, thereby compounding risks to U.S. financial stability.

Although the United States did not suffer a destabilizing failure of foreign banks, many rode out the crisis only with the help of extraordinary support from home- and host-country regulators. Following national treatment practice, the Federal Reserve itself provided substantial discount window access to U.S. branches and the opportunity to participate in the Primary Dealer Credit Facility to U.S. primary-dealer subsidiaries of foreign banks. Moreover, the potential for funding disruptions did not disappear with the waning of the global financial crisis. In 2011, for example, as concerns about the euro zone rose, U.S. money market funds suddenly pulled back their lending to large euro area banks, reducing lending to these firms by roughly $200 billion over just four months.17

While there has been some reduction in operations and some change in funding patterns by foreign banking organizations in the United States since the crisis, particularly by European firms reacting to euro zone financial stress, the basic circumstances have not changed.18 The proportion of foreign banking assets to total U.S. banking assets has remained at about one-fifth since the end of the 1990s. But the concentration and complexity of those assets have changed noticeably from earlier decades, and have not reversed in recent years despite the global financial crisis and subsequent events. Ten foreign banks now account for more than two-thirds of foreign bank third-party assets held in the United States, up from 40 percent in 1995.19 And while the

17 SEC N-MFP Form.
18 The significant funding pressures experienced by a number of European firms in 2011, highlighted by a quiet run by money market funds and other short-term funders, were mitigated by the liquidity-support measures undertaken by the European Central Bank. As a result, many of the U.S. operations of these firms are currently receiving net funding from their parents. A parallel development has been a shift in lending activity from a number of European firms to non-European firms, even as the total proportion of U.S. lending accounted for by foreign banks has remained roughly constant in the last few years.
19 FR Y-9C, FFIEC 002, FR 2886b, FFIEC 031/041, FR Y-7N/S, X-17A-5 Part II (SEC Form 1695), and X-17A-5 Part IIA (SEC Form 1696).
largest U.S. operations of foreign banks do not approach the size of our largest domestic financial institutions, it is striking that there are 23 foreign banks with at least $50 billion in assets in the United States—the threshold established by the Dodd-Frank Act for special prudential measures for domestic firms—compared with 25 U.S. firms.\(^{20}\)

Most notably, perhaps, five of the top-10 U.S. broker-dealers are owned by foreign banks. Like their U.S.-owned counterparts, large foreign-owned U.S. broker-dealers were highly leveraged in the years leading up to the crisis. Their reliance on short-term funding also increased, with much of the expansion of both U.S.-owned and foreign-owned U.S. broker-dealer activities attributable to the growth in secured funding markets during the past 15 years.\(^{21}\)

Finally, we should note that one of the fundamental elements of the current approach—our ability, as host supervisors, to rely on the foreign bank to act as a source of strength to its U.S. operations—has come into question in the wake of the crisis. The likelihood that some home-country governments of significant international firms will backstop their banks’ foreign operations in a crisis appears to have diminished. It also appears that constraints have been placed on the ability of the home offices of some large international banks to provide support to their foreign operations. The motivations behind these actions are not hard to understand and appreciate, but they do affect the supervisory terrain for host countries such as the United States.

**International and Domestic Regulatory Response**

Since the crisis, important changes have been made to strengthen international regulatory standards. The Basel III capital and liquidity frameworks are big improvements, and the

\(^{20}\) Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376 (2011). Sections 165 and 166 apply to all foreign banks with $50 billion or more in global consolidated assets and a U.S. banking presence of any size. More than 100 foreign banks operating in the United States would meet this threshold today (source: FR Y-7Q). Whether such a bank with relatively small U.S. operations should be subject to the same prudential requirements as those with U.S. operations in excess of $50 billion is an open question.

\(^{21}\) SEC FOCUS reports.
proposed capital surcharges for systemically important firms will be another important step forward. But these reforms are primarily directed at the consolidated level, with little attention to vulnerabilities posed by internationally active banks in host markets. The risks associated with large intra-group funding flows have remained largely unaddressed. Managing international regulatory initiatives also has become more difficult, as the number of complex items on the agenda has increased. And despite continued work by the Financial Stability Board, challenges to cross-border resolution are likely to remain significant. For the foreseeable future, then, our regulatory system must recognize that while internationally active banks live globally, they may well die locally.

Quite apart from the need to act pragmatically under the circumstances, it is not clear that we should aim toward extensive harmonization of national regulatory practices related to foreign banking organizations. The nature and extent of foreign banking activities vary substantially across national markets, suggesting that regulatory responses might best vary as well. For instance, the importance of the U.S. dollar in many international transactions can motivate foreign banks to use their U.S. operations to raise dollar funding for their international operations, potentially creating vulnerabilities. Such a model is unlikely to prevail in most other host financial markets around the world.

Indeed, in response to financial stability risks highlighted during the crisis, ongoing challenges associated with the resolution of large cross-border firms, and the limitations of the international reform agenda, several national authorities have already introduced their own policies to fortify the resources of internationally active banks within their geographic boundaries. Regulators in the United Kingdom, for example, have recently increased requirements for liquidity to cover local operations of domestic and foreign banks, set stricter
rules around intra-group exposures of U.K. banks to foreign subsidiaries, and moved to ring-fence home-country retail operations.\textsuperscript{22} Meanwhile, Swiss authorities have explicitly prioritized the domestic systemically important operations of their large, internationally active firms in resolution.\textsuperscript{23}

Here in the United States, Congress included in the Dodd-Frank Act a number of changes directed at the financial stability risk posed by foreign banks. Sections 165 and 166 instruct the Federal Reserve to implement enhanced prudential standards for large foreign banks as well as for large domestic BHCs and nonbank systemically important financial institutions. Dodd-Frank also bolstered capital requirements for FHCs, including foreign FHCs, by extending the well-capitalized and well-managed requirements beyond U.S. bank subsidiaries to the top-tier holding company.

In addition, the so-called Collins Amendment in Dodd-Frank removed the exemption from BHC capital requirements granted by the Federal Reserve’s Supervision and Regulation Letter 01-01.\textsuperscript{24} The required phase-out of SR 01-01 was clearly intended to strengthen the capital regime applied to the U.S. operations of foreign banks; however, the organizational flexibility that the amendment gave to foreign banks in the United States has allowed some large foreign banks to restructure their U.S. operations to minimize the impact of this regulatory change. As a result, in the absence of additional structural requirements for foreign banks in the United States, the effectiveness of our capital regime for large foreign banks with both bank and nonbank operations in the United States depends on the foreign bank’s own organizational choices.

A Rebalanced Approach to Foreign Bank Regulation

As has been the case in the past, we need to adjust the regulatory requirements for foreign banks in response to changes in the nature of their activities in the United States, the risks attendant to those changes, and instructions from Congress in new statutory provisions. The modified regime should counteract the risks posed to U.S. financial stability by the activities of foreign banking organizations, as manifested in the years leading up to, and through, the financial crisis. Special attention must be paid to the risk of runs associated with significant reliance on short-term funding. In addition, the regime should reduce the difficulties in resolution of cross-border firms. Finally, it should take steps to diminish the potential need for ex-post ring-fencing when losses mount or runs develop during a crisis, since such actions may well be unhelpfully procyclical.

At the same time, in modifying our regulatory regime for foreign banking organizations, we must remain mindful of the benefits that foreign banks can bring to our economy and of the important policies of national treatment and comparable competitive opportunity. Thus, we should chart a middle course, not moving to a fully territorial model of foreign bank regulation, but instead making targeted adjustments to address the risks I have identified. In basic terms, three such adjustments are desirable.

First, a more uniform structure should be required for the largest U.S. operations of foreign banks--specifically, that these firms establish a top-tier U.S. intermediate holding company (IHC) over all U.S. bank and nonbank subsidiaries. An IHC would make application of enhanced prudential supervision more consistent across foreign banks and reduce the ability of foreign banks to avoid U.S. consolidated-capital regulations. Because U.S. branches and agencies are part of the foreign parent bank, they would not be included in the IHC. However,
they would be subject to the activity restrictions applicable to branches and agencies today as well as to certain additional measures discussed below.

Second, the same capital rules applicable to U.S. BHCs should also apply to U.S. IHCs. These rules have been reshaped to counteract the risks to the U.S. financial system revealed by the crisis and should be implemented consistently across all firms that engage in similar activities. Similarly, other enhanced prudential standards required by the Dodd-Frank Act—including stress testing requirements, risk management requirements, single counterparty credit limits, and early remediation requirements—should be applied to the U.S. operations of large foreign banks in a manner consistent with the Board’s domestic proposal.25

Third, there should be liquidity standards for large U.S. operations of foreign banks. Standards are needed to increase the liquidity resiliency of these operations during times of stress and to reduce the threat of destabilizing runs as dollar funding channels dry up and short-term debt cannot be rolled over. For IHCs, the standards should be broadly consistent with the standards the Federal Reserve has proposed for large domestic BHCs, pending final adoption and phase-in of quantitative liquidity requirements by the Basel Committee.26 That is, they should be designed to ensure that, in stressed circumstances, the U.S. operations have enough high-quality liquid assets to meet expected net outflows in the short term. There should also be liquidity standards for foreign bank branch and agency networks in the United States, although they may be less stringent, in recognition of the integration of branches and agencies into the global bank as a whole.

By imposing a more standardized regulatory structure on the U.S. operations of foreign banks, we can ensure that enhanced prudential standards are applied consistently across foreign

banks and in comparable ways between U.S. banking organizations and foreign banking organizations. As with domestic firms subject to enhanced prudential standards, the Federal Reserve would work to ensure that the new regime is minimally disruptive, through transition periods and other means.

An IHC structure would also provide the Federal Reserve, as umbrella supervisor of the U.S. operations of foreign banks, with a uniform platform to implement a consistent supervisory program across large foreign banks. In the case of foreign banks with the largest U.S. operations, the IHC would also help mitigate resolution difficulties by providing U.S. regulators with one consolidated U.S. legal entity to place into receivership under title II of the Dodd-Frank Act if the failure of the foreign bank would threaten U.S. financial stability. Branches and agencies would remain separate, but all other entities would be included. Further, an IHC structure would facilitate a consistent U.S. capital regime for bank and nonbank activities of foreign banks under the IHC, similar to the approach taken in other jurisdictions, such as the United Kingdom and some continental European countries.

Some observers will, I am sure, ask if it is necessary to depart from the prevailing firm-by-firm approach to foreign banking regulation and to adopt generally applicable requirements in implementing the Dodd-Frank enhanced prudential standards for foreign banks. It is difficult to see how reliance on this approach can be effective in addressing risks to U.S. financial stability, at least in the absence of extraterritorial application of our own standards and supervision, and perhaps not even then. We would, at a minimum, need to make regular and detailed assessments of each firm’s home-country regulatory and resolution regimes, the financial stability risk posed by each firm in the United States, and the financial condition of the consolidated banking organization. In fact, such an approach might result in the worst of both worlds--an ongoing
intrusiveness into the consolidated supervision of foreign banks by their home-country regulators without the ultimate ability to evaluate those banks comprehensively or to direct changes in a parent bank’s practices necessary to mitigate risks in the United States. Although the Federal Reserve will continue to cooperate with its foreign counterparts in overseeing large, multinational banking operations, that supervisory tool cannot provide complete protection against risks engendered by U.S operations as extensive as those of many large U.S. institutions.

It is also important to note that while the reforms I have described today contain some elements that are more territorial than our current approach, including requiring some additional capital and liquidity buffers to be held in the United States, they do not represent a complete departure from prior practice. This enhanced approach would allow foreign banks to continue to operate branches in the United States and would generally allow branches to meet comparable capital requirements at the consolidated level. Similarly, this approach would not impose a cap on intra-group flows, thereby allowing foreign banks in sound financial condition to continue to obtain U.S. dollar funding for their global operations through their U.S. entities. It would instead provide an incentive to term out at least some of this funding in a way that reduces the risk of runs.

Requiring additional local capital and liquidity buffers, like any prudential regulation, may incrementally increase cost and reduce flexibility of internationally active banks that manage their capital and liquidity on a centralized basis. However, managing liquidity and capital on a local basis can have benefits not just for financial stability generally, but also for firms themselves. During the crisis, the more decentralized global banks relied somewhat less on cross-currency funding and were less exposed to disruptions in international wholesale funding.
and foreign exchange swap markets than the more centralized banks. Indeed, as noted earlier, in the wake of the crisis and of subsequent stresses, many foreign banks have modified their funding practices and business models. In revamping our approach, we will both be guarding against a return to pre-crisis practices and, more generally, ensuring that foreign banking operations in the United States that pose potential risks to U.S. financial stability are regulated similarly to domestic banking operations posing similar risks.

**Conclusion**

The imperative for change in our foreign bank regulation is clear and, indeed, mandated by Dodd-Frank. Of course, I have provided only an outline of the three key measures that will best navigate the middle course I have suggested. The all-important details are under discussion at the Board. I anticipate that in the coming weeks we will complete our work and issue a notice of proposed rulemaking that will elaborate the basic approach I have foreshadowed. I look forward to hearing your general reactions today and more specific feedback after the Board has adopted a proposed rule.

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