DOMESTICATING FOREIGN FINANCE

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Abstract

More than a decade after the 2008 financial crisis, U.S. policymakers still have not adequately addressed one of the primary causes of the crash: foreign banks. When foreign banks first entered the United States fifty years ago, they specialized in traditional banking products like loans and deposit accounts. Over time, however, many foreign banks shifted to a riskier strategy focused on speculative capital markets investments and fueled by volatile short-term debt. This novel business model created vulnerabilities for the U.S. financial system, as became clear when Deutsche Bank, Barclays, UBS, and other foreign banks accelerated the 2008 crisis.

This Article contends that while foreign banks' role in the U.S. financial system has evolved over time, the U.S. regulatory framework has not kept pace. After the financial crisis, policymakers tried to rein in foreign banks by regulating some of their U.S. offices directly, rather than deferring to home-country authorities. Some foreign banks, however, have evaded these reforms by shifting billions of dollars in assets to lightly regulated U.S. branches—a classic case of regulatory arbitrage. This Article asserts that foreign banks continue to pose risks to the U.S. financial system, threatening a recurrence of the Great Recession. Accordingly, this Article recommends an alternative regulatory approach—namely, mandatory subsidiarization of large foreign bank branches—that would better safeguard foreign banks' U.S. operations while remaining consistent with longstanding international regulatory norms.

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INTRODUCTION

When people remember the 2008 financial crisis, a handful of names probably come to mind: Lehman Brothers, AIG, Bear Stearns, Merrill Lynch, and Countrywide.[1] Although their paths to collapse were unique,

1. These firms' dominant role in the crisis has been documented in books and movies, among other mediums. *See, e.g.*, LAURENCE M. BALL, THE FED AND LEHMAN BROTHERS: SETTING THE RECORD STRAIGHT ON A FINANCIAL DISASTER 19–48 (2018) (analyzing Lehman Brothers' collapse); RODDY BOYD, FATAL RISK: A CAUTIONARY TALE OF AIG'S CORPORATE SUICIDE 235–50 (2011) (documenting AIG's failure); WILLIAM D. COHAN, HOUSE OF CARDS: A TALE OF HUBRIS AND WRETCHED EXCESS ON WALL STREET 108–36 (2009) (discussing Bear Stearns' emergency,

these firms had one thing in common: each was an *American* financial institution. Reflecting on the crisis, the general public, legal scholars, and—most troublingly—policymakers often overlook the unique role that *foreign* banks played in the crash that wiped out more than $17 trillion in household wealth.[2] By forgetting this history, the United States is now poised to repeat it: many foreign banks still operate domestically through lightly regulated legal entities that pose outsized risks to U.S. financial stability.

Foreign banking in the United States used to be boring, but it did not stay that way for long. When foreign banks first entered the United States in the 1970s, they focused on traditional banking activities—accepting deposits from and lending money to commercial and retail customers.[3] That changed, however, in the late 1990s. As domestic banks began to engage in riskier capital markets activities, foreign banks' U.S. offices soon followed suit.[4] The key difference was that many foreign banks' U.S. offices secured their funding from risky, short-term markets and channeled resources to their home jurisdictions—that is, outside the reach of U.S. regulators.[5]

As a result, foreign banks operating in the United States experienced severe distress when financial markets soured in 2007. Deutsche Bank, Credit Suisse, Barclays, UBS, and other foreign banks suffered extreme

government-assisted sale to JPMorgan); GREG FARRELL, CRASH OF THE TITANS: GREED, HUBRIS, THE FALL OF MERRILL LYNCH, AND THE NEAR-COLLAPSE OF BANK OF AMERICA 292–326, 422–35 (2010) (examining Merrill Lynch's failure and Bank of America's bailout); ADAM MICHAELSON, THE FORECLOSURE OF AMERICA: THE INSIDE STORY OF THE RISE AND FALL OF COUNTRYWIDE HOME LOANS, THE MORTGAGE CRISIS, AND THE DEFAULT OF THE AMERICAN DREAM 279–92 (2009) (discussing Bank of America's emergency acquisition of Countrywide in June 2008); TOO BIG TO FAIL (HBO Films 2011) (documenting big bank failures and government bailouts).

2. *See* MICHAEL S. BARR ET AL., FINANCIAL REGULATION: LAW AND POLICY 62–63 (2d ed. 2018) (citing data on household wealth destruction during the crisis).

3. *See* Daniel K. Tarullo, Member, Bd. of Governors of the Fed. Rsrv. Sys., Remarks at the Yale School of Management Leaders Forum: Regulation of Foreign Banking Organizations 5–6 (Nov. 28, 2012), https://www.federalreserve.gov/newsevents/speech/files/tarullo2012 1128a.pdf [https://perma.cc/H74F-55D8] (describing foreign banks' U.S. activities). A few foreign banks began operating in the United States as early as the 1870s. *See* Deborah Burand, *Regulation of Foreign Banks' Entry into the United States Under the FBSEA: Implementation and Implications*, 24 LAW & POL'Y INT'L BUS. 1089, 1089 n.2 (1993). However, these operations were quite limited, and foreign banks did not expand their U.S. activities in earnest until the 1970s. *See id.* at 1089.

4. *See* Tarullo, *supra* note 3, at 5–6.

5. *See* Daniel K. Tarullo, Member, Bd. of Governors of the Fed. Rsrv. Sys., Speech on Regulating Large Foreign Banking Organizations at the Harvard Law School Symposium on Building the Financial System of the Twenty-First Century: An Agenda for Europe and the United States 5–8 (Mar. 27, 2014), https://www.federalreserve.gov/newsevents/speech/files/tarullo 20140327a.pdf [https://perma.cc/8WYP-H9HL].

strains as credit markets froze.[6] To stabilize the financial system, the Federal Reserve took the unprecedented step of extending emergency loans to foreign banks, which relied heavily on U.S. government support to weather the crisis.[7]

In the aftermath of the crash, U.S. policymakers tried to strengthen the regulation of foreign banks' domestic operations. They did so by requiring a foreign bank to reorganize some of its U.S. offices underneath a single, intermediate holding company (IHC) subject to enhanced supervision and regulation by the Federal Reserve.[8] This reform, however, was a half measure at best. That is because policymakers permitted foreign banks to continue operating in the United States through separate legal entities: lightly regulated branches that pose even greater systemic risks.[9]

This Article is the first legal scholarship to analyze the United States' regulation of foreign banks since the Great Recession.[10] Despite post-crisis improvements in the U.S. regulatory framework, foreign banks still pose serious risks that current safeguards do not adequately address. In fact, post-crisis rules—including the IHC requirement—unintentionally exacerbate risks by incentivizing foreign banks to strategically shift

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6. *Cf.* Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77 Fed. Reg. 76,628, 76,630 (Dec. 28, 2012) (codified at 12 C.F.R. pt. 252 (2020)) (noting that foreign banking organizations that relied on short-term U.S. dollar liabilities were forced to sell assets rapidly).

7. *See, e.g.*, Prudential Standards for Large Foreign Banking Organizations, 84 Fed. Reg. 21,988, 21,989 (proposed May 15, 2019) (to be codified in scattered sections of 12 C.F.R.) (discussing foreign banks' use of Federal Reserve emergency lending facilities).

8. *See* Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17,240, 17,269–78 (Mar. 27, 2014) (codified at 12 C.F.R. § 252.153 (2020)).

9. *See id.* at 17,276 (noting that IHC requirement does not apply to foreign bank branches); *see also* Linda S. Goldberg & David R. Skeie, *Why Did U.S. Branches of Foreign Banks Borrow at the Discount Window During the Crisis?*, LIBERTY ST. ECON. (Apr. 13, 2011), https://libertystreeteconomics.newyorkfed.org/2011/04/why-did-us-branches-of-foreign-banks-borrow-at-the-discount-window-during-the-crisis.html [https://perma.cc/4646-L82A] (discussing unique risks of foreign bank branches).

10. Legal scholarship on international financial regulation has typically focused on global standard-setting bodies like the Basel Committee on Bank Supervision and Financial Stability Board (FSB), which attempt to coordinate regulatory policies among developed countries. *See, e.g.*, DAVID ZARING, THE GLOBALIZED GOVERNANCE OF FINANCE 46–61 (2020) (discussing standard-setting bodies for internationally active banks); Michael S. Barr, *Who's in Charge of Global Finance*, 45 GEO. J. INT'L L. 971, 980–88 (2014) (discussing international bank regulatory networks); Matthew C. Turk, *Reframing International Financial Regulation After the Global Financial Crisis: Rational States and Interdependence, Not Regulatory Networks and Soft Law*, 36 MICH. J. INT'L L. 59, 65–76 (2014) (analyzing the development of international financial regulatory networks); Pierre-Hughes Verdier, *Transnational Regulatory Networks and Their Limits*, 34 YALE J. INT'L L. 113, 132–43 (2009) (examining the development of efficacy of the Basel Committee on Bank Supervision). This Article, however, is the first post-crisis legal scholarship to focus on how the United States oversees foreign banks that operate domestically.

assets to their less-regulated branches.[11] This Article therefore proposes a better framework to safeguard foreign banks' U.S. operations while retaining the benefits they bring to the U.S. and global economies.

Foreign banks play a significant role in the U.S. financial system. Collectively, foreign banks' U.S. offices own more than $4 trillion in assets, constituting more than one-sixth of the domestic banking sector.[12] These assets are concentrated within the largest foreign banks. Indeed, six foreign banks—Bank of Montreal, Deutsche Bank, HSBC, Mitsubishi UFJ Financial Group, Royal Bank of Canada, and Toronto-Dominion—operate domestic offices that would rank among the thirteen biggest U.S. bank holding companies.[13]

Although foreign banks provide some valuable financial intermediation in the United States, they also expose the domestic financial sector to unique risks that domestic banks do not. For example, foreign banks' U.S. operations rely overwhelmingly on short-term wholesale financing, which can evaporate quickly and trigger asset fire sales, as occurred in 2008.[14] Moreover, foreign banks contribute disproportionately to credit bubbles: foreign bank lending increases more rapidly during expansionary periods and falls more sharply during contractions compared to domestic banks.[15] Meanwhile, foreign banks operating in the United States generally do not pay into the federal Deposit Insurance Fund, and thereby externalize costs on creditors and the broader financial system when they experience distress.[16] Foreign banks also pose unique challenges for U.S. authorities seeking to enforce anti-money-laundering laws, prevent terrorist financing, and detect other illicit activity.[17]

Despite these risks, foreign banks have traditionally benefitted from regulatory flexibility to structure their U.S. operations through several different legal entity types. Under U.S. law, a foreign bank that satisfies minimum regulatory requirements may establish a locally incorporated

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11. *See infra* Section II.B (documenting shift to foreign bank branches).

12. *See* FED. RSRV. BD., SHARE DATA FOR THE U.S. OFFICES OF FOREIGN BANKING ORGANIZATIONS (Mar. 31, 2021) [hereinafter FEDERAL RESERVE SHARE DATA], https://www.federalreserve.gov/releases/iba/fboshr.htm [https://perma.cc/DVZ3-4HKP].

13. *Compare* FED. RSRV. BD., STRUCTURE DATA FOR THE U.S. OFFICES OF FOREIGN BANKING ORGANIZATIONS (Mar. 31, 2021) [hereinafter FEDERAL RESERVE STRUCTURE DATA—BY COUNTRY], https://www.federalreserve.gov/releases/iba/202103/bycntry.htm [https://perma.cc/BQ3D-H4TF] (reporting asset size of foreign banks' U.S. offices), *with* NAT'L INFO. CTR., LARGE HOLDING COMPANIES, https://www.ffiec.gov/npw/Institution/TopHoldings [https://perma.cc/FL9Y-EZZ7] (listing asset size of U.S. bank holding companies).

14. *See infra* Section III.A.1.

15. *See infra* Section III.A.3.

16. *See infra* Section III.A.4.

17. *See infra* Section III.B.

bank subsidiary with all the privileges of a U.S. bank.[18] Alternatively, a foreign bank may seek a federal or state charter to operate a U.S. branch—an extension of the parent bank, rather than an independent legal entity.[19] In addition, a foreign bank that meets elevated regulatory standards may set up a nonbank subsidiary, such as a broker-dealer or insurance company, in the United States.[20] This optionality reflects the longstanding U.S. legal principle of "national treatment"—the commitment that foreign banks will be treated no less favorably than similarly situated U.S. banks.[21]

This regulatory flexibility, however, intensifies the risks that foreign banks pose to the domestic financial system. While foreign banks' U.S. depository institution subsidiaries are generally no riskier than their domestic counterparts, foreign banks' other U.S. offices create unique vulnerabilities.[22] For example, many foreign banks' U.S. branches—which do not accept retail deposits—rely heavily on volatile forms of short-term funding that magnify the likelihood of destabilizing runs.[23] Moreover, because foreign banks' U.S. branches are legally part of the parent company and are overseen primarily by their home-country regulator, U.S. authorities lack timely access to important information about their financial condition.[24] Further, because many foreign banks have traditionally operated in the United States through numerous legal entities, both foreign bank management and U.S. supervisors have faced difficulties in aggregating and monitoring a foreign bank's risks across all its U.S. legal entities.[25]

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18. *See* John C. Dugan et al., *Forms of Entry, Operation, Expansion, and Supervision of Foreign Banks in the United States*, *in* REGULATION OF FOREIGN BANKS & AFFILIATES IN THE UNITED STATES 1, 49–52 (Randall D. Guynn ed., 7th ed. 2013).

19. *See id.* at 52–54. Foreign banks may also operate agencies in the United States, which are virtually identical to branches. *See id.* at 60–61. The primary difference between a branch and an agency is that an agency generally may not accept deposits. *See id.* at 61. For simplicity, this Article does not distinguish between branches and agencies and instead refers to both entity types collectively as branches.

20. *See* Barbara R. Mendelson & Hillel T. Cohn, *Broker-Dealer Affiliates of Foreign*, *in* REGULATION OF FOREIGN BANKS & AFFILIATES IN THE UNITED STATES 1063, 1065–66 (Randall D. Guynn ed., 7th ed. 2013).

21. *See* Chris Brummer, *Territoriality as a Regulatory Technique: Notes from the Financial Crisis*, 79 U. CIN. L. REV. 499, 503–04 (2010) (discussing the national treatment principle).

22. *See, e.g.*, IMF, GLOBAL FINANCIAL STABILITY REPORT: NAVIGATING MONETARY POLICY CHALLENGES AND MANAGING RISKS 73–74 (Apr. 2015) (noting that foreign banks' U.S. bank subsidiaries tend to behave similarly to U.S. depository institutions).

23. *See* Goldberg & Skeie, *supra* note 9.

24. *See* Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77 Fed. Reg. 76,628, 76,642 (Dec. 28, 2012) (codified at 12 C.F.R. pt. 252 (2020)).

25. *See infra* Section V.A.1.a.

The United States' post-crisis reforms do not sufficiently mitigate the perils of foreign banking. The IHC requirement, which the Federal Reserve implemented in 2014, was well intentioned in that it aimed to create a single focal point for managing and supervising a foreign bank's U.S. operations.[26] The IHC mandate, however, contains a critical omission: it does not apply to foreign banks' riskiest U.S. offices—their lightly regulated branches—which continue to pose significant systemic risks.[27] In fact, the IHC rule and other post-crisis reforms actually incentivize foreign banks to shift activities from their U.S. subsidiaries to branches, thereby exacerbating systemic risks. Indeed, many foreign banks have already strategically moved assets from their IHCs to branches to evade stricter regulation.[28]

This Article proposes a better approach to foreign bank regulation: mandatory subsidiarization of large foreign bank branches. Requiring systemically important foreign banks to operate in the United States through locally incorporated IHCs instead of branches would have several benefits.[29] For example, mandatory subsidiarization would create a single focal point to monitor and address a foreign bank's consolidated risk profile within the United States, rather than the dual IHC and branch structures that many foreign banks currently maintain.[30] Moreover, by creating easily separable local units, compulsory subsidiarization would enhance the United States' ability to wind down a foreign bank's domestic operations in an orderly fashion if it were to experience distress.[31] Subsidiarization would also bring more foreign bank activity in the United States within the federal deposit insurance system, thereby

26. *See* Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77 Fed. Reg. at 76,637.

27. *See* Prudential Standards for Large Foreign Banking Organizations, 84 Fed. Reg. 21,988, 21,990 (proposed May 15, 2019) (to be codified in scattered sections of 12 C.F.R.) (noting that foreign banks continue to rely overwhelmingly on runnable short-term funding).

28. *See infra* Section II.B.

29. The FSB annually identifies "global systemically important banks," or GSIBs, whose failure would cause significant disruption to the financial system or broader economy. *See* BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, GLOBAL SYSTEMICALLY IMPORTANT BANKS: UPDATED ASSESSMENT METHODOLOGY AND THE HIGHER LOSS ABSORBENCY REQUIREMENT 3–5 (2013), https://www.bis.org/publ/bcbs255.pdf [https://perma.cc/8LSU-HL8Y]. In 2020, the FSB identified thirty GSIBs, of which twenty-two are foreign banks. *See* FIN. STABILITY BD., 2020 LIST OF GLOBAL SYSTEMICALLY IMPORTANT BANKS (G-SIBS) 3 (2020), https://www.fsb.org/wp-content/uploads/P111120.pdf [https://perma.cc/7UU5-LZTC]. This Article recommends mandatory subsidiarization for any foreign GSIB that operates in the United States and any non-GSIB foreign bank with more than $25 billion in U.S. branch assets. *See infra* Part V.

30. *See infra* Section V.A.1.a.

31. *See infra* Section V.A.1.b.

helping to offset foreign banks' systemic risks and potentially enhancing competition for the United States' largest retail banks.[32]

Contrary to popular perception, mandatory subsidiarization would not threaten the U.S. or global financial systems. Critics contend that compulsory subsidiarization would lead to harmful balkanization and provoke retaliation that disadvantages U.S. banks.[33] These myths are unfounded. While mandatory subsidiarization is likely to reduce some short-term, cross-border capital flows, this is a feature, not a bug.[34] By eliminating risky branches, mandatory subsidiarization would diminish short-term capital markets transactions of dubious societal value while preserving socially desirable long-term investments.[35] Nor would compulsory subsidiarization in the United States hurt U.S. banks by provoking retaliation by foreign regulators. U.S. banks are less internationally focused than most foreign banks, and in any event, many other countries have already ring-fenced banking activities within their borders.[36]

To be sure, implementing mandatory subsidiarization will be politically challenging. Both foreign and domestic banks have traditionally opposed stronger U.S. regulation of international banks.[37] If necessary, U.S. policymakers could substantially strengthen the regulation of foreign banks' branches as an alternative to mandatory subsidiarization. An improved branch regulatory framework would involve, at a minimum, standardized liquidity requirements to ensure that foreign bank branches maintain sufficient financial resources in the United States.[38] While not as effective as subsidiarization, stronger branch regulations would at least partially mitigate the risks foreign banks pose to U.S. financial stability.

At its core, this Article calls for a reprioritization of the United States' regulatory objectives. Professor Dirk Schoenmaker famously theorized a "trilemma" in international financial regulation.[39] According to

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32. *See infra* Section V.A.1.d.

33. *See, e.g.*, Eugene A. Ludwig, *A Fragmented Bank Isn't a Safer One*, AM. BANKER, Jan. 20, 2011, at 9 (opposing forced subsidiarization).

34. *See* Adair Turner, Speech at the Conference on Capital Account Management and Macro-Prudential Regulation for Financial Stability and Growth: Too Much of the Wrong Sort of Capital Flow 27–28 (Jan. 13, 2014), https://cafral.org.in/sfControl/content/DocumentFile/214201410222PM_Paper_INDIA%20LATEST-Toomuchofthewrongsortofcapitalflow Jan13.pdf [https://perma.cc/BBQ9-5DGZ].

35. *See id.*

36. *See infra* Section V.A.2.

37. *See, e.g.*, *U.S. Banks Join Foreign Banks in Drive to Kill Subsidiary Effort*, AM. BANKER-BOND BUYER, Nov. 2, 1992 (describing U.S. banks' efforts to block Treasury Department proposal for mandatory subsidiarization of foreign banks' U.S. operations out of fear of retaliation).

38. *See infra* Section V.B.

39. Dirk Schoenmaker, *The Financial Trilemma*, 111 ECON. LETTERS 57, 57 (2011).

Schoenmaker, the objectives of (1) financial stability, (2) financial integration, and (3) national financial policies are incompatible—policymakers can achieve two of these three goals, but they must sacrifice the third.[40] This Article contends that, throughout the past several decades, the United States has mistakenly prioritized excessive financial integration at the expense of financial stability. United States policymakers have allowed foreign banks to specialize in risky capital markets activities that do not demonstrably benefit the domestic or global financial system—what former UK Financial Services Authority Chairman Adair Turner has called "the wrong sort of capital flow."[41] Recognizing that the risks of these activities are primarily borne domestically, the proposals in this Article would rebalance the United States' regulatory objectives to prioritize financial stability, without sacrificing economically productive financial integration.

This Article proceeds as follows. Part I introduces the basics of foreign banking and traces the evolution of foreign banks' U.S. operations that contributed to the 2008 financial crisis. Part II then examines the United States' attempts to rein in foreign banks in the wake of the 2008 crash and foreign banks' subsequent efforts to evade these restrictions by shifting assets to lightly regulated branches. Part III assesses the safety-and-soundness and national security risks that foreign banks continue to pose under the current regulatory framework. Part IV examines the longstanding international principle of national treatment and contends that the United States has been excessively accommodating to foreign banks. Part V then recommends alternative regulatory approaches—namely, mandatory subsidiarization or enhanced oversight of foreign bank branches—to better safeguard the U.S. financial system while continuing to respect international regulatory norms. The Article concludes that these reforms are necessary to prevent foreign banks from once again propagating a financial crisis in the United States.

I. EVOLUTION OF FOREIGN BANKING IN THE UNITED STATES

This Part examines how foreign banks came to occupy a central role in domestic finance during the past fifty years. Section A explains the basics of foreign banking in the United States, distinguishing among various legal entity structures and business models. Section B then discusses foreign banks' initial entry into U.S. financial markets in the 1970s and 1980s, when such firms focused on traditional lending and policymakers generally outsourced oversight of foreign banks to their home-country regulators. Section C then analyzes foreign banks' rapid

40. *See* DIRK SCHOENMAKER, GOVERNANCE OF INTERNATIONAL BANKING: THE FINANCIAL TRILEMMA 6–7 (2013); Schoenmaker, *supra* note 39, at 57.

41. Turner, *supra* note 34, at 2.

expansion in the late 1990s and early 2000s and simultaneous shift into risky capital markets activities. In doing so, it demonstrates how foreign banks became key contributors to the 2008 financial crisis.

A. *The Basics of Foreign Banking*

Before delving into the history of foreign banking, it is helpful to understand how foreign banks operate in the United States. This Section distinguishes between two legal structures through which foreign banks may establish a U.S. presence—subsidiarization and branching. It also examines three popular foreign bank business models in the United States—wholesale, retail, and clearing.

1. Foreign Bank Legal Structures

A foreign bank that meets certain minimum standards may establish a U.S. presence through either a subsidiary or branch. The selection of a subsidiary or branch structure has important consequences for the way a foreign bank is regulated and the activities it may conduct. Thus, distinguishing between these legal structures is critical to understanding the expansion of foreign banks and the current foreign bank landscape in the United States.

As one option, a foreign bank may establish one or more locally incorporated U.S. subsidiaries. For example, a foreign bank that obtains requisite regulatory approvals may operate a depository institution, or bank, subsidiary in the United States.[42] A foreign bank's U.S. bank subsidiary functions similarly to a U.S. bank controlled by domestic shareholders—it may conduct the same activities as and is regulated identically to other U.S. banks.[43] In addition to a bank subsidiary, a foreign bank that satisfies elevated regulatory standards may establish separate U.S. subsidiaries to conduct nonbank financial activities, such as investment banking and insurance.[44] A foreign bank's U.S. subsidiaries—whether banking or nonbanking—are incorporated in the United States, are separately capitalized, have independent balance sheets, and are overseen by local boards of directors.[45] Figure A depicts

42. *See* 12 C.F.R. § 225.11(f) (2020) (establishing regulatory framework for a foreign bank's acquisition or establishment of a U.S. bank subsidiary). The United States offers several different types of depository institution charters that may be available to a foreign company. *See* BARR ET AL., *supra* note 2, at 171–72. For simplicity, this Article refers to all depository institutions as "banks" unless otherwise noted.

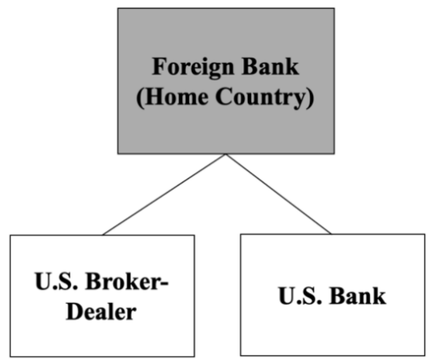
43. *See* Daniel Belton et al., *Foreign Banks, Liquidity Shocks, and Credit Stability* 31 (Bank for Int'l Settlements, Working Paper No. 845, 2020), https://www.bis.org/publ/work845.pdf [https://perma.cc/LY7Q-UQDU].

44. A foreign bank must be considered "well capitalized" and "well managed" in order to establish a nonbank financial subsidiary. *See* 12 U.S.C. § 1843(l)(3); 12 C.F.R. § 225.90 (2020).

45. *See* JONATHAN FIECHTER ET AL., IMF, SUBSIDIARIES OR BRANCHES: DOES ONE SIZE FIT ALL? 16 (2011).

a simplified foreign bank with a U.S. broker-dealer and U.S. bank subsidiary.

Figure A:
The Subsidiary Structure



A subsidiary structure offers several advantages, but also some critical drawbacks, for a foreign bank operating in the United States. Most significantly, a U.S. bank subsidiary benefits from the ability to accept deposits from retail customers—a reliable and attractive form of financing.[46] In addition, the subsidiary structure is generally thought to enhance managerial oversight because subsidiary managers control their local operations and benefit from the legitimacy and expertise of U.S. bank supervisors.[47] On the other hand, a bank subsidiary typically has a higher cost structure due, in part, to capital requirements and assessments payable to the Deposit Insurance Fund (DIF).[48] Moreover, a bank subsidiary has limited flexibility to redeploy capital and liquidity to its parent company or affiliates.[49]

As an alternative to the subsidiary model, a foreign bank may operate in the United States through one or more branches. In contrast to a subsidiary—which is a distinct legal entity owned by the foreign bank—

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46. *See* Dugan et al., *supra* note 18, at 49–50.

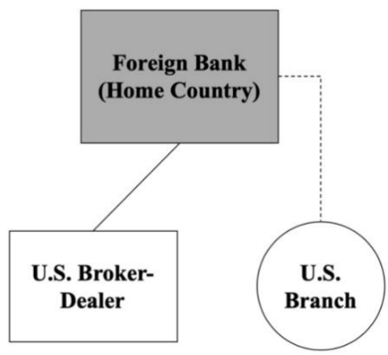
47. As one foreign bank executive put it: "There is no question in my mind that a subsidiari[z]ed structure . . . gives us a better management and governance structure internally." HOUSE OF COMMONS TREASURY COMM., TOO IMPORTANT TO FAIL—TOO IMPORTANT TO IGNORE 43 (2010) https://publications.parliament.uk/pa/cm200910/cmselect/cmtreasy/261/261i.pdf [https://perma.cc/AKP6-75TA] (quoting HSBC Group Finance Director Douglas Flint); *see also* Adrian E. Tschoegl, *Who Owns the Major US Subsidiaries of Foreign Banks? A Note*, 14 J. INT'L FIN. MKTS. INSTS. & MONEY 255, 256–57 (2004) ("[B]y incorporating its local operations the parent hires the governance services of the host country's regulatory authorities.").

48. *See* Dugan et al., *supra* note 18, at 50.

49. *See* FIECHTER ET AL., *supra* note 45, at 225.

a branch is simply an extension of the parent company.[50] A branch lacks an independent legal identity and is not separately capitalized.[51] Rather, the liabilities of a foreign bank branch represent claims on the parent company.[52] As a result, home-country authorities typically retain an active role in overseeing the activities of foreign banks' U.S. branches.[53] Figure B depicts a simplified foreign bank with a broker-dealer subsidiary and a branch in the United States.

Figure B:
The Branch Structure



Like the subsidiary structure, a branch structure has both advantages and disadvantages. Branches are attractive to some foreign banks because they allow capital and liquidity to flow relatively freely across borders, enabling the parent company to reallocate resources throughout the firm.[54] Furthermore, a branch may be less costly to maintain than a subsidiary due to lighter regulatory and tax burdens.[55] The primary drawback of a branch structure, however, is that a U.S. branch of a foreign bank generally may not accept retail deposits of less than $250,000.[56]

50. *See* 12 C.F.R. § 211.21(e) (2020) (defining a branch as "any place of business of a foreign bank, located in any state, at which deposits are received").

51. *See* FIECHTER ET AL., *supra* note 45, at 222.

52. *See* Giovanni Dell'Ariccia & Robert Marquez, *Risk and the Corporate Structure of Banks*, 65 J. FIN. 1075, 1076 (2010).

53. *See* Dugan et al., *supra* note 18, at 51 ("A U.S. branch of a foreign bank is subject to less U.S. regulation than a separately incorporated, federally insured bank subsidiary of a foreign bank.").

54. *See* FIECHTER ET AL., *supra* note 45, at 225.

55. *See* Eugenio Cerutti et al., *How Banks Go Abroad: Branches or Subsidiaries?*, 31 J. BANKING & FIN. 1669, 1671 (2007) (discussing regulatory and tax implications of foreign bank branch structures).

56. *See* 12 U.S.C. § 3104(b)–(c) (prohibiting foreign bank branches from receiving deposits below the federal deposit insurance limit); 12 U.S.C. § 1821(a)(1)(E) (setting the federal deposit insurance limit at $250,000). Currently, ten foreign bank branches are permitted to accept retail deposits under a grandfathering exemption. *See* 12 U.S.C. § 3104(d)(2) (establishing grandfather exemption); FED. RSRV. BD., STRUCTURE DATA FOR THE U.S. OFFICES OF FOREIGN BANKING ORGANIZATIONS (Mar. 31, 2021) [hereinafter FEDERAL RESERVE STRUCTURE DATA—BY TYPE],

Thus, foreign branches are typically limited to accepting wholesale deposits from corporations and high net worth individuals.[57]

In light of these trade-offs, a foreign bank's decision of how to conduct banking activities in the United States—through subsidiaries, branches, or both—represents an important strategic choice. Traditionally, a few foreign banks have chosen to establish only local bank subsidiaries.[58] Other foreign banks operate in the United States exclusively through branches.[59] However, most large foreign banks today establish both subsidiaries and branches to provide maximum flexibility for their U.S. activities and thereby optimize their domestic operations.[60]

2. Foreign Bank Business Models

A foreign bank's structure is closely related to its U.S. business model. Today, foreign banks typically pursue three distinct business models in the United States: wholesale banking, retail banking, and dollar clearing. This Section briefly describes these strategies and identifies the foreign banks most commonly associated with each business model.

First, some foreign banks adopt a wholesale strategy in which they serve corporate clients, including other financial institutions. This business model is the preferred strategy of many of the largest European banks—notably, Barclays, Credit Suisse, Deutsche Bank, and UBS.[61] Consistent with their historical focus on investment banking, these firms

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https://www.federalreserve.gov/releases/iba/202103/bytype.htm [https://perma.cc/CL66-BL2G] (listing foreign bank branches eligible for exemption).

57. *See* John C. Dugan et al., *FDIC Insurance and Regulation of U.S. Branches of Foreign Banks*, *in* REGULATION OF FOREIGN BANKS & AFFILIATES IN THE UNITED STATES 767, 777–78 (Randall D. Guynn ed., 7th ed. 2013).

58. *See* Dugan et al., *supra* note 18, at 50.

59. *See* FEDERAL RESERVE STRUCTURE DATA—BY COUNTRY, *supra* note 13 (listing foreign banks' U.S. bank subsidiaries and branches).

60. *See id.*

61. *See generally* RYM AYADI ET AL., CTR. FOR EUROPEAN POL'Y STUD., BUSINESS MODELS IN EUROPEAN BANKING: A PRE- AND POST-CRISIS SCREENING 80–100 (2011), http://aei.pitt.edu/32659/1/82._Business_Models_in_European_Banking.pdf [https://perma.cc/9NKW-5GCX] (describing European banks' business models); *Building on Strong 2Q20 Performance, Credit Suisse Launches Key Initiatives to Reinforce Strategy*, Credit Suisse (July 30, 2020), https://www.credit-suisse.com/about-us/en/media-news/media-releases.html (search in "Media & news" search bar for "key initiatives"; then select "2020" in "Year" dropdown; then click query button) (noting Credit Suisse's wholesale strategy of serving corporate and institutional clients); UBS Group, Handbook 2001/2002, at 14 (2002), https://www.ubs.com/global/en/investor-relations/financial-information/annual-reporting/ar-archive/_jcr_content/mainpar/toplevelgrid/col1/accordionbox/table_979533848.0327163548.file/dGFibGVUZXh0PS9jb250ZW50L2RhbS91YnMvZ2xvYmFsL2Fib3V0X3Vicy9pbnZlc3Rvcl9yZWxhdGlvbnMvMzI4NDlfSEJfMjAwMV9lLnBkZg==/32849_HB_2001_e.pdf [https://perma.cc/EEX8-LLFQ]. Other large European banks, including BNP Paribas and Société Générale, also pursue a wholesale business model in the United States. *See* AYADI ET AL., *supra*.

specialize in brokering and dealing in the United States.[62] In addition, the European wholesale banks provide underwriting, cash management, and treasury services to other financial institutions and large, nonfinancial corporate clients.[63] Wholesale-oriented foreign banks typically operate in the United States through numerous legal entities, including investment bank subsidiaries, bank subsidiaries, and U.S. branches.[64]

A second subset of foreign banks adopts a retail strategy focused on traditional banking products like loans and deposit accounts. Today, the retail business model is most closely associated with banks from Canada—including Toronto-Dominion and Bank of Montreal—and Europe—such as Spain's Santander.[65] These banks serve retail and commercial customers, often through separately branded U.S. bank subsidiaries. For example, Toronto-Dominion operates TD Bank and Bank of Montreal operates BMO Harris Bank, the eighth- and nineteenth-largest commercial banks in the United States, respectively.[66] In addition to these bank subsidiaries, many retail-oriented foreign banks maintain U.S. branches and some also have investment bank subsidiaries.[67]

Finally, a third group of foreign banks focuses on dollar clearing in the United States. Dollar clearing is the process by which a bank converts a client's or affiliate's foreign currency into U.S. dollars in connection

62. AYADI ET AL., *supra* note 61, at 80–100.

63. *See id.* at 27 (discussing wholesale banks).

64. Barclays, Credit Suisse, Deutsche Bank, and UBS each maintain one or more U.S. branches and at least $75 billion in U.S. nonbank assets. *See* MARC LABONTE, CONG. RSCH. SERV., R45711, ENHANCED PRUDENTIAL REGULATION OF LARGE BANKS 7 (2019); FEDERAL RESERVE STRUCTURE DATA—BY COUNTRY, *supra* note 13 (listing the U.S. branches of Barclays, Credit Suisse, Deutsche Bank, and UBS). In addition, of the four firms, three operate a bank subsidiary in the United States—only Credit Suisse does not. *See* BARR ET AL., *supra* note 2, at 772.

65. *See, e.g.*, Sital S. Patel, *Canadian Banks Map Next Stage of U.S. Invasion*, MARKETWATCH (July 25, 2014), https://www.marketwatch.com/story/why-canadas-big-banks-smell-profit-in-a-us-invasion-2014-07-23 [https://perma.cc/VW7S-CAVY]; Laura Alix, *Santander CEO's Growth Plan: Challenge Fintechs, Emphasize Global Ties*, AM. BANKER (Dec. 26, 2019), https://www.americanbanker.com/news/santander-ceos-growth-plan-challenge-fin techs-emphasize-global-ties [https://perma.cc/2EWE-RSMB]. In addition, some Japanese banks—including Mitsubishi UFJ Financial Group—and European banks—such as HSBC—blend the retail and wholesale business models in their United States' operations. *See* Kristin Broughton, *MUFG's Big Plan to Expand Its U.S. Business is Just Getting Started*, AM. BANKER (Apr. 1, 2018), https://www.americanbanker.com/news/mufgs-big-us-expansion-is-just-getting-started [https://perma.cc/J6L2-CRBU]; Laura Alix, *Once Focused on Affluent Households, HSBC Now Eyes Mass Market*, AM. BANKER (June 20, 2019), https://www.americanbanker.com/news/once-focused-on-affluent-households-hsbc-now-eyes-mass-market [https://perma.cc/3CPA-U64Z].

66. *See* FED. RSRV. STAT. RELEASE, LARGE COMMERCIAL BANKS (June 30, 2020), https://www.federalreserve.gov/releases/lbr/20200630/default.htm [https://perma.cc/QDP2-L2Q3].

67. *See* FEDERAL RESERVE STRUCTURE DATA—BY COUNTRY, *supra* note 13 (listing U.S. branches of Toronto-Dominion, Bank of Montreal, and Santander, among other retail-focused foreign banks); *see also* Patel, *supra* note 65 (discussing Canadian banks' U.S. investment bank subsidiaries).

with a loan payment, supplier payment, or other financial transaction.[68] In general, clearing-oriented foreign banks focus on servicing home-country clients rather than U.S. customers.[69] Prominent dollar clearing banks include the UK's Standard Chartered Bank and many smaller foreign banks for whom "[t]he role of being a direct dollar clearer has historically carried prestige."[70] Clearing-oriented banks typically operate through U.S. branches that are often—but not always—smaller than other foreign bank branches.[71]

In sum, the modern-day foreign bank sector is not monolithic. To the contrary, there is considerable variation in foreign banks' U.S. legal structures and business models.[72] Foreign banks' business models, however, have not remained static over time. Foreign banks have transformed their U.S. operations in response to changes in U.S. financial regulation and the domestic bank competition, as the next two Sections describe.

B. *Early Foreign Banking*

Foreign banking in the United States has evolved rapidly since its modest beginnings roughly fifty years ago.[73] Foreign banks' U.S. presence surged in the latter part of the twentieth century, growing from less than 4% of the U.S. banking sector in 1973 to nearly 20% by 2000.[74] Faced with intensified competition, domestic banks argued that foreign banks enjoyed unfair regulatory advantages, and a series of scandals involving foreign banks intensified misgivings about foreign bank oversight.[75] As a result, Congress enacted two laws—the International

68. *See* Andrew R. Johnson, *5 Things on Dollar Clearing and BNP Paribas*, WALL ST. J. (June 30, 2014), https://www.wsj.com/articles/BL-263B-880 [https://perma.cc/A2YH-7MBQ].

69. *See* Duncan Kerr, *Clearing: European Banks Weigh Up US Dollar Clearing Options*, EUROMONEY (Jan. 5, 2015), https://www.euromoney.com/article/b12kjyygbzp9v4/clearing-european-banks-weigh-up-us-dollar-clearing-options [https://perma.cc/Y5NK-TX9X].

70. *Id.*; *see also* Rachel Louise Ensign & Max Colchester, *Standard Chartered Aims to Fix Money-Clearing System*, WALL ST. J. (Aug. 21, 2014), https://www.wsj.com/articles/standard-chartered-faces-need-to-repair-anti-money-laundering-systems-1408563887 [https://perma.cc/BD97-GSPZ] (discussing Standard Chartered's dollar clearing business).

71. *See* FEDERAL RESERVE STRUCTURE DATA—BY TYPE, *supra* note 56 (depicting variation in asset sizes of foreign banks' U.S. branches).

72. While many foreign banks fall neatly into one of the wholesale, retail, or dollar clearing categories, some firms combine elements of two or even all three business models. *See, e.g.*, Broughton, *supra* note 65.

73. While a few foreign banks established modest U.S. operations in the 1870s, foreign firms did not enter the United States in earnest until the 1970s. *See* Burand, *supra* note 3, at 1089.

74. *See* Dugan et al., *supra* note 18, at 4 n.1 (highlighting data from 1973); FEDERAL RESERVE SHARE DATA, *supra* note 12 (showing data from 2000).

75. *See* Dugan et al., *supra* note 18, at 10.

Banking Act of 1978 (IBA)[76] and Foreign Bank Supervision Enhancement Act of 1991 (FBSEA)[77]—in an attempt to ensure a level competitive playing field and prevent foreign bank misconduct. Nonetheless, U.S. regulators conducted limited safety-and-soundness oversight of foreign banks' U.S. operations, instead deferring to foreign banks' home-country authorities on prudential matters.[78] This Section traces the early evolution of foreign banking in the United States and policymakers' efforts to maintain competitive equity and avert unsavory conduct.

When foreign banks entered the United States in the mid-twentieth century, they were subject to a patchwork of state-level licensing laws and regulations, with little federal oversight.[79] A foreign bank that operated in the United States exclusively through branches was not subject to federal limitations on either interstate branching or nonbanking activities applicable to domestic banks.[80] Nor was such a bank subject to federal prudential rules, such as reserve requirements.[81] Foreign banks took advantage of this flexibility, doubling their share of U.S. banking assets between 1972 and 1977.[82] Domestic banks complained that the inconsistent regulatory regimes disadvantaged U.S. depository institutions, which were all subject to some federal oversight.[83]

In response to these concerns, Congress adopted the IBA in 1978 to establish federal oversight of foreign banks that operate branches in the United States. The IBA purported to institute a principle of "national treatment," or "parity of treatment between foreign and domestic banks in like circumstances."[84] In an effort to equalize oversight, the IBA

76. Pub. L. No. 95-369, 92 Stat. 607 (codified as amended in scattered sections of 12 U.S.C.).

77. Pub. L. No. 102-242, 105 Stat. 2286 (codified as amended in scattered sections of 12 U.S.C. and 15 U.S.C.).

78. *See* Tarullo, *supra* note 3, at 3–4.

79. *See* Tarullo, *supra* note 3, at 3–4. *Id.*; Derek M. Bush, *A Dramatic Departure? National Treatment of Foreign Banks*, THE CLEARING HOUSE (2015), https://www.theclearinghouse.org/banking-perspectives/2015/2015-q1-banking-perspectives/articles/national-treatment-of-foreign-banks [https://perma.cc/XB93-9CLD].

80. *See* Bush, *supra* note 79.

81. *See* Bradley K. Sabel, *Federal Reserve's Reserve Requirements on Deposits as Applied to Branches and Agencies of Foreign Banks*, *in* REGULATION OF FOREIGN BANKS & AFFILIATES IN THE UNITED STATES 283, 290–91 (Michael Gruson & Ralph Reisner eds., 7th ed. 2013).

82. *See* Tarullo, *supra* note 3, at 3 n.4.

83. *See* Bush, *supra* note 79.

84. S. REP. NO. 95-1073, at 2 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 1421, 1422; *see also* Arvind Mahajan et al., Note, *Valuation Effects of the International Banking Act on Foreign Banks Operating in the United States*, 23 J. MONEY, CREDIT, & BANKING 110, 110 (1991) (describing Congress's desire to regulate foreign banks at a national level). Although the IBA is generally regarded as having established the principle of "national treatment" for foreign banks operating in the United States, the phrase appears only once in the statute—in a section directing the Secretary of the Treasury to conduct a study on the extent to which U.S. banks are denied

subjected foreign banks to limitations on interstate expansion and nonbanking activities similar to domestic banks.[85] Likewise, the IBA required foreign bank branches that accepted retail deposits to maintain Federal Deposit Insurance Corporation (FDIC) deposit insurance, just like U.S. banks.[86] At the same time, the IBA authorized foreign banks to seek a federal branch charter from the Office of the Comptroller of the Currency (OCC) as an alternative to a state charter, paralleling the charter choice available to domestic banks under the United States' dual banking system.[87]

Even after the IBA eliminated foreign banks' perceived competitive advantages, overseas firms continued to expand their banking activities in the United States. Foreign banks again doubled their share of U.S. assets between 1980 and 1992.[88] Despite their increased size, foreign banks generally did not raise safety-and-soundness concerns since they primarily engaged in traditional lending to home-country and U.S. clients.[89] Moreover, foreign bank parents provided ample funding to their U.S. operations, contributing more financial resources to their U.S. subsidiaries and branches than they withdrew.[90] Thus, as the Federal Reserve observed, "[a]lthough foreign banking organizations expanded steadily in the United States during the 1970s, 1980s, and 1990s, their activities here posed limited risks to overall U.S. financial stability."[91]

Despite the perception of foreign banks as safe, a series of scandals revealed continued deficiencies in U.S. oversight of foreign banks. In 1989, media outlets reported that the Atlanta branch of Banca Nazionale del Lavoro—Italy's largest state-owned bank—had violated U.S. policy by extending more than $3 billion in loans to Iraq.[92] Shortly thereafter,

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national treatment when operating abroad. International Banking Act of 1978 § 9, Pub. L. No. 95-369, 92 Stat. 607, 623–24 (codified at 12 U.S.C. § 601 note).

85. International Banking Act of 1978 §§ 5, 8. Congress later liberalized these restrictions for both foreign and domestic banks in the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994 and the Gramm–Leach–Bliley Act. *See* Dugan et al., *supra* note 18, at 17–25.

86. International Banking Act of 1978 § 6. This provision required foreign branches that accepted deposits of less than the standard maximum deposit insurance amount—at the time $100,000—to obtain FDIC deposit insurance. *See* Dugan et al., *supra* note 57, at 770.

87. International Banking Act of 1978 § 4.

88. *See* Mitchell Berlin, *New Rules for Foreign Banks: What's at Stake?*, 98 BUS. REV. 1, 1 (2015).

89. *See* Tarullo, *supra* note 3, at 5.

90. *See id.*

91. Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77 Fed. Reg. 76,628, 76,629 (Dec. 28, 2012) (codified at 12 C.F.R. pt. 252 (2020)).

92. *See* Alan Riding, *Italian Bank's Unauthorized Credits to Iraq*, N.Y. TIMES, Sept. 7, 1989, at D1; Laura Colby, *BNL Routinely Sent Iraqi Loans to Atlanta Unit*, WALL ST. J., Sept. 21, 1989, Factiva, Doc. No. j000000020011116dl9l00p9h.

authorities discovered that global banking conglomerate Bank of Credit and Commerce International (BCCI) had unlawfully acquired several U.S. banks and perpetrated widespread frauds involving illegal loans, concealed losses, and accounting misrepresentations.[93] At the time, experts considered the BCCI scandal to be "the biggest financial fraud in history."[94] U.S. authorities and their international counterparts shut down BCCI and its affiliates, seizing $20 billion in assets in the process.[95]

In response to these scandals, Congress again attempted to rein in foreign banks—this time by centralizing foreign bank oversight in the Federal Reserve and limiting their involvement in retail activities. The FBSEA, enacted in 1991, requires a foreign bank to obtain Federal Reserve approval before establishing a presence in the United States.[96] Although the FBSEA preserves a foreign bank's choice of the OCC or a state as its chartering authority, the statute directs the Federal Reserve to review all charter applications and coordinate periodic examinations of foreign banks' U.S. operations with the relevant supervisory agencies.[97] Further, the FBSEA prohibits new foreign bank branches from obtaining federal deposit insurance, reversing the IBA's requirement that new branches maintain insurance.[98] Thus, after the FBSEA, foreign bank branches are generally limited to accepting high-dollar deposits and engaging in wholesale activities.[99] The FBSEA's prohibition on foreign branch deposit insurance was generally understood to protect domestic banks' competitiveness in retail markets.[100]

While U.S. policymakers concentrated on equalizing the competitive playing field and preventing misconduct, they devoted comparatively little attention to overseeing the safety and soundness of foreign banks'

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93. *See* David Lascelles et al., *The Biggest Bank Fraud in History*, FIN. TIMES, Nov. 9, 1991, at I.

94. Daniel M. Laifer, *Putting the Super Back in the Supervision of International Banking, Post-BCCI*, 60 FORDHAM L. REV. S467, S467 (1992).

95. *See* David Lascelles & Richard Donkin, *BCCI Shut Down Worldwide Amid Fraud Disclosures: Unprecedented Operation as Authorities Seize Bank's Assets*, FIN. TIMES, July 6, 1991, at 1.

96. Foreign Bank Supervision Enhancement Act of 1991, Pub. L. No. 102-242, § 202(a), 105 Stat. 2286, 2286–87 (codified at 12 U.S.C. § 3105). When acting on a foreign bank's application to establish a U.S. office, the Federal Reserve must consider, among other factors, the foreign bank's "financial and managerial resources" and whether the foreign bank "is subject to comprehensive supervision or regulation on a consolidated basis by the appropriate authorities in its home country[.]" *Id.* (codified at 12 U.S.C. § 3105(d)(2)–(3)).

97. *See id.* §§ 202–03.

98. *See id.* § 214(a), (c).

99. *See* Dugan et al., *supra* note 57, at 771–74. Congress grandfathered foreign bank branches that obtained federal deposit insurance prior to enactment of the FBSEA. *See* 12 U.S.C. § 3104(c)(2). Currently, eight foreign banks operate a total of ten grandfathered, insured branches. *See* FEDERAL RESERVE STRUCTURE DATA—BY TYPE, *supra* note 56.

100. *See* Dugan et al., *supra* note 57, at 768–69.

U.S. operations. To be sure, foreign banks' U.S. subsidiaries were subject to capital, liquidity, and risk-management standards similar to other U.S. depository institutions.[101] Foreign bank branches, however, generally escaped U.S. safety-and-soundness oversight—despite far exceeding the size of foreign bank subsidiaries.[102] Instead, U.S. policymakers deferred to a foreign bank's home-country regulator to assess the health of its U.S. branches.[103] This practice was considered appropriate in light of the establishment of the international Basel Accord in 1988, which sought to eliminate divergences in bank capital requirements among developed countries.[104] Thus, while many states and the OCC initially established asset pledge requirements for foreign bank branches to ensure that they maintained sufficient financial resources in the United States, policymakers consistently weakened these protections over time as they increasingly relied on home-country authorities to monitor foreign banks' U.S. branches.[105]

In sum, throughout the late twentieth century, foreign banks expanded rapidly in the United States while policymakers focused on maintaining a level playing field and preventing foreign bank misconduct. During this time, foreign bank safety and soundness was not a primary focus for U.S. regulatory agencies, consistent with the assumptions that foreign banks posed little risk and were adequately regulated by their home-country authorities. Just a few years later, however, both of these beliefs would be severely challenged.

C. *The Pre-Crisis Metamorphosis in Foreign Banking*

Many foreign banks transformed their U.S. operations in the lead-up to the 2008 financial crisis. Diverging from their traditional lending activities, some foreign banks began focusing on capital market

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101. Dugan et al., *supra* note 18, at 49–52.

102. *See* FEDERAL RESERVE SHARE DATA, *supra* note 12 (indicating that foreign bank branches had between two and three times as many assets as foreign bank depository institution subsidiaries throughout the 1980s and 1990s). In addition to foreign banks' U.S. branches, foreign banks' U.S. broker-dealer subsidiaries—like all U.S. broker-dealers—were effectively not subject to financial stability oversight prior to the 2008 financial crisis. *See* Hilary J. Allen, *The SEC as Financial Stability Regulator*, 43 J. CORP. L. 715, 725 (2018) ("[T]he SEC has not typically been concerned with promoting the stability of individual client-facing institutions.").

103. *See* Roberta Romano, *For Diversity in the International Regulation of Financial Institutions: Critiquing and Recalibrating the Basel Architecture*, 31 YALE J. ON REG. 1, 52 (2014) (describing consolidated supervision under the Basel Accord).

104. *See id.* (noting that after the Basel Accord, home-country regulators were responsible for overseeing the solvency of foreign bank branches).

105. *See* Kathleen A. Scott, *State Regulation of Foreign Banks*, *in* REGULATION OF FOREIGN BANKS & AFFILIATES IN THE UNITED STATES 347, 365–66 (Randall D. Guynn ed., 7th ed. 2013) (discussing relaxation of state regulations); Rebecca Christie, *OCC Eases Capital Regs for US Branches of Foreign Banks*, DOW JONES CAP. MKTS. REP., Mar. 4, 2002 (discussing weakening of federal safeguards).

investments, which they funded with volatile short-term financing. Neither U.S. nor home-country regulators, however, fully appreciated the extent or riskiness of these new activities. As a result, when credit markets began to tighten in 2007, foreign banks' U.S. operations propagated distress throughout the financial system and necessitated unprecedented emergency interventions by the U.S. government. This Section analyzes the dramatic shift in foreign banks' U.S. activities in the lead-up to the 2008 financial crisis and how these changes contributed to the market crash.

Around the turn of the century, foreign banks changed their U.S. strategy in three significant ways. First, many foreign banks' domestic operations began investing heavily in capital markets instruments—including mortgage-backed securities, reverse repurchase agreements, and trading assets—in lieu of their traditional lending activities.[106] Consistent with this capital markets orientation, foreign banks reallocated large amounts of assets to their U.S. broker-dealer subsidiaries, which enjoyed freedom to invest in a wide range of financial assets.[107] Even foreign bank branches substantially increased their capital markets activities, nearly doubling their trading assets while their lending remained flat.[108] Wholesale-oriented European banks led this trend toward capital markets activities, but even retail-oriented foreign banks bolstered their investment banking operations.[109]

Second, foreign banks reversed the flow of intragroup funding: rather than providing financial resources to their U.S. operations, as they had in the past, foreign banks began using their U.S. presence as a source of dollar financing for their parent companies. Foreign banks' U.S. branches had previously received funding from their parent companies, but by 2007, U.S. branches provided more than $450 billion in financing to their

106. *See* Tarullo, *supra* note 3, at 1 (discussing how foreign banks expanded operations beyond "traditional lending activities").

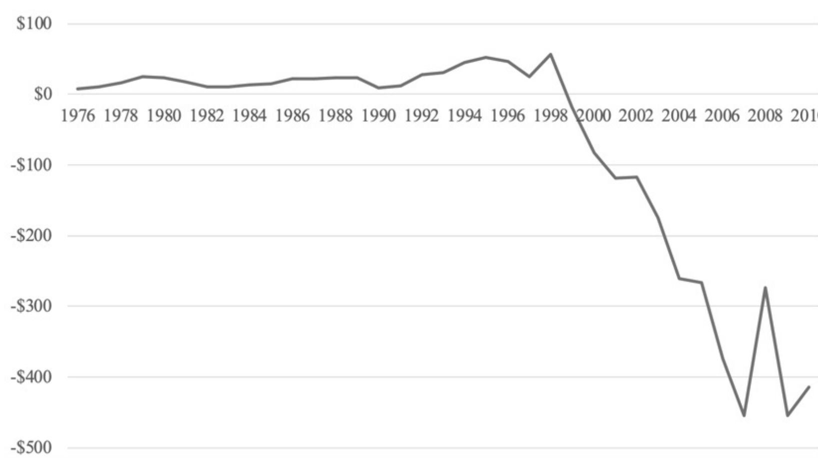
107. *See* Tarullo, *supra* note 5, at 6–7 (discussing shift to broker-dealers); *see also* Mendelson & Cohn, *supra* note 20, at 1101–14 (discussing permissible activities for foreign banks' broker-dealer subsidiaries).

108. Foreign bank branches increased their trading assets by 93% between 2000 and 2006, while expanding commercial and industrial lending by only 5%. *See* FED. RSRV. BD., ASSETS AND LIABILITIES OF U.S. BRANCHES AND AGENCIES OF FOREIGN BANKS, DECEMBER 31, 2006 (Stat. Supp. 2007), https://www.federalreserve.gov/pubs/supplement/2007/05/table4_30p1.htm [https://perma.cc/36ZJ-ZPMG]; BD. OF GOVERNORS OF THE FED. RSRV. SYS., ASSETS AND LIABILITIES OF U.S. BRANCHES AND AGENCIES OF FOREIGN BANKS, DECEMBER 31, 2000, 87 FED. RSRV. BULL. 283, A72 (2001).

109. *See, e.g.*, Laura Noonan, *The Rise and Dramatic Fall of European Investment Banks in the US*, FIN. TIMES (Mar. 2, 2020), https://www.ft.com/content/68f8d7a6-56fb-11ea-a528-dd0f971febbc [https://perma.cc/2U84-DMZP]; Alissa Schmelkin, *Bank of Montreal Buying a U.S. Investment Bank*, AM. BANKER, Apr. 7, 2003, at 20.

parents, on net.[110] Figure C depicts this sharp reversal. This shift represented a significant change in foreign banks' U.S. strategy and risk profile. In the past, foreign bank branches borrowed funds from their parents and used those funds to lend to commercial clients in the United States.[111] But in the lead-up to the financial crisis, the funds flowed in the opposite direction: U.S. branches became a source of funding for their parent companies.

Figure C:[112]
Net Due from U.S. Branches to Affiliated Foreign Banks ($ millions)



Third, in order to satisfy their parent companies' demand for U.S. dollars, foreign banks' U.S. operations relied increasingly on volatile, short-term wholesale financing. Beginning in the early 2000s, foreign banks' U.S. branches expanded their use of short-term financing

110. *See* BD. OF GOVERNORS OF THE FED. RSRV. SYS., ASSETS AND LIABILITIES OF U.S. BRANCHES AND AGENCIES OF FOREIGN BANKS—DECEMBER 31, 2007 (2008), https://www.federalreserve.gov/pubs/supplement/2008/05/default.htm [https://perma.cc/8ZD8-VMXS].

111. *See* Tarullo, *supra* note 3, at 5–6 (discussing this shift from a "'lending branch' model to a 'funding branch' model").

112. In Figure C, positive values represent net borrowing by U.S. branches from affiliated foreign banks. Negative values represent net lending by U.S. branches to affiliated foreign banks. Data are sourced from the Federal Reserve's Table 4.30: Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks. Data from 2009 and 2010 are available on the Federal Reserve's public website at https://www.federalreserve.gov/data/assetliab/default.htm [https://perma.cc/VZ7H-4STL]. Earlier data are published in the Federal Reserve Bulletin, which can be accessed at https://fraser.stlouisfed.org/title/federal-reserve-bulletin-62?browse=1910s [https://perma.cc/667K-QGLP].

instruments like repurchase agreements and securities lending arrangements, while shifting away from relatively stable deposit funding.[113] This emphasis on runnable, short-term financing created maturity mismatches as U.S. branches up-streamed funding to their parent companies, which used those funds to invest in long-term, dollar-denominated project and trade finance and asset-backed securities.[114] In sum, within the span of a few years, foreign banks' U.S. operations significantly increased their risk profile by investing in capital markets instruments, distributing funding to their parent companies, and relying on more volatile forms of financing.

Despite foreign banks' abrupt shift in strategy, neither U.S. nor home-country regulators fully appreciated the increased risks of this new business model. The Federal Reserve generally lacked access to timely information about the global operations of foreign banks and, accordingly, had limited insight into the overall risk profile of foreign banks' U.S. operations.[115] Meanwhile, foreign banks' home-country authorities did not typically recognize the full extent of the risks such firms were amassing abroad.[116] Further, home-country regulators may have sought to protect domestic interests at the expense of foreign banks' host countries by declining to share sensitive supervisory information.[117]

Foreign banks' riskier business models and inadequate supervisory oversight combined to create several systemic problems in the United States when market conditions deteriorated in mid-2007. For example, because of disruptions in wholesale funding markets, foreign banks' U.S. operations were unable to secure needed liquidity, forcing them to engage in asset fire sales that further depressed already declining asset prices.[118] Faced with significant stresses, foreign banks' U.S. operations curtailed

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113. Between 2001 and 2008, U.S. branches' "other borrowed money" increased six-fold, while their deposits merely doubled. *Compare* BD. OF GOVERNORS OF THE FED. RESERVE SYS., ASSETS AND LIABILITIES OF U.S. BRANCHES AND AGENCIES OF FOREIGN BANKS—DECEMBER 31, 2001, 88 FED. RES. BULL. 235, A72 (2002), *with* BD. OF GOVERNORS OF THE FED. RESERVE SYS., ASSETS AND LIABILITIES OF U.S. BRANCHES AND AGENCIES OF FOREIGN BANKS—DECEMBER 31, 2008, https://www.federalreserve.gov/econresdata/releases/assetliab/assetsliab20090331.htm [https://perma.cc/UQ48-AHQV].

114. Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77 Fed. Reg. 76,628, 76,630 (Dec. 28, 2012) (codified at 12 C.F.R. pt. 252 (2020)).

115. *Id.*

116. *See* Daniel K. Tarullo, Member, Bd. of Governors of the Fed. Rsrv. Sys., Remarks at the 18th Annual International Banking Conference: Shared Responsibility for the Regulation of International Banks 8 (Nov. 5, 2015), https://www.federalreserve.gov/newsevents/speech/files/tarullo20151105a.pdf [https://perma.cc/CH87-L66P] (noting that home country regulators failed to appreciate the risks that firms were assuming in other countries).

117. *See id.*

118. Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77 Fed. Reg. at 76,630.

their lending, reducing the supply of credit to U.S. borrowers when they needed it most.[119] Moreover, foreign banks' sizeable intra-firm, cross-border capital flows generated cross-currency funding risks that destabilized derivatives markets.[120] Despite these vulnerabilities, however, foreign bank parents were generally unwilling or unable to fortify their U.S. operations by providing needed capital or liquidity.[121]

As a result of this distress, the United States took extraordinary actions to stabilize foreign banks amidst the crisis. For instance, the Federal Reserve provided substantial assistance to foreign banks' U.S. branches through the discount window. Indeed, foreign bank branches accounted for a disproportionate share of discount window borrowing during the crisis, relative to domestic banks.[122] The Federal Reserve also opened its emergency liquidity facilities to foreign banks.[123] Almost half of foreign banks with U.S. operations borrowed from the Term Auction Facility, and foreign bank broker-dealer subsidiaries were active users of the Primary Dealer Credit Facility.[124] The Federal Reserve even lent to foreign central banks, establishing U.S. dollar swap lines to assist central banks in stabilizing their domestic banking systems.[125]

These interventions helped normalize financial markets and avert large-scale foreign bank collapses, but the 2008 market crash exposed the United States' systemic vulnerabilities to foreign banks. While financial markets generally experienced unprecedented stresses, "foreign banking

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119. *See id.*; *see also infra* Section III.A.3 (discussing foreign banks' tendency to curtail lending outside of their home countries during times of stress); Viral V. Acharya et al., How Do Global Banks Scramble for Liquidity? Evidence from the Asset-Backed Commercial Paper Freeze of 2007, at 27 (Fed. Rsrv. Bank of N.Y., Staff Rep. No. 623, Apr. 2016), https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr623.pdf [https://perma.cc/V3K6-LV4F] (documenting that foreign banks raised interest rates for U.S. dollar-denominated loans more than U.S. banks after funding disruptions in 2007).

120. Tarullo, *supra* note 3, at 7.

121. *See id.* at 7–8 (describing how foreign banks "were forced to sell U.S. dollar assets[,]" thus losing liquidity).

122. *See* Tarullo, *supra* note 116, at 12. During the week of peak discount window usage in October 2008, foreign banks accounted for at least 70% of the $110 billion borrowed from the Federal Reserve. *See* Bradley Keoun & Craig Torres, *Foreign Banks Used Fed Secret Lifeline Most at Crisis Peak*, BLOOMBERG (Apr. 1, 2011), https://www.bloomberg.com/news/articles/2011-04-01/foreign-banks-tapped-fed-s-lifeline-most-as-bernanke-kept-borrowers-secret [https://perma. cc/6X4C-LC2]. Wholesale-oriented European banks borrowed heavily from the discount window but so too did other foreign banks including Bank of China, Dexia, and Depfa Bank. *See id.*

123. *See* Keoun & Torres, *supra* note 122.

124. *See* Prudential Standards for Large Foreign Banking Organizations, 84 Fed. Reg. 21,988, 21,989 (proposed May 15, 2019) (to be codified in scattered sections of 12 C.F.R.); Tarullo, *supra* note 5, at 12.

125. *See* Colleen Baker, *The Federal Reserve's Use of International Swap Lines*, 55 ARIZ. L. REV. 603, 621 (2013).

in the United States [was] particularly volatile."[126] Foreign banks' distress reverberated throughout the U.S. financial system as their U.S. operations and parent companies purged dollar-denominated assets, pulled back on lending, and sent shocks through derivatives markets.[127] Domestic and foreign regulators, meanwhile, were ill-equipped to address these risks.[128]

II. THE POST-CRISIS FOREIGN BANK LANDSCAPE

In the aftermath of the 2008 crisis, U.S. policymakers sought to strengthen oversight of foreign banks to protect the domestic financial system. As the centerpiece of the reform agenda, the Federal Reserve mandated that a foreign bank with significant U.S. operations establish an intermediate holding company (IHC)—a shell company that would control the foreign bank's U.S. subsidiaries and be subject to enhanced regulation.[129] Although the IHC rule is an advancement over pre-crisis foreign bank regulation, it is merely a half-measure. That is because the IHC requirement addresses foreign banks' U.S. subsidiaries but not their U.S. branches. In response to this reform, foreign banks have predictably shifted their activities away from their subsidiaries and into branches, substantially undermining the effectiveness of the IHC rule. This Part describes the Federal Reserve's attempts to bolster foreign bank oversight through the IHC rule and foreign banks' efforts to evade these new safeguards.

A. *The Intermediate Holding Company Requirement*

In 2014, the Federal Reserve adopted a controversial new requirement that a foreign bank with a sizeable domestic presence must establish an IHC to hold its U.S. operations.[130] The Federal Reserve reasoned that the IHC requirement would enhance foreign bank oversight by creating a focal point for the supervision and regulation of the firm's subsidiaries.[131]

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126. William Goulding & Daniel E. Nolle, *Foreign Banks in the U.S.: A Primer* 27 (Bd. of Governors of the Fed. Rsrv. Sys., Int'l Fin. Discussion Paper, Working Paper No. 1064, 2012), https://www.federalreserve.gov/pubs/ifdp/2012/1064/ifdp1064.pdf [https://perma.cc/EG2D-V65W].

127. *Id.*

128. *Id.*

129. *See* Press Release, Bd. of Governors of the Fed. Rsrv. Sys., Federal Reserve Board Approves Final Rule Strengthening Supervision and Regulation of Large U.S. Bank Holding Companies and Foreign Banking Organizations (Feb. 18, 2014), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20140218a.htm [https://perma.cc/9ELG-XKFS].

130. *See* Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17,240, 17,269–78 (Mar. 27, 2014) (codified at 12 C.F.R. § 252.153 (2020)).

131. *See* Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77 Fed. Reg. 76,628, 76,637 (Dec. 28, 2012) (codified at 12 C.F.R. pt. 252 (2020)).

The IHC rule, however, contained a significant omission: it applied only to a foreign bank's U.S. subsidiaries but not its U.S. branches.

The Federal Reserve's IHC requirement is straightforward. A foreign bank with $50 billion or more in non-branch U.S. assets must establish an IHC to hold and operate its U.S. subsidiaries.[132] An IHC is then subject to prudential oversight by the Federal Reserve, similar to a U.S. bank holding company (BHC).[133] For example, an IHC must comply with U.S. capital requirements,[134] participate in Federal Reserve-run stress tests,[135] maintain a buffer of high-quality liquid assets,[136] and establish a risk committee of its board of directors.[137] At the time the rule was adopted, seventeen foreign banks were expected to form U.S. IHCs.[138]

The Federal Reserve's IHC requirement enhances foreign bank oversight in several ways. Most significantly, the creation of an IHC enables the Federal Reserve to supervise and regulate all of a foreign bank's U.S. subsidiaries on a consolidated basis.[139] Before the 2008 crisis, large segments of foreign banks' U.S. operations—including their broker-dealers and other nonbank subsidiaries—were not subject to safety-and-soundness oversight.[140] The IHC requirement, however, brings these nonbank subsidiaries into the prudential regulatory framework.[141] Moreover, because IHCs must maintain minimum levels of capital and liquidity in the United States, the IHC requirement attempts to ensure that foreign banks hold sufficient financial resources in the United States.[142] Ideally, consolidated capital and liquidity requirements will protect the solvency of a foreign banks' U.S. operations. Even if a

132. *See* 12 C.F.R. § 252.153(a) (2020). The Dodd–Frank Act did not expressly instruct the Federal Reserve to adopt the IHC rule. Rather, in issuing the IHC rule, the Federal Reserve cited the Dodd–Frank Act's general directive to establish appropriate prudential standards to prevent or mitigate risks to U.S. financial stability. *See* Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. at 17,269–70.

133. *See* Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. at 17,269–70.

134. *See* 12 C.F.R. § 252.153(e)(1).

135. *See id.* § 252.153(e)(5).

136. *See id.* § 252.153(e)(4).

137. *See id.* § 252.153(e)(3).

138. *See* Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. at 17,314.

139. *See* Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77 Fed. Reg. 76,628, 76,637 (Dec. 28, 2012) (codified at 12 C.F.R. pt. 252 (2020)).

140. *See* Allen, *supra* note 102, at 725.

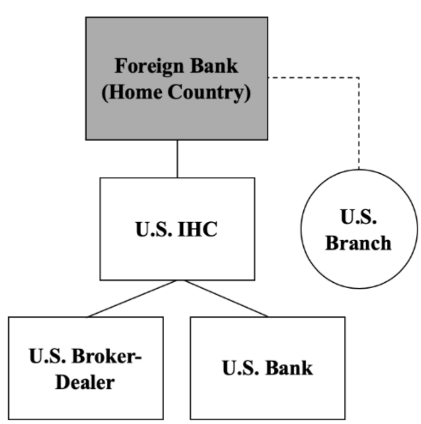
141. In doing so, the IHC requirement also helps equalize the treatment of foreign banks' U.S. operations with that of U.S. bank holding companies, whose nonbank subsidiaries are subject to consolidated oversight by U.S. authorities. *See* Tarullo, *supra* note 3, at 13–14.

142. *See* Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77 Fed. Reg. at 76,639–40, 76,642–43.

foreign bank's IHC experienced distress, however, ex ante capital and liquidity requirements could facilitate the firm's orderly resolution without relying on additional financial contributions by the foreign parent company.[143]

Despite the Federal Reserve's attempts to establish consolidated oversight of foreign banks' U.S. operations, the IHC rule contained a glaring omission: it did not require a foreign bank to situate its U.S. branches within its IHC. Instead, the Federal Reserve continued to allow a foreign bank to operate branches in the United States as an extension of the parent company.[144] In deciding not to require foreign banks to transfer branch assets to the IHCs, the Federal Reserve reasoned that "Congress has permitted foreign banking organizations to establish branches . . . in the United States if they meet specific standards," and excluding branches from the IHC requirement would "preserve flexibility for foreign banking organizations to operate directly in the United States based on the capital adequacy of their consolidated organization . . . ."[145] Accordingly, a foreign bank may continue to operate directly in the United States through one or more branches, but if it controls subsidiaries with $50 billion or more in total consolidated assets, it must hold those subsidiaries in an IHC that is subject to enhanced prudential standards.[146] Figure D depicts a simplified bank subject to the U.S. IHC requirement that also operates a U.S. branch.

Figure D:
The IHC Structure



143. *See id.* at 76,637.

144. *See* Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17,240, 17,272 (Mar. 27, 2014) (codified at 12 C.F.R. § 252.153 (2020)).

145. *See* Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77 Fed. Reg. 76,628, 76,638 (Dec. 28, 2012) (codified at 12 C.F.R. pt. 252 (2020)).

146. *Id.*

The Federal Reserve applied modest new prudential standards to foreign banks' U.S. branches after the 2008 crisis, but these rules are considerably weaker than the safeguards it applied to U.S. IHCs. For example, the Federal Reserve required a U.S. branch to maintain a fourteen-day buffer of highly liquid assets based on an internal stress test—a standard less than half as stringent as the thirty-day buffer required for a U.S. IHC.[147] In addition, the Federal Reserve mandated that a foreign bank establish a U.S. risk committee to oversee its U.S. branches, but it allowed the foreign bank to situate the risk committee at its U.S. IHC instead of the branch or parent company.[148] This arrangement raises doubts about whether a foreign bank's U.S. risk committee will have sufficient access to and authority over the bank's U.S. branches.[149] Finally, as in the past, the Federal Reserve declined to subject foreign banks' U.S. branches to domestic capital requirements or capital stress tests.[150] Instead, the United States continues to rely on a foreign bank's home-country regulator to oversee its solvency at the parent company level.[151]

The Federal Reserve's omission of branches from the IHC requirement is noteworthy because foreign bank branches were particularly problematic during the 2008 crisis. Foreign bank branches created acute liquidity pressures since they were generally unable to accept insured deposits and therefore relied overwhelmingly on short-term wholesale funding that evaporated during the crisis.[152] Moreover, foreign bank branches curtailed lending even more dramatically than foreign bank subsidiaries, exacerbating disruptions in domestic credit markets.[153] In addition, concerns about the efficacy of the United States' resolution framework for failed foreign bank branches may have contributed to the Federal Reserve's unprecedented emergency loans to foreign banks.[154] By omitting foreign bank branches from the IHC

147. *See* 12 C.F.R. § 252.157(c)(3)(i) (2020) (requiring a U.S. branch to maintain a fourteen-day liquidity buffer); *see also id.* § 252.157(c)(2)(i) (requiring U.S. IHCs to maintain a thirty-day liquidity buffer). Furthermore, in contrast to U.S. IHCs, U.S. branches are not subject to standardized liquidity requirements as a supplement to liquidity stress tests. *See id.* § 252.153(e)(4).

148. *See id.* § 252.155(a)(3)(ii)(B).

149. *See* Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. at 17,285.

150. *See id.* at 17,267–69.

151. *See id.*

152. *See* Prudential Standards for Large Foreign Banking Organizations, 84 Fed. Reg. 21,988, 21,990 (proposed May 15, 2019) (to be codified in scattered sections of 12 C.F.R.).

153. *See infra* Section IV.A.1.c.

154. *See generally* Steven L. Schwarcz, *The Confused U.S. Framework for Foreign-Bank Insolvency: An Open Research Agenda*, 1 REV. L. & ECON. 81, 85–89 (2005) (discussing U.S. insolvency regime for foreign bank branches).

requirement, therefore, the Federal Reserve failed to address one of the most prominent sources of risk from the 2008 crisis.

The United States' implementation of an IHC requirement for foreign bank subsidiaries is generally consistent with the international trend. Since the 2008 crisis, several other jurisdictions have established IHC requirements or equivalent restrictions on foreign banks operating within their borders.[155] Most significantly, in 2019, the European Union mandated that foreign banks with more than €40 billion of European assets establish IHCs for their European subsidiaries.[156] Commentators viewed the EU's mandate as retaliation for the United States' IHC requirement.[157] Like the United States, however, the EU's IHC requirement does not apply to foreign bank branches.[158] Thus, in many developed jurisdictions, host-country authorities have enforced new prudential requirements for foreign bank subsidiaries, but home-country authorities retain primary responsibility for oversight of their banks' foreign branches.[159]

In sum, the United States responded to risks propagated by foreign banks during the 2008 financial crisis by mandating that certain foreign banks establish an IHC that would be subject to enhanced regulation. This reform, however, was incomplete in that it addressed only foreign bank subsidiaries and effectively ignored foreign bank branches. As the next Section demonstrates, this disconnect has prompted foreign banks to shift assets from their IHCs to branches, thereby undermining the efficacy of the United States' post-crisis reforms.

B. *Regulatory Arbitrage and Migration to Branches*

In response to the United States' IHC requirement, foreign banks shrank their domestic subsidiaries while simultaneously expanding their U.S. branches in an effort to avoid onerous regulation in the United States. This asset migration is a classic case of regulatory arbitrage—institutions shifting activities to less regulated legal entities to avoid oversight.[160] In addition to the IHC rule, the United States further encouraged foreign banks to shift assets by adopting new deposit

155. *See infra* Section IV.A.2.b.

156. *See* Barnabas Reynolds et al., *The New EU Law on Intermediate Holding Companies for Third-Country Banking Groups*, SHEARMAN & STERLING (Mar. 26, 2019), https://www.shearman.com/perspectives/2019/03/the-new-eu-law-on-intermediate-holding-companies-for-third-country-banking-groups [https://perma.cc/LZX6-RJ3F].

157. *See* Alex Barker et al., *EU to Retaliate Against U.S. Bank Capital Rules*, FIN. TIMES (Nov. 21, 2016), https://www.ft.com/content/26078750-b003-11e6-a37c-f4a01f1b0fa1 [https://perma.cc/XMD2-VA9F].

158. *See* Reynolds et al., *supra* note 156.

159. *See* FIECHTER ET AL., *supra* note 45, at 222.

160. For a seminal academic treatment of regulatory arbitrage, see Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227 (2010).

insurance rules that privileged uninsured U.S. branches.[161] This Section describes both the evolution of foreign banks' U.S. operations in response to post-crisis reforms and how regulatory arbitrage threatens to impede the efficacy of these safeguards.

In a textbook example of regulatory arbitrage, foreign banks have strategically shifted activities from IHCs—where they are subject to relatively stringent U.S. oversight—to their branches, where they face comparatively little scrutiny. Moving or recharacterizing activities in response to regulatory developments is a common phenomenon in financial markets.[162] Indeed, it is generally expected that financial activities will migrate to legal entities that are subject to looser regulation.[163]

Foreign banks began shifting assets out of their U.S. subsidiaries even before the Federal Reserve officially adopted the IHC rule. Some firms, including Royal Bank of Scotland and Socièté Gènèrale, reduced their non-branch U.S. assets below $50 billion after the Federal Reserve finalized the IHC rule in 2014 so they did not have to establish U.S. IHCs.[164] Deutsche Bank, meanwhile, halved the assets it held in U.S. subsidiaries before the U.S. IHC rule became effective in mid-2016.[165] This shrinkage reflected, in part, foreign banks' retrenchment in response to the European debt crises in the early 2010s.[166] However, the reduction in foreign banks' U.S. subsidiaries was also directly related to the IHC requirement, as foreign banks simultaneously increased assets in their U.S. branches.[167]

161. *See* Belton et al., *supra* note 43, at 22–25; Lawrence L. Kreicher et al., *The 2011 FDIC Assessment on Banks' Managed Liabilities: Interest Rate and Balance-Sheet Responses* 15–21 (Bank for Int'l Settlements, Working Paper No. 413, 2013), https://www.bis.org/publ/work413.pdf [https://perma.cc/TW92-MYJB].

162. *See, e.g.*, Erik F. Gerding, *The Dialectics of Bank Capital: Regulation and Regulatory Capital Arbitrage*, 55 WASHBURN L.J. 357, 370–75 (2016) (discussing regulatory arbitrage with respect to bank capital requirements); Jeremy C. Kress & Matthew C. Turk, *Too Many to Fail: Against Community Bank Deregulation*, 115 NW. U. L. REV. 647, 708 (2020) (discussing regulatory capital arbitrage with respect to interest rate ceilings and repurchase agreements).

163. *See* Annelise Riles, *Managing Regulatory Arbitrage: A Conflict of Laws Approach*, 47 CORNELL INT'L L.J. 63, 68–76 (2014).

164. *See* Lawrence L. Kreicher & Robert N. McCauley, *The New U.S. Intermediate Holding Companies: Reducing or Shifting Assets?*, BIS Q. REV., Mar. 2018, at 10.

165. *See id.*

166. *See, e.g.*, Marietta Cauchi, *Europe's Battered Lenders Turn to Retrenchment*, WALL ST. J. (Feb. 23, 2012), https://www.wsj.com/articles/SB10001424052970203918304577238711214428858 [https://perma.cc/5SRL-G677].

167. *See* FEDERAL RESERVE SHARE DATA, *supra* note 12 (showing increase of $125 billion in assets in foreign bank branches between 2012 and 2016); *see also* Teodora Paligorova & Juit Temesvary, *Foreign Banks' Asset Reallocation In Response to the Introduction of the Intermediate Holding Company Rule of 2016* (FEDS Notes, May 12, 2021), https://www.federalreserve.gov/econres/notes/feds-notes/foreign-banks-asset-reallocation-intermediate-holding-company-rule-of-2016-20210512.htm [https://perma.cc/M8D2-M8PQ] (finding

The migration of foreign bank assets out of subsidiaries and into branches accelerated in earnest after the IHC requirement went into effect. Between the third quarter of 2016 and year-end 2019, foreign banks reduced their U.S. IHC assets by $230 billion.[168] By contrast, foreign banks grew their U.S. branches by almost the same amount—$209 billion—over the same period.[169] Thus, once the IHC rule became law, it drove even more foreign bank activity into lightly regulated branches.[170]

Besieged by domestic debt crises and flagging profitability, the wholesale-oriented European banks led the post-2016 contraction in U.S. IHC assets. In response to challenges at home, Deutsche Bank, Credit Suisse, UBS, and Barclays gradually retreated from the United States in the latter part of the 2010s.[171] In aggregate, these four banks shrank their U.S. footprints by more than 20% between 2016 and 2019.[172]

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that "the reduction in [foreign bank] assets that would be subject to the IHC rule began in advance" of the rule's implementation date, as foreign banks "shifted assets to branches" in anticipation of the rule).

168. Twelve foreign banks were required to establish U.S. IHCs when the rule went into effect in the third quarter of 2016: Toronto-Dominion, HSBC, Credit Suisse, Barclays, Deutsche Bank, UBS, MUFG, BNP Paribas, Royal Bank of Canada, Santander, Bank of Montreal, and BBVA. These banks' U.S. IHCs had $2.25 trillion in assets as the third quarter of 2016. *See* NAT'L INFO. CTR., *supra* note 13 (select September 30, 2016 report date). By year-end 2019, the same IHCs had $2.02 trillion in assets. *See id.* (select December 31, 3019 report date).

169. *Compare* BD. OF GOVERNORS OF THE FED. RESERVE SYS., ASSETS AND LIABILITIES OF U.S. BRANCHES AND AGENCIES OF FOREIGN BANKS—SEPTEMBER 30, 2016, https://www.federalreserve.gov/econresdata/releases/assetliab/assetsliab20161231.htm [https://perma.cc/5Z6A-LYS4] (reporting $2.29 trillion in foreign bank branch assets), *with* BD. OF GOVERNORS OF THE FED. RESERVE SYS., ASSETS AND LIABILITIES OF U.S. BRANCHES AND AGENCIES OF FOREIGN BANKS—DECEMBER 31, 2019, https://www.federalreserve.gov/data/assetliab/assetsliab20200331.htm [https://perma.cc/68HV-DG44] (reporting $2.50 trillion in foreign bank branch assets).

170. U.S. law imposes two modest limits on a foreign bank's ability to move assets from its IHC to a branch. First, foreign bank branches may engage only in the "business of banking," so a foreign bank may not shift nonbanking activities to its U.S. branch. *See* 12 U.S.C. § 3102(b) (providing that a foreign bank branch may conduct activities permissible for national banks); *id.* § 24 (Seventh) (restricting national banks to the "business of banking"). Second, a foreign bank's transfer of assets from a U.S. IHC to a U.S. branch generally must comply with the affiliate transaction limits in section 23A of the Federal Reserve Act. *See* Robert E. Mannion & Tengfei (Harry) Wu, *Transactions Between Foreign Banks and Affiliated Entities*, *in* REGULATION OF FOREIGN BANKS & AFFILIATES IN THE UNITED STATES 377, 381, 416–18 (Randall D. Guynn ed., 7th ed. 2013) (discussing application of affiliate transaction limits to foreign bank branches).

171. *See* Noonan, *supra* note 109; *Deutsche Bank's Retreat Ends European Hopes of Conquering Wall Street*, ECONOMIST (July 11, 2019), https://www.economist.com/leaders/2019/07/11/deutsche-banks-retreat-ends-european-hopes-of-conquering-wall-street [https://perma.cc/SH5S-LCBE].

172. Collectively, Deutsche Bank, Credit Suisse, UBS, and Barclays controlled $1.11 trillion in U.S. assets as of September 30, 2016. *See* NAT'L INFO. CTR., *supra* note 13 (select September 30, 2016 report date for IHC assets); FED. RSRV. BD., STRUCTURE DATA FOR THE U.S. OFFICES OF FOREIGN BANKING ORGANIZATIONS (Sept. 30, 2016) [hereinafter SEPTEMBER 2016 STRUCTURE

The European wholesale banks' waning U.S. presence, however, masked a troubling dynamic: while these firms pulled back from the United States, they also reorganized their remaining U.S. operations in a way that limits domestic oversight. Between 2016 and 2019, Barclays, Credit Suisse, Deutsche Bank, and UBS collectively slashed $298 billion, or 33%, of the assets from their U.S. IHCs.[173] Over the same time period, these firms *increased* their U.S. branch assets by $129 billion, or 42%, before slightly moderating the size of their branches.[174] Exhibit E depicts the sharp drop in IHC assets and the simultaneous increase in branch assets at the four European wholesale banks after the IHC rule went into effect. These banks have been transparent about their intentions to evade stricter U.S. oversight. A Deutsche Bank representative, for example, confirmed that the migration of assets to its U.S. branches reflected its "capital optimization" strategy.[175]

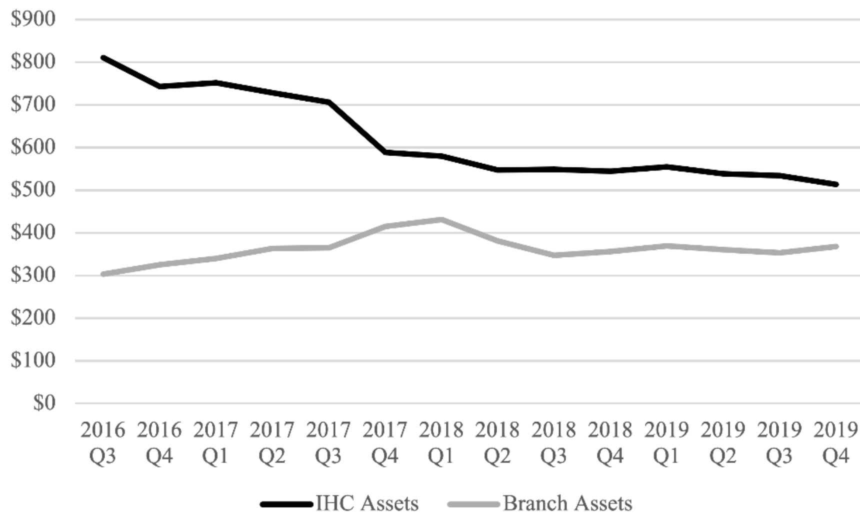
DATA] (reporting branch assets), https://www.federalreserve.gov/releases/iba/201609/bycntry.htm [https://perma.cc/UXT4-L2RK]. At year-end 2019, the four banks controlled $880 billion in U.S. assets, in total. *See* NAT'L INFO. CTR., *supra* note 13 (select December 31, 2019 report date for IHC assets); FED. RSRV. BD., STRUCTURE DATA FOR THE U.S. OFFICES OF FOREIGN BANKING ORGANIZATIONS (Dec. 31, 2019) [hereinafter DECEMBER 2019 STRUCTURE DATA] (reporting branch assets), https://www.federalreserve.gov/releases/iba/201912/bycntry.htm [https://perma.cc/3CJ5-EDAT].

173. *Compare* NAT'L INFO. CTR., *supra* note 13 (select September 30, 2016 report date for third quarter 2016 IHC assets), *with id.* (select December 31, 2019 report date for year-end 2019 IHC assets).

174. *Compare* SEPTEMBER 2016 STRUCTURE DATA, *supra* note 172 (reporting that Barclays, Credit Suisse, Deutsche Bank, and UBS had U.S. branch assets totaling $302 billion), *with* FED. RESERVE BD., STRUCTURE DATA FOR THE U.S. OFFICES OF FOREIGN BANKING ORGANIZATIONS (Mar. 31, 2018), https://www.federalreserve.gov/releases/iba/201803/bycntry.htm [https://perma.cc/Q3LK-4RYU] (reporting that the same banks had U.S. branch assets totaling $432 billion).

175. Laura Noonan, *European Banks Slash $280 Billion from Main U.S. Businesses*, FIN. TIMES (Nov. 24, 2019), https://www.ft.com/content/ef651618-0b08-11ea-bb52-34c8d9dc6d84 [https://perma.cc/QU7A-C7BK].

Figure E:[176]
European Wholesale Banks—IHC versus Branch Assets ($ billions)



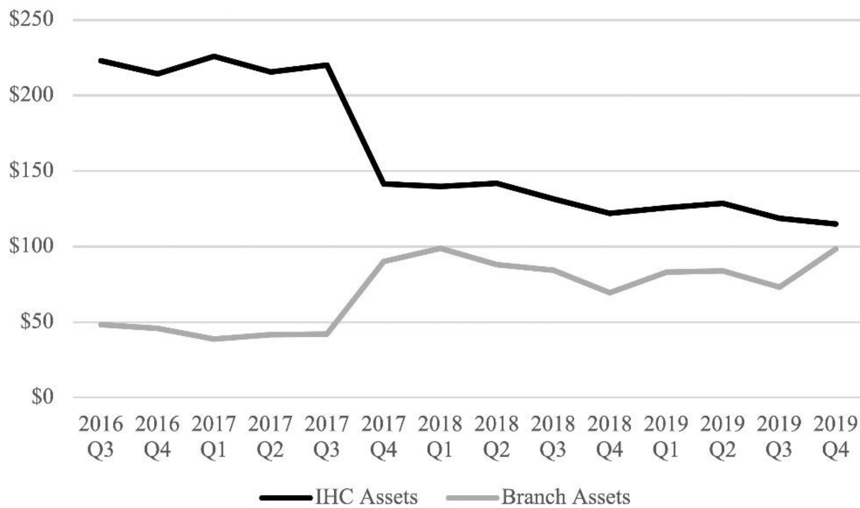
A case study of Credit Suisse demonstrates how foreign banks transferred risk to their U.S. branches in the wake of the IHC rule. When the IHC requirement went into effect in late 2016, Credit Suisse had $223 billion in assets in its U.S. IHC—primarily in its investment bank subsidiary—and $48 billion in its New York branch.[177] Within just three years, however, Credit Suisse had moved $108 billion out of its IHC, with roughly half of these assets flowing directly into its New York branch.[178] Exhibit F depicts Credit Suisse's restructuring of its U.S. operations in response to the IHC rule.

176. Data for Figure E are from the National Information Center's Large Holding Companies List and the Federal Reserve's Structure Data for U.S. Banking Offices of Foreign Entities. *See* NAT'L INFO. CTR., *supra* note 13 (select quarterly report dates beginning on September 30, 2016—the first quarter in which foreign banks were required to form IHCs); FED. RESERVE BD., STRUCTURE DATA FOR THE U.S. OFFICES OF FOREIGN BANKING ORGANIZATIONS, https://www.federalreserve.gov/releases/iba/ [https://perma.cc/5A3L-WP9G].

177. *See* NAT'L INFO. CTR., *supra* note 13 (select September 30, 2016 quarterly report date); SEPTEMBER 2016 STRUCTURE DATA, *supra* note 172. In contrast to the other European wholesale banks, Credit Suisse does not have a U.S. bank subsidiary. *See supra* note 64.

178. *See* NAT'L INFO. CTR., *supra* note 13 (select September 30, 2016 quarterly report date); DECEMBER 2019 STRUCTURE DATA, *supra* note 172.

Figure F:[179]
Credit Suisse—IHC versus Branch Assets ($ billions)



Credit Suisse's strategic reorganization of its U.S. operations increased the risk profile of its New York branch. Indeed, both the assets and liabilities that Credit Suisse shifted to its branch create potential vulnerabilities. For example, between 2016 and 2019, Credit Suisse shrank its IHC's trading assets by $18 billion, while simultaneously increasing its branch's trading assets by $27 billion.[180] Credit Suisse also moved more than $50 billion of reverse repurchase agreements (reverse repos)—a form of short-term wholesale lending—out of its IHC, with almost half of these instruments migrating to its branch.[181] Troublingly,

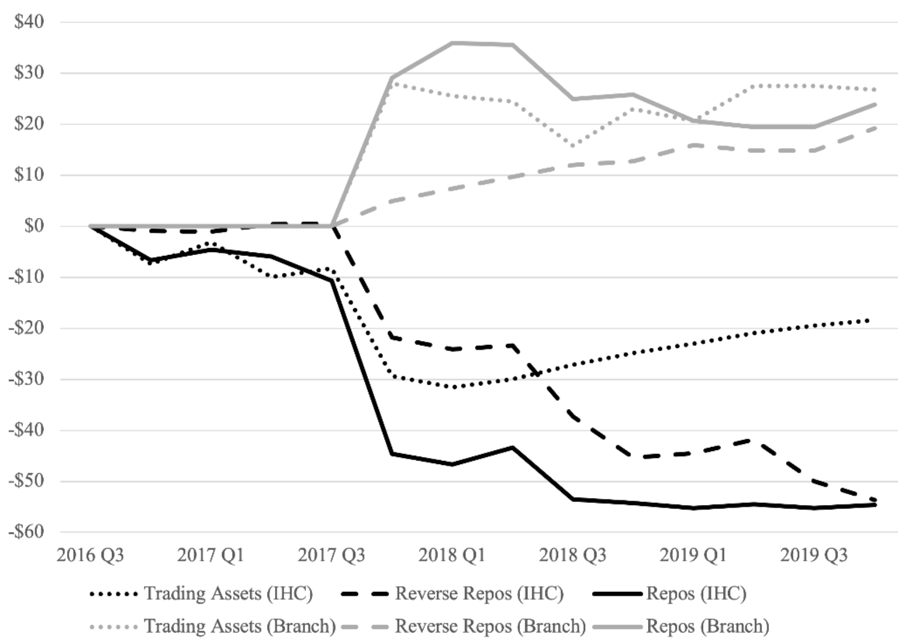
179. For data sources for Figure F, see *supra* note 176.

180. More than two-thirds of trading assets that Credit Suisse moved into its branch were Level 2 assets—or trading instruments that do not have easily determinable fair market values. *See* S.P. Kothari & Rebecca Lester, *The Role of Accounting in the Financial Crisis: Lessons for the Future*, 26 ACCT. HORIZONS 335, 340 (2012) (defining Level 2 assets). IHC data are sourced from Credit Suisse's Form FR Y-9C, Consolidated Financial Statements for Holding Companies, filed quarterly with the Federal Reserve. *See* NAT'L INFO. CTR., CREDIT SUISSE HOLDINGS (USA), INC., https://www.ffiec.gov/npw/Institution/Profile/1574834?dt=20160701 [https://perma.cc/XC62-Q7MM]. Branch data are sourced from Credit Suisse's Form FFIEC 002, Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks. *See* NAT'L INFO. CTR., CREDIT SUISSE NY BR, https://www.ffiec.gov/npw/Institution/Profile/4512?dt=20050513 [https://perma.cc/29YR-DA4D].

181. *See* data sources cited *supra* note 180. The financial regulatory agencies have noted that reverse repos "can give rise to certain funding risks" since the lender "is exposed to risk of borrower default and fluctuation in the price of the underlying collateral." Net Stable Funding

Credit Suisse financed this reallocation of assets with especially volatile funding. Indeed, Credit Suisse relocated roughly $25 billion in repurchase agreements (repos) from its IHC to its branch. Figure G depicts the change in certain assets and liabilities in Credit Suisse's IHC and U.S. branch over time.

Figure G:[182]
Credit Suisse—Change in Assets and Liabilities ($ billions)



This strategic reallocation of resources left Credit Suisse's branch considerably larger, riskier, and more capital markets-focused than before the IHC rule went into effect. Figure H compares the assets and liabilities of Credit Suisse's branch in mid-2016 and at year-end 2019. Within three years, Credit Suisse's branch not only doubled in size, it also substantially increased the risk profile of its assets. While the branch previously kept most of its assets in cash and had only de minimis investments in trading assets and reverse repos, by 2019 trading assets and reverse repo accounted for nearly half of its investments. At the same time, Credit Suisse's branch increased its repo funding from zero to nearly one-third of its funding. U.S. regulators, however, did not account for Credit Suisse's reallocation of risk. In fact, the asset pledge

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Ratio: Liquidity Risk Measurement Standards and Disclosure Requirements, 86 Fed. Reg. 9120, 9157 (Feb. 11, 2021) (to be codified in scattered sections of 12 C.F.R.).

182. For data sources for Figure G, see *supra* note 176.

requirement for Credit Suisse's New York branch *decreased* during this time, despite the branch's increased size and risk profile.[183]

Figure H:[184]
Credit Suisse U.S. Branch—Assets and Liabilities ($ billions)

Assets (9/30/16)				Liabilities (9/30/16)		
Cash	$29.22	60.78%		Deposits	$17.85	37.12%
Reverse Repos	$0.00	0.00%		Repos	$0.00	0.00%
Loans	$4.61	9.60%		Trading Liabilities	$0.01	0.02%
Trading Assets	$0.11	0.23%		Other Liabilities	$30.23	62.88%
Net Due from Home Office	$13.48	28.03%				
Other Assets	$0.65	1.36%				
Total Assets	**$48.08**	**100.00%**		**Total Liabilities**	**$48.08**	**100.00%**

Assets (12/31/19)				Liabilities (12/31/19)		
Cash	$16.32	16.61%		Deposits	$44.67	45.46%
Reverse Repos	$19.17	19.51%		Repos	$28.64	29.15%
Loans	$2.45	2.49%		Trading Liabilities	$2.36	2.40%
Trading Assets	$26.87	27.34%		Other Liabilities	$22.59	22.99%
Net Due from Home Office	$18.85	19.18%				
Other Assets	$14.60	14.86%				
Total Assets	**$98.26**	**100.00%**		**Total Liabilities**	**$98.26**	**100.00%**

While the European wholesale banks led the strategic reallocation of resources in response to the IHC rule, foreign banks with large U.S. retail operations likewise shifted assets to obtain regulatory advantages. Retail-focused foreign banks have expanded in the United States since the 2008 financial crisis, while wholesale-oriented banks have pulled back.[185] In general, however, retail-oriented foreign banks have grown through their lightly regulated U.S. branches, rather than their more heavily regulated U.S. subsidiaries.[186] Indeed, excluding the four European wholesale banks, other foreign banks expanded their U.S. IHCs by $68 billion, or

183. The asset pledge requirement for Credit Suisse' branch declined slightly from $105 million on September 30, 2016 to $104.97 million on December 31, 2019. *See* NAT'L INFO. CTR., CREDIT SUISSE HOLDINGS (USA), INC., https://www.ffiec.gov/npw/Institution/Profile/1574834?dt=20160701 [https://perma.cc/EFL4-59HM] (Form 002, Schedule RAL).

184. For data sources for Figure H, see *supra* note 180.

185. In one notable exception, BBVA agreed to sell its retail-focused U.S. bank subsidiary to PNC Financial Services in November 2020. *See* Lauren Hirsch & Raphael Minder, *PNC Strikes $11.6 Billion Deal to Buy U.S. Operations of Spanish Bank BBVA*, N.Y. TIMES (Nov. 15, 2020), https://www.nytimes.com/2020/11/15/business/dealbook/pnc-spanish-bank-bbva-sale.html [https://perma.cc/9UPL-LYAA].

186. On a proportional basis, only two foreign banks—Bank of Montreal and MUFG—grew their U.S. IHCs by more than their U.S. branches between 2016 and 2019. *See* data sources cited *supra* note 176.

4.7%, between 2016 and 2019.[187] By comparison, the same firms grew their U.S. branches by $132 billion, or 34.7%, over the same time period.[188] Thus, the European wholesale banks were not alone in engaging in regulatory arbitrage in response to the IHC rule—even foreign banks that adopt a retail-focused business model responded to the IHC rule by shifting more activity to their branches.[189]

Foreign banks' strategic relocation of assets was an easily foreseeable consequence of the IHC requirement. In fact, public commenters on the IHC proposal warned the Federal Reserve that foreign banks would likely attempt to move activities from their IHCs to branches to minimize regulation in the United States.[190] In response, the Federal Reserve insisted that it would "monitor how foreign banking organizations adapt their operations to the U.S. [IHC] requirement, including whether foreign banking organizations relocate activities from U.S. subsidiaries into their U.S. branches . . . ."[191] To date, however, the Federal Reserve has taken no public action to stop foreign banks from engaging in this type of regulatory arbitrage.

To the contrary, U.S. policymakers have hastened the migration of assets to foreign bank branches through another post-crisis regulatory reform. The Dodd–Frank Act instructed the FDIC to change its methodology for calculating banks' deposit insurance assessments payable to the DIF.[192] Previously, the FDIC determined banks' annual assessments based on the amount of their insured deposits.[193] Beginning in 2011, however, the FDIC calculated assessments based on the difference between a bank's total assets and its tangible equity.[194] The

187. The U.S. IHCs of BBVA, BNP Paribas, Bank of Montreal, HSBC, MUFG, RBC, Santander, and Toronto-Dominion collectively had $1.44 trillion in assets as of September 30, 2016. On December 31, 2019, the same firms had $1.51 trillion in assets. *See* NAT'L INFO. CTR., *supra* note 13 (select quarterly report dates September 30, 2016 and December 31, 2019).

188. *See* SEPTEMBER 2016 STRUCTURE DATA, *supra* note 172; DECEMBER 2019 STRUCTURE DATA, *supra* note 172.

189. The pre-existing legal structure of a foreign bank's U.S. operations likely influenced the extent to which the bank strategically relocated assets in response to the IHC rule. Indeed, a study by Federal Reserve economists found "compelling evidence that US-based [foreign banks] with no pre-existing holding companies increased their less regulated branch assets and reduced their US-regulated non-branch assets relative to those [foreign banks] which already had a holding company in place." Paligorova & Temesvary, *supra* note 167.

190. *See* Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17,240, 17,276 (Mar. 27, 2014) (codified at 12 C.F.R. § 252.153 (2020)).

191. *Id.*

192. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 331(b), 124 Stat. 1376, 1538 (2010) (codified at 12 U.S.C. § 1817 note).

193. *See* Belton et al., *supra* note 43, at 9.

194. *See* Assessments, Large Bank Pricing, 76 Fed. Reg. 10,672, 10,676–83 (Feb. 25, 2011) (codified at 12 C.F.R. § 327.5 (2020)).

primary goal of this reform was to shift the DIF funding burden toward larger banks that rely disproportionately on wholesale financing, which had been excluded from the FDIC's previous formula.[195] As an unintended consequence of this reform, however, uninsured branches of foreign banks—which do not pay assessments to the DIF—enjoyed relatively cheaper access to wholesale funding than their U.S. counterparts that were subject to the FDIC's new methodology.[196] Several academic studies have concluded that the change in the FDIC's assessment formula encouraged a redistribution of financial activity from FDIC insured banks to foreign banks' U.S. branches.[197] The FDIC's new assessment methodology, in short, compounds foreign banks' incentives to shift assets from their IHCs to branches.

In sum, in an effort to mitigate risks elsewhere in the U.S. financial system, policymakers have unintentionally encouraged the growth of foreign banks' U.S. branches. Foreign banks have responded to both the Federal Reserve's IHC requirement and the FDIC's new assessment methodology by shifting assets into their U.S. branches. As a result, foreign bank branches' total assets reached an all-time high of $2.9 trillion in 2020.[198] As the next Part contends, the increased prominence of foreign banking in the United States—especially foreign bank branches—poses underappreciated systemic risks that U.S. regulators have not adequately addressed.

III. RISKS OF FOREIGN BANKING

Despite policymakers' efforts to safeguard the financial system, foreign banks continue to pose risks to the United States. Because of their large size and unique business models, foreign banks can threaten U.S. financial stability—much as they did in 2008. In addition, persistent weaknesses in foreign banks' internal controls undermine the United States' attempts to prevent money laundering, terrorist financing, and other illicit activity. This Part examines the numerous ways in which the United States remains exposed to the risks of foreign banks.

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195. *See Enhanced Oversight After the Financial Crisis: The Wall Street Reform Act at One Year: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs*, 112th Cong. 18 (2011) (statement of Martin J. Gruenberg, Acting Chairman, Federal Deposit Insurance Corporation).

196. *See* Kreicher et al., *supra* note 161, at 4.

197. *See* Belton et al., *supra* note 43, at 28–29 (concluding that the new FDIC assessment methodology increased the cost of wholesale funding for domestic banks while reducing it for foreign banks); Kreicher et al., *supra* note 161, at 22–23 (concluding that the new FDIC assessment methodology had the unintended consequence of shifting financial activity from FDIC insured banks to uninsured U.S. branches that continue to rely on wholesale funding).

198. *See* FEDERAL RESERVE SHARE DATA, *supra* note 12.

A. *Financial Stability Risks*

Foreign banks can threaten the stability of the U.S. financial system. To be sure, many banks—foreign and domestic—may propagate systemic risks.[199] Foreign banks, however, pose four financial stability risks that domestic banks do not. First, in light of their disproportionate reliance on short-term wholesale funding, foreign banks' U.S. operations are unusually prone to liquidity strains that can jeopardize their stability and spread to other market participants. Second, because U.S. supervisors oversee only a portion of a foreign bank's global operations, domestic authorities may be unaware of developing safety-and-soundness concerns until too late. Third, foreign banks amplify fluctuations in the U.S. economy by contributing to the creation of credit bubbles and importing credit shocks from abroad. Finally, foreign banks externalize the costs of their risk-taking on the U.S. financial system because their branches generally do not contribute to the FDIC's DIF. This Section analyzes each of these financial stability risks in turn.

1. Liquidity

Foreign banks pose unique risks to U.S. financial stability because their domestic operations rely on particularly volatile funding sources. Foreign banks' U.S. branches fund themselves overwhelmingly with unstable, short-term wholesale financing. Thus, when short-term funding markets dry up—as they did in 2008—foreign branches are especially prone to liquidity strains that propagate throughout the U.S. financial system. Despite these risks, however, the U.S. regulatory framework has not addressed foreign bank branches' funding vulnerabilities.

Since U.S. law generally prohibits foreign banks' U.S. branches from accepting retail deposits, foreign branches rely instead on other sources of U.S. dollars, including volatile, short-term instruments. For example, foreign banks' domestic branches borrow a large proportion of their dollar funding through repurchase agreements, securities financing transactions, and foreign exchange derivatives.[200] In contrast to retail deposits, which are a reliably stable funding source, these short-term instruments are notoriously volatile, evaporating quickly during times of stress.[201] Collectively, foreign banks' U.S. operations rely on short-term wholesale instruments for 30% of their financing, compared to domestic

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199. The traditional bank business model, which relies on short-term liabilities to fund long-term assets, is inherently unstable. *See* Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. POL. ECON. 401, 401–02 (1983) (discussing bank runs).

200. *See supra* note 113 and accompanying text. Foreign bank branches also source dollars through brokered deposits and interbank borrowing. *See* Goldberg & Skeie, *supra* note 9.

201. *See, e.g.*, Paolo Saguato, *The Liquidity Dilemma and the Repo Market: A Two-Step Policy Option to Address the Regulatory Void*, 22 STAN. J.L. BUS. & FIN. 85, 106–11 (2017) (analyzing short-term funding markets during the 2008 financial crisis).

banks which obtain only 15% of their funding from such sources.[202] At the extreme, some foreign banks fund up to 60% of their U.S. assets with short-term wholesale financing.[203] These short-term instruments are concentrated in foreign banks' U.S. branches, which rely twice as much on short-term wholesale financing as foreign banks' U.S. IHCs.[204]

A foreign bank branch's heavy use of short-term financing creates vulnerabilities that could destabilize the bank's other U.S. operations and the broader financial system. If short-term funding markets seize, a foreign branch may have to sell illiquid assets at discounted prices to satisfy liquidity demands, thereby deteriorating the branch's financial condition.[205] Moreover, as the Federal Reserve has observed, "funding

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202. *See* Prudential Standards for Large Foreign Banking Organizations, 84 Fed. Reg. 21,988, 21,990 (proposed May 15, 2019) (to be codified in scattered sections of 12 C.F.R.) (quantifying foreign banks' reliance on short-term wholesale funding); BD. OF GOVERNORS OF THE FED. RSRV. SYS., FINANCIAL STABILITY REPORT—MAY 2020, at 51 (2020), https://www.federalreserve.gov/publications/files/financial-stability-report-20200515.pdf [https://perma.cc/W8JW-HAWZ] (depicting U.S. banks' reliance on short-term wholesale funding).

203. *See* Prudential Standards for Large Foreign Banking Organizations, 84 Fed. Reg. at 21,990.

204. *See* Press Release, Bd. of Governors of the Fed. Rsrv. Sys., Statement on Proposals to Modify Enhanced Prudential Standards for Foreign Banks and to Modify Resolution Plan Requirements for Domestic and Foreign Banks by Governor Lael Brainard (Apr. 8, 2019), https://www.federalreserve.gov/newsevents/pressreleases/3B1F641BEB4A485B994EBC38165F0F3B.htm [https://perma.cc/W9UE-PHCC]. Foreign bank branches are safer today than they were before the 2008 crisis in one respect: they are now net recipients of funding from their parent companies, instead of net lenders to their parent companies as they were in the lead-up to the crisis. In 2007, foreign banks' U.S. branches were owed close to $500 billion, on net, by their parent companies, some of which proved unwilling or unable to repay when the crisis hit. *See* BD. OF GOVERNORS OF THE FED. RSRV. SYS., ASSETS AND LIABILITIES OF U.S. BRANCHES AND AGENCIES OF FOREIGN BANKS—DECEMBER 31, 2007 (2008), https://www.federalreserve.gov/pubs/supplement/2008/05/default.htm [https://perma.cc/AVW2-797H] (documenting U.S. branches' net due from related depository institutions); *see also supra* note 121 and accompanying text (discussing foreign banks' inability to satisfy claims of their U.S. affiliates). As of 2019, however, foreign banks had lent, on net, $132 billion to their U.S. branches. *See* BD. OF GOVERNORS OF THE FED. RSRV. SYS., ASSETS AND LIABILITIES OF U.S. BRANCHES AND AGENCIES OF FOREIGN BANKS—DECEMBER 31, 2019, https://www.federalreserve.gov/data/assetliab/assetsliab20200331.htm [https://perma.cc/G5E2-A2YX]. This reversal in funding flows may be partially related to the Federal Reserve's post-crisis swap lines with foreign central banks, which provide foreign banks an alternative source of U.S. dollars. It remains to be seen whether foreign banks would continue to be net sources of funding for their U.S. branches if the Federal Reserve were to discontinue its swap lines. For background on the Federal Reserve's swap lines, see Dan Awrey, *Brother, Can You Spare a Dollar? Designing an Effective Framework for Foreign Currency Liquidity Assistance*, 2017 COLUM. BUS. L. REV. 934, 977–85; Colleen Baker, *The Federal Reserve's Use of International Swap Lines*, 55 ARIZ. L. REV. 603, 618–28 (2013); Peter Conti-Brown & David Zaring, *The Foreign Affairs of the Federal Reserve*, 44 J. CORP. L. 665, 670 (2019).

205. *See* Changes to Applicability Thresholds for Regulatory Capital Requirements for Certain U.S. Subsidiaries of Foreign Banking Organizations, 84 Fed. Reg. 24,296, 24,308 (May 24, 2019) (codified in scattered sections of 12 C.F.R.).

vulnerabilities at a U.S. branch can expose a foreign banking organization's other U.S. operations to heightened liquidity risk because their customers and counterparties may not distinguish liquidity stress at one component of the U.S. operations from the liquidity position of another part of the U.S. operations."[206] Liquidity strains within a foreign bank's U.S. operations can transmit instability throughout the financial system by imposing losses on the foreign bank's direct counterparties, and illiquidity-induced fire sales may depress asset prices market-wide.[207] Thus, as the Federal Reserve has concluded, a foreign bank branch's "inability to meet liquidity needs could lead to disruptions in U.S. financial stability in a similar manner to the distress or failure of other large banking organizations . . . ."[208]

Despite these vulnerabilities, U.S. policymakers have taken only modest steps to address foreign bank branches' liquidity risks. Historically, foreign bank branches have been required to keep a relatively small amount of highly liquid assets in the United States under asset pledge or maintenance agreements with their chartering authorities.[209] As discussed above, the Federal Reserve adopted a new requirement that a foreign bank's U.S. branch must maintain a buffer of highly liquid assets in the United States at least equal to its liquidity needs for fourteen days, as measured by stress tests performed by the foreign bank.[210] While generally stronger than historical asset pledge and maintenance agreements, this branch liquidity standard is substantially weaker than the comparable requirement for U.S. IHCs, which must maintain a thirty-day buffer of highly liquid assets in the United States.[211] Furthermore, the Federal Reserve has exempted foreign banks' U.S. branches from standardized liquidity requirements applicable to U.S. IHCs that serve as a backstop to liquidity stress tests.[212] Thus, despite their disproportionate reliance on volatile short-term funding, foreign banks U.S. branches are not subject to commensurate requirements to maintain liquid assets in the United States.

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206. Prudential Standards for Large Foreign Banking Organizations, 84 Fed. Reg. at 21,990.

207. *See* Jeremy C. Kress, Patricia A. McCoy & Daniel Schwarcz, *Regulating Entities and Activities: Complementary Approaches to Nonbank Systemic Risk*, 92 S. CAL. L. REV. 1455, 1490–96 (2019) (discussing the counterparty and asset liquidation channels through which financial institutions may transmit systemic risk).

208. Changes to Applicability Thresholds for Regulatory Capital Requirements for Certain U.S. Subsidiaries of Foreign Banking Organizations, 84 Fed. Reg. at 24,321.

209. *See supra* note 105 and accompanying text.

210. *See supra* note 147 and accompanying text.

211. *See* 12 C.F.R. § 252.157(c)(2)(i) (2020).

212. *See id.* § 249.2(a) (applying liquidity coverage ratio to U.S. IHCs); *see also* Bd. of Governors of the Fed. Rrsv. Sys., *supra* note 204 (discussing foreign bank branches' exemption from the liquidity coverage ratio).

In sum, foreign bank branches' heavy reliance on short-term wholesale funding exacerbates maturity mismatch and exposes the U.S. financial system to potential systemic risks. U.S. policymakers, however, have not insisted that foreign banks maintain highly liquid assets in the United States to mitigate these risks. Instead, U.S. policymakers typically defer to a foreign bank's home-country regulator to monitor its U.S. dollar liquidity on a consolidated basis.[213] As the next Section demonstrates, however, deference to home-country regulators may be insufficient to protect U.S. financial stability.

2. Information Asymmetries

Foreign banks pose unique risks to the U.S. financial system for a second reason: local authorities lack information about a foreign bank's financial condition that may be necessary to regulate it appropriately. While U.S. supervisors oversee a foreign bank's activities in the United States, they generally have limited insight into the parent company's worldwide operations. Since a foreign bank's parent company could transmit distress to its U.S. operations, information asymmetries between home-country supervisors and U.S. authorities expose the U.S. financial system to unforeseen vulnerabilities.

In general, U.S. authorities have limited visibility into a foreign bank's operations outside of the United States. As former Federal Reserve Governor Daniel Tarullo observed, "[a]lthough U.S. supervisors have full authority over the local operations of foreign banks, [they] see only a portion of a foreign bank's worldwide activities, and regular access to information on its global activities can be limited."[214] To be sure, U.S. authorities assess a foreign bank's consolidated financial condition when the bank initially establishes a presence in the United States.[215] Ongoing monitoring after a foreign bank's initial entry, however, is typically limited to annual and, in some cases, quarterly financial reports.[216] These reports include only high-level financial data and omit critical information such as the foreign bank's liquidity position and its asset

213. While U.S. authorities oversee liquidity risks in a foreign bank's U.S. operations, the bank's home-country regulator is responsible for supervising U.S. dollar liquidity on a firmwide basis. *See* Tarullo, *supra* note 116, at 10 (discussing shared responsibility between home and host regulators).

214. Tarullo, *supra* note 3, at 2.

215. *See* Mark J. Welshimer & Andrew R. Gladin, *U.S. Capital and Liquidity Regulation of Foreign Banking Organizations*, *in* REGULATION OF FOREIGN BANKS & AFFILIATES IN THE UNITED STATES 203, 264–77 (Randall D. Guynn ed., 7th ed. 2013) (discussing financial standards for foreign banks entering the United States).

216. *See* Ernest T. Patrikis, *Supervision and Enforcement of the U.S. Activities of Foreign Banks*, *in* REGULATION OF FOREIGN BANKS & AFFILIATES IN THE UNITED STATES 97, 135–40 (Randall D. Guynn ed., 7th ed. 2013) (discussing periodic reporting requirements for foreign banks operating in the United States).

quality.[217] Moreover, U.S. authorities are generally unable to scrutinize a foreign bank's intra-quarter financial performance, worldwide risk management framework, corporate governance systems, and other relevant supervisory information they rely on to oversee domestic banks.[218]

U.S. authorities' lack of visibility into foreign banks' worldwide operations is problematic because an overseas parent company can transmit distress to its U.S. operations and the broader economy. A run on a foreign bank parent company, for example, may cast doubt on the solvency of its U.S. operations and trigger a copycat run in the United States.[219] Likewise, a troubled foreign bank might attempt to repatriate financial resources to fortify its balance sheet, leaving its U.S. operations in a weaker position.[220] Further, a distressed foreign bank may be forced to liquidate dollar-denominated assets, destabilizing U.S. financial markets.[221] Thus, during the 2008 financial crisis, uncertainty about the health of major European banks contributed to the Federal Reserve's decision to backstop their U.S. affiliates with emergency support.[222] More recently, Deutsche Bank's deteriorating performance in Germany has raised concerns about the viability of its U.S. operations.[223] In sum, local authorities have limited visibility into foreign banks' international operations despite the United States' susceptibility to risks transmitted from overseas.

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217. For example, a foreign bank with significant U.S. operations reports only twenty line items to the Federal Reserve on a quarterly basis, focused almost exclusively on its capital ratios. *See* BD. OF GOVERNORS OF THE FED. RSRV. SYS., THE CAPITAL AND ASSET REPORT FOR FOREIGN BANKING ORGANIZATIONS—FR Y-7Q (2019), https://www.federalreserve.gov/reportforms/forms/FR_Y-7Q20191231_f.pdf [https://perma.cc/C2E3-3KQE].

218. *See generally* BD. OF GOVERNORS OF THE FED. RSRV. SYS., SR 12-17/CA 12-14, CONSOLIDATED SUPERVISION FRAMEWORK FOR LARGE FINANCIAL INSTITUTIONS (2012), https://www.federalreserve.gov/supervisionreg/srletters/sr1217.pdf [https://perma.cc/DV8H-8ZKR] (explaining framework for consolidated supervision of large financial institutions).

219. Changes to Applicability Thresholds for Regulatory Capital Requirements for Certain U.S. Subsidiaries of Foreign Banking Organizations, 84 Fed. Reg. 24,296, 24,303 (May 24, 2019) (codified in scattered sections of 12 C.F.R.) (noting that liquidity stress at one part of a foreign bank can spread to its entire U.S. operations).

220. *See* Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77 Fed. Reg. 76,628, 76,630 (Dec. 28, 2012) (codified at 12 C.F.R. pt. 252 (2020)) (observing that capital and liquidity may become trapped at a foreign banks' home entity).

221. *See* Tarullo, *supra* note 3, at 7–8.

222. *See supra* notes 122–25 and accompanying text.

223. *See* Jack Ewing, *Deutsche Bank Reports Huge Loss for 2019*, N.Y. TIMES (Jan. 30, 2020) https://www.nytimes.com/2020/01/30/business/deutsche-bank.html [https://perma.cc/GAA3-84PF] (labeling Deutsche Bank as "one of Europe's most troubled big lenders"); Laura Noonan, *Deutsche Bank's U.S. Operations Criticized by New York Fed*, FIN. TIMES (May 13, 2020), https://www.ft.com/content/28756b4b-8e9a-4a85-92b5-4a91c37dfc02 [https://perma.cc/K8JB-4XWK].

Although U.S. authorities maintain information sharing agreements with foreign banks' home countries, these informal arrangements are likely insufficient to protect U.S. financial stability. Developed countries typically pre-commit to sharing supervisory information about internationally active banks and consulting on common supervisory issues.[224] As Professor Richard Herring has noted, however, "in times of stress, information sharing agreements are likely to fray. Bad news tends to be guarded as long as possible."[225] Indeed, a home-country regulator has strong incentives to withhold information from its international counterparts when one of its banks experiences distress. For example, the regulator might fear that disseminating negative information could trigger a liquidity crisis that would hasten the bank's downfall.[226] Alternatively, the regulator may hesitate to share information out of concern that other supervisors would take actions that limit the home country's discretion to address the problems—for example, closing the bank's local operations.[227] As a result, information sharing agreements do not guarantee the United States access to information needed to protect the U.S. financial system from foreign bank risks.

Thus, foreign banks pose unique dangers because their worldwide operations are largely shielded from U.S. oversight. This information asymmetry is dangerous because foreign banks can transmit distress to the United States in several ways. Moreover, given a home country's incentive to withhold negative information, bad news about a foreign bank may catch U.S. authorities by surprise and thereby inflict even greater damage.

3. Procyclicality

In addition to liquidity strains and information asymmetries, foreign banks threaten the U.S. economy by intensifying procyclicality. That is, foreign banks amplify fluctuations in the U.S. credit cycle by increasing lending more during expansionary periods and reducing lending more during contractionary periods compared to domestic banks. Foreign banks not only magnify domestic credit booms and busts, they also import credit shocks from their home countries into the United States.

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224. *See, e.g.*, FRAMEWORK COOPERATION ARRANGEMENT BETWEEN THE EUROPEAN BANKING AUTHORITY AND THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, THE FEDERAL DEPOSIT INSURANCE CORPORATION, THE OFFICE OF THE COMPTROLLER OF THE CURRENCY, THE U.S. SECURITIES AND EXCHANGE COMMISSION, AND THE NEW YORK STATE DEPARTMENT OF FINANCIAL SERVICES (2017), https://www.sec.gov/about/offices/oia/oia_bilateral/eba-framework-cooperation-arrangement-sep17.pdf [https://perma.cc/X6Y3-7V4T].

225. Richard J. Herring, *Conflicts Between Home and Host Country Prudential Supervisors*, *in* INTERNATIONAL FINANCIAL INSTABILITY: GLOBAL BANKING AND NATIONAL REGULATION 201, 208 (Douglas D. Evanoff et al. eds., 2007).

226. *See id.* at 208–09.

227. *See id.*

Thus, foreign banks' lending patterns pose serious risks to U.S. financial stability.

Until recently, the traditional view in financial regulatory circles was that foreign bank lending was countercyclical. Policymakers assumed that foreign banks helped protect the U.S. economy from recessions by offsetting decreases in domestic bank lending with corresponding increases in credit availability.[228] Indeed, the potential for foreign banks to compensate for cyclical variations in domestic bank lending has long been one of the primary justifications for preserving foreign banks' role in the U.S. economy.[229] Despite widespread acceptance, however, the perception of foreign bank lending as countercyclical generally lacked empirical support.

In the aftermath of the 2008 financial crisis, economic studies demonstrated that—contrary to popular belief—foreign bank lending in the United States is unequivocally procyclical. Several post-crisis analyses document that foreign banks contribute more to the creation of credit booms than domestic banks.[230] Foreign banks' relatively aggressive loan growth during good times may be attributable to their easy access to low-cost wholesale funding or the absence of strong, local risk management systems.[231] Conversely, research also shows that foreign banks pull back on lending to a greater extent than domestic competitors when economic conditions worsen.[232] Some researchers

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228. *See* Tarullo, *supra* note 3, at 1 ("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."); *see also* Stijn Claessens & Neeltje van Horen, *Foreign Banks: Trends, Impact and Financial Stability* 3 (IMF, Working Paper No. 12/10, 2012) ("Before the crisis, the general consensus was that . . . foreign banks . . . bring greater financial stability.").

229. *See* Tarullo, *supra* note 3, at 1.

230. *See* Goulding & Nolle, *supra* note 126, at 9 (finding that foreign branch lending in the United States increased by three times more than domestic bank lending between 2004 and 2008); *see also* Stijn Claessens & Neeltje van Horen, *The Role of Foreign Banks in Local Credit Booms*, *in* THE FUTURE OF LARGE, INTERNATIONALLY ACTIVE BANKS 273, 275 (Asli Demirgüç-Kunt et al. eds., 2017) (concluding that foreign banks contributed more than domestic banks to local credit booms in ninety-three countries between 2005 and 2007); Glenn Hoggarth et al., *Which Way Do Foreign Branches Sway? Evidence from the Recent UK Domestic Credit Cycle* 5–10 (Bank of Eng., Fin. Stability Paper No. 22, 2013), https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-paper/2013/which-way-do-foreign-branches-sway-evidence-from-the-recent-uk-domestic-credit-cycle.pdf?la=en&hash=4ADEF9A462FB32B7117C30576D48F3D715338194 [https://perma.cc/B25L-EAT3] (reporting that foreign bank lending in the UK increased more rapidly in the lead-up to the 2008 crisis than domestic bank lending).

231. *See* Mariassunta Giannetti & Luc Laeven, *The Flight Home Effect: Evidence From the Syndicated Loan Market During Financial Crises*, 104 J. FIN. ECON. 23, 24 (2012) (attributing foreign banks' procyclical lending behavior to reliance on short-term wholesale funding).

232. *See* Goulding & Nolle, *supra* note 126, at 9 (finding that foreign branch lending in the United States decreased by five times more than domestic bank lending between 2008 and 2010); *see also* Moon Jung Choi et al., *Dissecting Foreign Bank Lending Behavior During the 2008-*

refer to this dynamic as a "flight home effect," wherein foreign banks withdraw credit from international customers in favor of borrowers in their home country during times of stress.[233] These fluctuations in domestic lending have significant negative effects on the real economy. Indeed, firms that depend on foreign bank credit experience lower return on assets and revenue growth during credit contractions than firms that have borrowing relationships with domestic banks.[234]

Foreign banks not only amplify cyclical fluctuations in the U.S. economy, they also import economic shocks from abroad. Consider Professor Joe Peek's and Federal Reserve Bank of Boston President Eric Rosengren's research on the Japanese banking crisis in the 1990s. Peek and Rosengren found that the Japanese credit market contraction led to lower lending by Japanese banks' U.S. affiliates, creating a supply shock to U.S. credit markets that negatively affected U.S. economic activity.[235] Additional research has confirmed that international credit shocks may adversely impact the domestic economy through foreign banks' U.S.

2009 Crisis, 25 FIN. MKTS., INSTS. & INSTRUMENTS 361, 385 (2016) (concluding that foreign banks curtailed credit more than domestic banks during 2009 in a study of fifty-one countries); Claessens & van Horen, *supra* note 228, at 17–18 (concluding that foreign banks reduced lending more compared to their domestic counterparts during 2009 in a study of 118 countries); Hoggarth et al., *supra* note 230, at 15–16 (concluding that foreign bank lending to UK borrowers fell sharply and by much more than domestic bank lending during the 2008 crisis); Steven Ongena et al., *Shocks Abroad, Pain at Home? Bank-Firm-Level Evidence on the International Transmission of Financial Shocks*, 63 IMF ECON. REV. 698, 702 (2015) (finding that foreign banks reduced credit to a greater extent during the 2008 crisis compared to domestic banks in a study of thirteen countries).

233. *See* Giannetti & Laeven, *supra* note 231, at 23 ("[T]he collapse of the global market for syndicated loans during financial crises can in part be explained by a flight home effect whereby lenders rebalance their loan portfolios in favor of domestic borrowers."); Mariassunta Giannetti & Luc Laeven, *Flight Home, Flight Abroad, and International Credit Cycles*, 102 AM. ECON. REV. 219, 219 (2012) (concluding that banks demonstrate a stronger bias toward home-country borrowers when funding conditions deteriorate); *see also* Jonathan Adams-Kane et al., *Foreign Bank Behavior During Financial Crises*, 49 J. MONEY, CREDIT & BANKING 351, 384 (2017) (concluding that internationally active banks whose home countries experienced financial crises reduced lending in their host countries by 13 to 42 % more than foreign banks whose home countries did not experience financial crises).

234. *See* Ongena et al., *supra* note 232, at 720–21 (finding that firms with a foreign-bank borrowing relationship experience 1.1% lower return on assets and 3.7% lower growth in revenue compared to firms with a domestic-bank borrowing relationship during a credit contraction).

235. *See* Joe Peek & Eric S. Rosengren, *Collateral Damage: Effects of the Japanese Bank Crisis on Real Activity in the United States*, 90 AM. ECON. REV. 30, 39–43 (2000); *see also* Joe Peek & Eric S. Rosengren, *The International Transmission of Financial Shocks: The Case of Japan*, 87 AM. ECON. REV. 495, 501–04 (1997) (finding that a decline in Japanese parent banks' risk-based capital ratios led to a statistically significant decline in lending by U.S. branches of Japanese banks).

operations.[236] Thus, in addition to reinforcing fluctuations in domestic credit cycles, foreign banks also disrupt U.S. credit markets based on economic conditions in their home countries.

In sum, foreign banks contribute disproportionately to the inflation and sudden collapse of credit bubbles in the United States. The procyclicality of foreign bank lending disrupts domestic credit markets and impedes the U.S. economy.

4. Externalities

Finally, foreign banks threaten U.S. financial stability by externalizing the costs of their risk-taking on other market participants. Because most foreign banks' U.S. branches do not pay federal deposit insurance premiums to the DIF, they do not help offset the systemic risks they create. Instead, when foreign banks' local branches transmit distress, other market participants—and potentially U.S. taxpayers—absorb the costs. Foreign banks, therefore, enjoy the benefits of participating in U.S. financial markets without internalizing all the costs of their domestic activities.

The majority of foreign bank activity in the United States is exempt from the FDIC's deposit insurance system, which requires domestic banks to at least partially internalize the risks they pose to the U.S. economy. Recall that the FDIC levies annual assessments on U.S. banks based on each bank's total liabilities, risk profile, and supervisory condition.[237] As a result, riskier banks contribute more to the DIF, which is used to satisfy depositors' claims when a U.S. bank becomes insolvent.[238] Under FBSEA, however, all but ten grandfathered foreign bank branches are currently uninsured and are therefore exempt from deposit insurance assessments.[239] Since nearly two-thirds of foreign banks' U.S. assets are held in uninsured branches, foreign banks generally are not required to absorb the full costs of their risk taking.[240]

Even though foreign bank branches do not contribute to the DIF, they may deplete the fund in several ways. For example, when a foreign bank branch experiences distress, it may impose losses on its U.S. bank

236. *See, e.g.*, Claessens & van Horen, *supra* note 230, at 286 (concluding that when a parent bank experiences a credit boom in its home-country, its foreign affiliates are more likely to add to a credit boom in their host countries).

237. *See supra* note 194 and accompanying text.

238. The DIF currently has $111 billion in assets, representing 1.41% of insured deposits in the United States. *See* FED. DEPOSIT INS. CORP., 2019 ANNUAL REPORT 92, 103 (2020).

239. Eight foreign banks operate a total of ten grandfathered, insured branches. *See supra* note 98 and accompanying text.

240. Foreign banks' U.S. operations own $4.22 trillion in assets, of which $2.55 trillion are held in uninsured U.S. branches. *See* FEDERAL RESERVE SHARE DATA, *supra* note 12; FEDERAL RESERVE STRUCTURE DATA—BY TYPE, *supra* note 56.

counterparties, potentially triggering their insolvency.[241] Similarly, if a foreign branch were to engage in fire sales of dollar-denominated assets, the downward pressure on asset prices could precipitate domestic bank collapses that drain the DIF.[242] Moreover, even though the FDIC is not legally obligated to cover losses by uninsured foreign bank branch depositors, the DIF could be used to satisfy such claims in the future. Indeed, that is exactly what happened when Iceland's three biggest banks failed in 2008, leaving nearly $5 billion in uninsured depositor claims in their overseas branches.[243] UK and Dutch authorities ultimately reimbursed customers of the Icelandic bank branches, even though their domestic deposit insurance regimes did not require them to do so.[244]

When foreign banks directly or indirectly deplete the DIF, they effectively free ride off deposit insurance assessments paid by U.S. banks. In addition, since the Treasury Department backstops the DIF through a $100 billion line of credit, U.S. taxpayers could be on the hook if foreign banks were to inflict widespread losses on the U.S. financial system.[245] In this way, therefore, foreign banks expose the United States to unjustified risks by externalizing the costs of their risk taking on other market participants and U.S. taxpayers.

In sum, foreign banks threaten U.S. financial stability in ways that domestic banks do not. Foreign banks' U.S. operations are uniquely likely to experience liquidity strains, amplify economic fluctuations, and externalize costs on the broader financial system. At the same time, U.S. authorities cannot monitor and address these risks proactively since significant portions of foreign banks' operations are shielded from supervisory scrutiny. Accordingly, despite foreign banks' unique risks, the U.S. regulatory framework is not well suited to mitigate the financial stability threats posed by such firms.

B. *National Security Risks*

In addition to threatening U.S. financial stability, foreign banks also expose the United States to unique national security risks. Given their cross-border operations, foreign banks are potential conduits for money

241. *See supra* note 207 and accompanying text.

242. *See supra* note 207 and accompanying text.

243. *See* SCHOENMAKER, *supra* note 40, at 82–85.

244. *See* Tim Wallace, *UK Left Out of Pocket as Iceland Draws a Line Under Bank Collapse*, THE TELEGRAPH (Sept. 18, 2015, 8:47 PM), https://www.telegraph.co.uk/finance/financialcrisis/11875720/UK-left-out-of-pocket-as-Iceland-draws-a-line-under-bank-collapse.html [https://perma.cc/SD3A-G6GK].

245. *See* 12 U.S.C. § 1824(a)(1); *see also* Jessica Holzer, *FDIC Considers Borrowing from Treasury to Shore Up Deposit Insurance*, WALL ST. J. (Sept. 18, 2009, 2:51 PM), https://www.wsj.com/articles/SB125328162000123101 [https://perma.cc/364D-252Z]. Before borrowing from the Treasury, the FDIC must present a plan to repay the loan through future deposit insurance assessments, further straining insured U.S. banks. 12 U.S.C. § 1824(c)(1).

laundering, terrorist financing, and other illicit activity. Nonetheless, anti-money-laundering controls at many foreign banks remain inadequate, as evidenced by numerous enforcement actions over the past several years. This Section contends, therefore, that persistent weaknesses in foreign banks' internal controls jeopardize U.S. national security.

Foreign banks operating in the United States are popular conduits for illicit activity. When drug cartels, terrorist groups, or other international criminals transfer money, at least a portion of their transactions often occur in U.S. dollars, the world's dominant currency.[246] To facilitate dollar-denominated payments, foreign banks typically route transactions through their U.S. offices.[247] Since they provide a nexus to the U.S. payments system, therefore, international actors often use foreign banks—witting or unwitting—to evade sanctions, launder criminal proceeds, fund terrorist activity, and engage in other illicit conduct.[248] These payments can threaten U.S. national security interests, as when BNP Paribas hid records and manipulated payment instructions in order to launder $100 billion to assist clients in evading U.S. sanctions against Sudan, Iran, and Cuba.[249]

In light of these risks, U.S. law requires banks operating in the United States to implement policies and procedures to detect and prevent illicit activities by their clients. The USA PATRIOT Act directs each bank operating domestically to establish an anti-money-laundering program, including the designation of a compliance officer, ongoing employee training, and an independent audit function.[250] Similarly, so-called "Know Your Customer" rules mandate that banks perform enhanced due diligence to identify terrorists, drug traffickers, or other unsavory clients who attempt to conduct business through the bank.[251] The Bank Secrecy

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246. *See* Suzanne Katzenstein, *Dollar Unilateralism: The New Frontline of National Security*, 90 IND. L.J. 293, 294–95 (2015) (noting that the U.S. government relies on foreign banks to track illicit financial flows because of the dollar's dominant status in the global financial system).

247. *See* Ben Protess & Jessica Silver-Greenberg, *BNP Paribas Admits Guilt and Agrees to Pay $8.9 Billion Fine to U.S.*, N.Y. TIMES DEALBOOK (June 30, 2014, 4:21 PM), https://dealbook.nytimes.com/2014/06/30/bnp-paribas-pleads-guilty-in-sanctions-case/ [https://perma.cc/FD89-3NJF] (noting prevalence of foreign banks funneling illicit payments through their New York operations).

248. Christian Leuprecht et al., *Tracking Transnational Terrorist Resourcing Nodes and Networks*, 46 FLA. ST. U. L. REV. 289, 332 (2019) (noting the prevalence of internationally active banks in review of anti-money-laundering prosecutions).

249. *See* Jeffrey R. Boles, *Financial Sector Executives as Targets for Money Laundering Liability*, 52 AM. BUS. L.J. 365, 403 (2015).

250. *See* 31 U.S.C. § 5318(h)(1).

251. *See* Bruce Zagaris, *The Merging of the Anti-Money Laundering and Counter-Terrorism Financial Enforcement Regimes After September 11, 2001*, 22 BERKELEY J. INT'L. L. 123, 127–28 (2004) (discussing Know Your Customer requirements).

Act likewise instructs banks to screen and report transactions over $10,000 and other suspicious payments.[252] Collectively, these mandates protect U.S. national security interests by deterring banks from facilitating illicit payments, whether intentionally or unintentionally.

Despite being popular conduits for illicit payments, many foreign banks have not established sufficiently strong internal controls to prevent such activity, as evidenced by numerous enforcement actions citing deficiencies in foreign banks' anti-money-laundering programs. In 2012, for example, HSBC agreed to pay nearly $2 billion in fines for failing to maintain an effective compliance program and conduct basic due diligence on account holders, resulting in the bank laundering money for Mexican drug cartels.[253] More recently, Standard Chartered paid a $1.1 billion fine in 2019 for processing millions of dollars in payments from sanctioned countries including Cuba, Iran, Sudan, and Syria.[254] Standard Chartered was a repeat offender, having been fined $330 million for processing payments on behalf of Iranian customers several years earlier.[255] Deutsche Bank likewise has come under scrutiny for recurring violations of U.S. anti-money-laundering laws. In 2020, the Federal Reserve reprimanded Deutsche Bank's U.S. operations for failing to correct weaknesses in its compliance systems despite repeated warnings and a $629 million settlement relating to money laundering for Russian clients.[256] In sum, notwithstanding U.S. policymakers' emphasis on money laundering prevention, many foreign banks' internal controls still fail to protect U.S. national security interests.

Despite aggressive enforcement of U.S. money laundering laws, weaknesses in some foreign banks' anti-money-laundering controls may nonetheless escape undetected or unpunished. Consider Japan's largest

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252. *See* 31 U.S.C. § 5316; *see also* Christina Parajon Skinner, *Executive Liability for Anti-Money-Laundering Controls*, 116 COLUM. L. REV. SIDEBAR 1, 3 (2016) (describing Bank Secrecy Act requirements).

253. *See* Aruna Viswanatha & Brett Wolf, *HSBC to Pay $1.9 Billion U.S. Fine in Money-Laundering Case*, REUTERS (Dec. 11, 2012, 12:45 AM), https://www.reuters.com/article/us-hsbc-probe/hsbc-to-pay-1-9-billion-u-s-fine-in-money-laundering-case-idUSBRE8BA05M20121211 [https://perma.cc/87B2-U2ED].

254. *See* Emily Flitter, *Standard Chartered Fined $1.1 Billion for Violating Sanctions and Anti-Money Laundering Laws*, N.Y. TIMES (Apr. 9, 2019), https://www.nytimes.com/2019/04/09/business/standard-chartered-sanctions-violations.html [https://perma.cc/345F-JCG2].

255. *See* Neil Gough, *Standard Chartered to Pay $330 Million to Settle Iran Money Transfer Claims*, N.Y. TIMES DEALBOOK (Dec. 6, 2012, 3:55 AM), https://dealbook.nytimes.com/2012/12/06/standard-chartered-to-pay-u-s-330-million-to-settle-iran-laundering-claims/ [https://perma.cc/94V3-2EXX].

256. *See* Patricia Kowsmann et al., *Fed Sends Fresh Rebuke to Deutsche Bank*, WALL ST. J. (May 13, 2020), https://www.wsj.com/articles/fed-sends-fresh-rebuke-to-deutsche-bank-11589402514 [https://perma.cc/M9MQ-Y4Y5].

bank, Mitsubishi UFJ Financial Group (MUFG).[257] In 2013, the New York Department of Financial Services (NYDFS) fined MUFG's state-chartered New York branch $250 million for illegally processing payments on behalf of clients in Iran, Sudan, and Myanmar.[258] Four years later, the NYDFS began investigating MUFG again for suspected sanctions violations.[259] This time, however, rather than submit to the NYDFS inquiry—which could have resulted in a significant fine—MUFG's New York branch applied to the OCC to switch to a federal charter.[260] The OCC hastily approved MUFG's charter conversion without input from the NYDFS, and MUFG kicked NYDFS out of its offices before the regulator could finish its investigation.[261] In 2019, the OCC discovered shortcomings in anti-money-laundering procedures at MUFG's New York branch, but it did not require MUFG to pay a fine.[262] By strategically switching its U.S. regulator, therefore, MUFG's New York branch escaped stringent oversight of its anti-money-laundering controls, demonstrating how weaknesses in some foreign banks' internal controls may persist.

Thus, foreign banks expose the United States to national security risks because of their unique susceptibility to money laundering, terrorist financing, and other illicit activity. While policymakers require banks to

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257. *See* Ryan Tracy, *Switching U.S. Regulators Upends Probe into Japan's Biggest Bank*, WALL ST. J. (Nov. 17, 2017, 5:33 AM), https://www.wsj.com/articles/japanese-bank-switches-u-s-regulators-in-middle-of-investigation-1510741802 [https://perma.cc/9FDD-WPLE].

258. *See* Jessica Silver-Greenberg & Ben Protess, *Regulator in New York Sets Tough Bank Fine*, N.Y. TIMES DEALBOOK (June 20, 2013, 9:35 AM), https://dealbook.nytimes.com/2013/06/20/japans-largest-bank-to-pay-250-million-fine-for-iran-deals/ [https://perma.cc/RG7X-HAN6]. NYDFS later increased the penalty by $315 million when it discovered that MUFG pressured an external consultant to water down a report about MUFG that it submitted to NYDFS. *See* Ben Protess & Jessica Silver-Greenberg, *Bank of Tokyo Fined for 'Misleading' New York Regulator on Iran*, N.Y. TIMES DEALBOOK (Nov. 18, 2014, 4:20 PM), https://dealbook.nytimes.com/2014/11/18/lawsky-fines-bank-of-tokyo-mitsubishi-ufj-another-315-million/ [https://perma.cc/M2FZ-45VU].

259. *See* Tracy, *supra* note 257.

260. *See id.*

261. *See id.* News reports offered several possible explanations for why the OCC might permit MUFG to switch its charter under these circumstances. On one hand, the OCC may have approved the charter conversion to allow MUFG—which also owns an OCC-regulated national bank in California—to consolidate all its U.S. operations under the OCC's oversight for supervisory efficiency. *See id.* On the other hand, however, the OCC may have had financial incentive to approve the charter conversion because the banking agencies collect fees from the banks they oversee. *See id.* Finally, the Acting Comptroller of the Currency at the time of MUFG's charter conversion was Keith Noreika, who previously represented MUFG as outside counsel on issues relating to its anti-money-laundering controls. *See id.*

262. *See* Kristin Broughton, *U.S. Regulator Asks MUFG Branches to Strengthen Anti-Money-Laundering Controls*, WALL ST. J. (Feb. 22, 2019, 2:05 PM), https://www.wsj.com/articles/u-s-regulator-asks-mufg-branches-to-strengthen-anti-money-laundering-controls-11550862332 [https://perma.cc/XP5J-UBZQ].

implement programs to detect and prevent illegal conduct, many foreign banks' controls are inadequate, and some have used creative legal strategies to evade tougher oversight. Accordingly, under the current regulatory framework, foreign banks intensify the United States' vulnerability to national security threats.

IV. THE NATIONAL TREATMENT CONUNDRUM

Despite the unique risks of foreign banks, U.S. policymakers have traditionally resisted stronger foreign bank oversight in deference to the longstanding principle of national treatment in international banking. As embodied in the Basel Accords, national treatment is a norm of nondiscrimination.[263] It provides that host countries should treat foreign banks no less favorably than domestic banks.[264] Although the concept of national treatment may seem straightforward, in practice, it poses numerous interpretational challenges for local authorities that oversee foreign banks.[265] This Part examines the principle of national treatment and contends that U.S. policymakers have interpreted it too deferentially, thereby favoring foreign banks and exposing the U.S. financial system to unwarranted risks.

A. *The National Treatment Principle*

The national treatment principle establishes an expectation that local authorities will treat foreign banks similarly to domestic firms in comparable circumstances. As Professor Chris Brummer has explained, national treatment "means that foreign firms are treated no differently from local firms and must comply with the same rules as their local counterparts."[266] The Basel Committee on Bank Supervision (BCBS)—an international standard-setting body—has codified national treatment as a central tenet of international bank supervision.[267] Thus, international financial regulators typically expect local jurisdictions to strive for competitive parity between foreign and domestic banks.

As a regulatory concept, national treatment is seemingly straightforward. In practice, however, national treatment poses

263. *See* ZARING, *supra* note 10, at 21–23.

264. *See id.*

265. *See* Tarullo, *supra* note 3, at 2 n.2 (noting difficulty of applying the national treatment principle).

266. Brummer, *supra* note 21, at 504. The concept of national treatment in banking is generally derived from international trade agreements, which have long provided for national treatment. *See* David Zaring, *Finding Legal Principle in Global Financial Regulation*, 52 VA. J. INT'L L. 683, 706 (2012).

267. The BCBS' core principles provide that national regulators should "require the local operations of foreign banks to be conducted to the same standards as those required of domestic banks." BASEL COMM. ON BANKING SUPERVISION, CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION 37 (2012), https://www.bis.org/publ/bcbs230.pdf [https://perma.cc/D55H-X8YD].

interpretational challenges that complicate its implementation. This Section examines why international financial regulators have adopted the national treatment principle and why national regulators often face barriers in achieving parity between foreign and domestic banks.

1. Why Have a National Treatment Principle?

National treatment is an essential norm in a globalized financial sector consisting of multi-national institutions operating within a system of national governance. Left to their own devices, national regulators may have incentive to treat their domestic banks more favorably than foreign competitors.[268] This sort of favoritism, however, could distort competition and diminish the benefits of globalized finance.[269] By establishing an expectation of nondiscrimination, therefore, the national treatment principle aims to deter supervisory favoritism, ensure competitive equity between foreign and domestic firms, and preserve the benefits of cross-border banking.

The modern financial system necessitates a cooperative approach to bank supervision involving both home- and host-country authorities. Despite the financial sector's increasing globalization, experts agree that there is virtually no chance of establishing a single, global bank regulator.[270] Likewise, it would be imprudent to rely solely on home- or host-country regulators to oversee internationally active banks. On its own, home-country regulation is likely to undervalue risks to a bank's host jurisdictions, while exclusive host-country regulation may not protect a foreign bank's local operations from distress caused by its overseas parent.[271] Optimal foreign bank oversight, therefore, necessarily involves some combination of home- and host-country authority.[272]

In a system of shared home- and host-country regulation, the national treatment principle discourages host-country regulators from discriminating against foreign banks and thereby diminishing the benefits of cross-border finance. When subject to appropriate macroprudential oversight, globalization in banking offers numerous advantages. For example, cross-border operations can help firms diversify risks, enhance efficiencies, and promote competition.[273] Home-country authorities, however, may face internal pressures to grant domestic firms preferential

268. *See* ZARING, *supra* note 10, at 21.

269. *See id.*

270. *See* Tarullo, *supra* note 5, at 1. Moreover, as Governor Tarullo notes, even if a global bank regulator were feasible, it may not be desirable, given issues of monetary and political sovereignty. *See id.* at 1 n.1.

271. *See* Tarullo, *supra* note 116, at 5–6.

272. *See id.* at 7.

273. *See id.* at 2.

treatment and protection against foreign competitors.[274] When home-country authorities succumb to these influences—by formally or informally subjecting foreign firms to stricter oversight than domestic firms—the ensuing balkanization diminishes the benefits of cross-border banking.[275] The national treatment norm is therefore critical to preserve competitive equity and the advantages of globalized finance. Although the BCBS lacks authority to compel compliance with the nondiscrimination principle, the BCBS enforces its expectation of national treatment through peer assessments of national regulators.[276] In this way, national regulators are held accountable for preserving competitive parity between domestic and foreign banks within their jurisdictions.

2. Subjectivity in National Treatment

The national treatment principle may seem straightforward in theory, but in practice it is far from clear-cut. Recall that national treatment is a norm of nondiscrimination between foreign and domestic banks *in like circumstances*.[277] In some cases, however, identifying similarly situated domestic banks as comparators for foreign banks may be difficult or impossible.[278] Thus, when a host-country regulator applies the national treatment principle, it often must make subjective comparisons, leading to lingering controversies as to whether the country's regulatory framework achieves competitive equity.

Consider an example: the United States' IHC rule, which requires foreign banks with $50 billion or more in non-branch U.S. assets to establish local holding companies for their U.S. subsidiaries.[279] Foreign banks protested that this rule—which forces them to maintain minimum levels of capital and liquidity in the United States—denies them national

274. *See* ZARING, *supra* note 10, at 21.

275. *See, e.g.*, Mark Carney, Governor, Bank of Can. & Chairman, Fin. Stability Bd., Address at the Thomas d'Aquino Lecture on Leadership, Richard Ivey School of Business: Rebuilding Trust in Global Banking 2 (Feb. 25, 2013), https://www.bis.org/review/r130226c.pdf [https://perma.cc/6GUK-WP7H].

276. *See* ZARING, *supra* note 10, at 29–30, 50–51, 56 (describing peer review in international financial regulation).

277. *See* Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17,240, 17,268 (Mar. 27, 2014) (codified at 12 C.F.R. § 252.153 (2020)) ("[N]ational treatment . . . generally means that foreign banking organizations operating in the United States should be treated no less favorably than *similarly-situated* U.S. banking organizations . . . .") (emphasis added).

278. *See* ZARING, *supra* note 10, at 22 ("[T]he application of national treatment in any particular case can be uneven . . . .").

279. *See supra* Section II.A.

treatment.[280] In their view, the IHC rule is discriminatory because "large domestic banks, such as J.P. Morgan or Citigroup, can achieve compliance with [Dodd–Frank's] prudential standards by drawing on assets held *abroad* in foreign subsidiaries," while a foreign bank "must satisfy the same requirements by relying solely on the assets held in its newly formed U.S. IHC."[281] The Federal Reserve, by contrast, insisted that the IHC requirement preserves national treatment by subjecting a foreign bank's IHC to a regulatory framework comparable to that of a U.S. BHC.[282]

The dispute over the IHC rule reflected a disagreement as to relevant comparators for purposes of national treatment. Foreign banks contended that they were similarly situated to multi-national U.S. banking conglomerates that were permitted to recognize foreign resources to satisfy Dodd–Frank rules.[283] The Federal Reserve, on the other hand, effectively analogized foreign banks' U.S. operations to similarly sized U.S. BHCs, such as PNC and Capital One, which operate primarily or exclusively in the United States. While the Federal Reserve ultimately overrode the foreign banks' objections, the foreign firms' interpretation of national treatment was at least a plausible understanding of the nondiscrimination principle.

Thus, national treatment is often open to interpretation, and nondiscrimination frequently depends on a subjective determination of relevant comparators.[284] Achieving strict parity between domestic and foreign banks may be unachievable because differences in organizational structure, home-country regulatory systems, and other factors make it difficult, if not impossible, to identify direct comparators.[285] Accordingly, while host-country authorities are expected to grant foreign banks national treatment, they also have considerable discretion in applying this principle.

B. *U.S. Authorities' Excessive Deference to National Treatment*

Until the enactment of the IHC rule in 2014, the United States applied the national treatment principle in a manner that was highly accommodating to foreign banks. Internationally active banks

280. *See* Alexander Coley, Note, *U.S. Regulation of Cross-Border Banks: Is It Time to Embrace Balkanization in Global Finance?*, 56 VA. J. INT'L L. 701, 722–23, 725–28 (2016) (summarizing comments on the IHC proposed rule).

281. *Id.* at 706.

282. *See* Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. at 17,268.

283. *See id.*

284. As banking lawyer Derek Bush has written, "Like virtually any non-discrimination question, the rub lies in how like circumstances are defined." Bush, *supra* note 79.

285. *See* Tarullo, *supra* note 3, at 2 n.2.

traditionally lobbied for looser oversight of their U.S. operations by invoking the national treatment principle.[286] And the United States frequently obliged. For example, the United States exempted foreign banks from domestic leverage requirements in 2001 and eliminated U.S. capital requirements entirely for certain foreign firms shortly thereafter.[287] While Dodd–Frank and the IHC rule reversed some of this favorable treatment, the overall U.S. regulatory framework remains accommodating to foreign banks. In general, the United States has demonstrated excessive deference to the national treatment principle and has thereby exposed the U.S. financial system to unwarranted risks.

In an effort to not discriminate against foreign banks, the United States actually grants them several competitive advantages. Most notably, the United States permits foreign banks to operate through uninsured branches.[288] This privilege is highly favorable for foreign branches, which borrow cheaply—due to their exemption from U.S. deposit insurance assessments—and invest those funds in interest-bearing accounts at the Federal Reserve.[289] Foreign bank branches thereby earn risk-free returns that are unavailable to domestic banks whose funding costs are higher due to deposit insurance assessments.[290] In addition, the United States excludes foreign bank branches from some limitations on affiliate transactions that apply to U.S. banks.[291] Further, U.S. authorities exempt a foreign bank's domestic nonbank subsidiaries from prudential standards if the bank has less than $50 billion in U.S. non-branch

286. *See, e.g.*, Becky Gaylord & Gregg Hitt, *Foreign Banks Bracing for Fight on Interstate Branching*, DOW JONES NEWSWIRES, Apr. 12, 1994, Factiva, Doc. No. dj00000020011031dqc05vcs (noting that foreign banks invoked national treatment in opposition to proposed interstate banking standards).

287. *See* 12 C.F.R. § 225.90 (2020) (exempting foreign banks from U.S. leverage standards for financial holding companies); Letter from Richard Spillenkothen, Dir., Div. of Banking Supervision & Reg., to Officer in Charge of Supervision at Each Federal Reserve Bank, BD. OF GOVERNORS OF THE FED. RSRV. SYS., APPLICATION OF THE BOARD'S CAPITAL ADEQUACY GUIDELINES TO BANK HOLDING COMPANIES OWNED BY FOREIGN BANKING ORGANIZATIONS, SR 01-1 (SUP) (2001), https://www.federalreserve.gov/boarddocs/srletters/2001/sr0101.htm [https://perma.cc/677F-LYFY] (exempting any U.S. BHC owned by a foreign bank that the Federal Reserve deems to be well-capitalized from U.S. capital requirements).

288. *See supra* notes 50–57 and accompanying text.

289. *See* Kreicher et al., *supra* note 161, at 12–23 (discussing foreign banks' use of short-term wholesale funding to invest in central bank reserves); *see also* Goulding & Nolle, *supra* note 126, at 15–16 (noting that foreign banks control more than half of reserves held at the Federal Reserve).

290. *See* Kreicher et al., *supra* note 161, at 12–23.

291. *See* Transactions Between Member Banks and Their Affiliates, 67 Fed. Reg. 76,560, 76,598–601 (Dec. 12, 2002) (codified at 12 C.F.R. pt. 223) (noting that although federal law does not subject foreign banks' U.S. branches to affiliate transaction limits, the Federal Reserve applies such limits on a discretionary basis to transactions between foreign banks' U.S. branches and U.S. affiliates engaged in financial activities authorized by the Gramm-Leach-Blilely Act); *see also* Mannion & Wu, *supra* note 170, at 381, 416–18.

assets.[292] A U.S. BHC, by contrast, enjoys no such exemption. The United States typically justifies these special privileges for foreign banks based on the national treatment principle.[293]

The national treatment principle, however, does not necessitate preferential treatment for foreign banks. To the contrary, U.S. authorities have granted foreign banks more deference than U.S. law or international norms demand. For one, because a U.S. BHC must conduct its domestic banking activities through an insured depository institution subsidiary, there is no direct comparator to a foreign bank's U.S. branch that would require any particular regulatory approach for the sake of parity.[294] Moreover, although policymakers sometimes assert that U.S. law *mandates* national treatment for foreign banks, that is not the case.[295] Instead, U.S. law requires only that regulators "give due regard" to national treatment.[296] This looser standard is consistent with the BCBS' core principles, which acknowledge that a home-country regulator may deviate from national treatment when necessary to protect the domestic financial system or when a foreign bank is not subject to effective home-country oversight.[297]

In sum, the United States has considerable discretion in how it implements the national treatment principle. Over time, it has used this discretion in a way that unnecessarily favors foreign firms. While Dodd–Frank and the IHC rule reversed some of this preferential treatment, U.S. authorities continue to accord foreign banks—and especially their branches—special privileges relative to U.S. banks. By favoring foreign banks, U.S. authorities expose the domestic financial system to unjustified risks, with few offsetting benefits for U.S. consumers and businesses. The United States' special treatment of foreign banks, however, is not required by either U.S. law or international regulatory norms.

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292. *See supra* note 132 and accompanying text.

293. *See, e.g.*, Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77 Fed. Reg. 76,628, 76,632 (Dec. 28, 2012) (codified at 12 C.F.R. pt. 252 (2020)) (citing the national treatment principle to explain why the Federal Reserve allowed foreign banks to continue operating U.S. branches outside of their IHCs).

294. *See* 12 U.S.C. § 378(a)(1) (prohibiting non-depository institutions from accepting deposits).

295. *See, e.g.*, 156 CONG. REG. S5,903 (daily ed. July 15, 2010) (statement of Sen. Lincoln) ("[T]he U.S. policy of national treatment . . . has been part of U.S. law since the International Banking Act of 1978 . . . .").

296. 12 U.S.C. §§ 1843(l)(3), 5365(b)(2).

297. *See* Romano, *supra* note 103, at 52, 54.

V. Reforming Foreign Banking

As the previous Parts demonstrated, foreign banks' unique business models and the United States' deference to the national treatment principle have exposed the domestic economy to unwarranted financial stability and national security risks. Post-2008 regulatory reforms have exacerbated these vulnerabilities by incentivizing foreign banks to transfer assets to U.S. branches, which are subject to lighter domestic oversight. The current U.S. regulatory framework, therefore, is inadequate to protect the stability of the domestic financial system and U.S. national security interests.

This Part proposes a new approach to overseeing foreign banks' U.S. operations. Specifically, it recommends that U.S. policymakers should (1) require systemically important foreign banks to establish separately capitalized local subsidiaries instead of branches to conduct business in the United States, and (2) prohibit any other foreign bank from operating branches with more than $25 billion in U.S. assets.[298] This approach—a form of mandatory subsidiarization—would enhance U.S. authorities' ability to protect the domestic financial system without sacrificing national interests. If mandatory subsidiarization is not politically possible, U.S. policymakers should substantially strengthen the regulation of foreign banks' domestic branches as a next-best alternative. Although less effective than mandatory subsidiarization, improving branch oversight could accomplish some of the same goals. Either of the strategies proposed in this Part—mandatory subsidiarization or enhanced branch regulation—would substantially reduce the United States' vulnerabilities to the risks of foreign banking while maintaining compliance with the national treatment norm.

A. *Mandatory Subsidiarization*

The optimal approach to mitigating foreign banking risks would be to require systemically important banks and other foreign banks with sizeable U.S. footprints (collectively, "large foreign banks") to establish local subsidiaries instead of branches. Mandatory subsidiarization would enhance the United States' ability to protect the domestic financial system, while still permitting foreign banks to operate locally. Historically, the dominant trend in the United States' regulation of foreign banks has been a progressive shift of power from home-country authorities to U.S. regulators, in recognition of the fact that foreign

298. For purposes of this Article, a foreign bank is considered systemically important if the FSB has designated it as a GSIB. *See supra* note 29.

banking risks are primarily borne in the United States.[299] Mandatory subsidiarization would bring this trend to its logical conclusion.

Mandatory subsidiarization is not a new concept. The United States, in fact, seriously considered adopting a subsidiarization requirement in the early 1990s after the BCCI scandal.[300] At the time, Assistant Secretary of the Treasury Jerome Powell—now Chairman of the Federal Reserve—was one of the strongest proponents of subsidiarizing foreign banks' U.S. operations.[301] However, the Federal Reserve—led by free-market adherent Alan Greenspan—vigorously opposed compulsory subsidiarization, insisting that it would cause foreign banks to flee the United States and increase costs for U.S. consumers.[302] Congress ultimately sided with Greenspan, subsidiarization proponents dropped their proposal, and the debate faded into history.[303]

The recent evolution of the U.S. banking system, however, has substantially strengthened the case for mandatory subsidiarization. In light of the increased financialization and interconnectedness in modern markets, subsidiarization is necessary to preserve domestic control over the U.S. financial system and insulate the United States from the macroeconomic risks of foreign banks. By contrast, subsidiarization would not impair U.S. competitiveness, as Greenspan and other subsidiarization opponents feared. This Section explains the rationale for mandatory subsidiarization, debunks myths about its potential consequences, and proposes a framework for enacting this critical reform.

1. Reasons to Require Subsidiarization

The United States should require large foreign banks to establish local subsidiaries for four reasons. First, mandatory subsidiarization would strengthen the management and supervision of a foreign bank's U.S. operations by creating a focal point for consolidated oversight. Second, compulsory subsidiarization would enhance the United States' ability to wind down a foreign bank's domestic operations in an orderly fashion if it were to experience distress. Third, foreign bank subsidiaries are less likely than branches to intensify procyclical credit fluctuations or otherwise transmit economic shocks. Finally, subsidiarization would

299. *See supra* Sections I.B, II.A (documenting trend toward more local regulation of foreign banks' U.S. operations).

300. *See* Peter Truell, *Fed Challenges Treasury Plan on Rules for Foreign Banks' Operations in U.S.*, WALL ST. J., June 12, 1991, at A4.

301. *See* Kenneth H. Bacon, *Foreign Banks Seek Help as Congress Begins Writing Some Checks on Them*, WALL ST. J., June 6, 1991, at A20.

302. *See* Peter Riddell, *Greenspan Hits at Banking Proposal: Treasury Plan 'Would Encourage Foreign Banks to Move Away from the U.S.,'* FIN. TIMES, Apr. 24, 1991, at 6.

303. *See Treasury Drops Proposal for Foreign Banks in U.S.*, WALL ST. J., Dec. 22, 1992, at C13.

bring all foreign bank activity in the United States within the federal deposit insurance system, thereby helping to offset foreign banks' systemic risks and potentially enhancing competition for the United States' largest retail banks.

a. Enhance Management and Supervision of U.S. Risks

Requiring large foreign banks to establish locally incorporated subsidiaries would strengthen the oversight of these firms' U.S. risks. Many large foreign banks currently operate in the United States through subsidiaries situated underneath an IHC and one or more branches.[304] These dual structures create complicated management silos, wherein a local team oversees the IHC, while parent company leadership manages the branch.[305] Such parallel structures also create challenges for U.S. supervisors, who may be unable to obtain a full understanding of the foreign bank's consolidated U.S. risks.[306] However, if a foreign bank with significant U.S. operations were required to subsidiarize—and thereby conduct all its local operations underneath a single IHC—both the bank's management and domestic authorities would be better able to identify and address the bank's enterprise-wide U.S. risks.

The desirability of creating a focal point for overseeing a foreign bank's U.S. operations is precisely why the Federal Reserve adopted the IHC requirement in 2014. Before the 2008 crisis, a foreign bank typically operated in the United States through a variety of bank and nonbank subsidiaries, without a single, top-tier U.S. entity through which to oversee and regulate the firm's consolidated U.S. operations.[307] These scattered structures created challenges for both the foreign bank's managers and its supervisory agencies.[308] For example, both managers and supervisors may have been caught unaware if several foreign bank subsidiaries each had credit derivative exposures that appeared reasonable in isolation, but potentially dangerous when aggregated. Accordingly, the Federal Reserve reasoned that the IHC requirement would "facilitate the foreign company's ability to oversee and the

304. Of the thirteen foreign banks that are currently required to maintain U.S. IHCs, all but one—HSBC—also operate in the United States through one or more branches or agencies. *See* NAT'L INFO. CTR., *supra* note 13 (listing thirteen foreign banks with U.S. holding companies that control more than $50 billion in assets); FEDERAL RESERVE STRUCTURE DATA—BY COUNTRY, *supra* note 13 (listing foreign banks' U.S. branches and agencies).

305. *See supra* note 149 and accompanying text.

306. *See* Tarullo, *supra* note 3, at 2.

307. *See* Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77 Fed. Reg. 76,628, 76,637 (Dec. 28, 2012) (codified at 12 C.F.R. pt. 252 (2020)).

308. *See id.*

[Federal Reserve's] ability to supervise the combined risks taken by the foreign company's U.S. operations."[309]

The Federal Reserve's IHC requirement, however, did not go far enough: it rationalized the oversight of foreign bank subsidiaries, but it failed to address foreign bank branches. As a result, many foreign banks continue to operate dual IHC and branch structures that pose managerial and supervisory challenges reminiscent of pre-2008. Without a single nexus for all of its activities in the United States, a foreign bank and its supervisors may be unable to aggregate, monitor, and report risks across all its U.S. legal entities in a timely and accurate manner.[310] The difficulties may be particularly severe for U.S. authorities, which face barriers to supervising foreign branches that are legally part of the parent company in its home jurisdiction.[311]

To be sure, the Federal Reserve has implemented rules purporting to require a foreign bank to establish a U.S. risk committee and employ a U.S. chief risk officer in charge of monitoring the combined risks in its IHC and branches on a consolidated basis.[312] Foreign banks, however, warned that these expectations were unrealistic, given the difficulty in aggregating risks across separate silos and management information systems.[313] Moreover, industry experts report that some foreign banks are still unable to reliably monitor their IHCs and U.S. branches on a consolidated basis, more than five years after the requirements went into effect.[314] These bleak reports raise doubts about whether it is feasible for foreign banks to effectively manage risks in siloed IHC and branch structures.

Mandatory subsidiarization, however, would alleviate this problem. Compulsory subsidiarization would create a single managerial and supervisory focal point—the IHC—for a systemically important foreign bank.[315] Rather than facing the complicated task of aggregating risks across separate IHC and branch structures, both bank leadership and U.S. authorities could concentrate on a single, top-tier U.S. holding company, which consolidates its subsidiaries in the ordinary course of business. In

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309. *Id.*

310. *See supra* note 149 and accompanying text.

311. *See supra* Section III.A.2 (discussing information asymmetries).

312. *See* 12 C.F.R. § 252.155 (2020).

313. *See* Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17,240, 17,285 (Mar. 27, 2014) (codified at 12 C.F.R. § 252.153 (2020)) (discussing foreign banks' objections to enhanced risk management standards).

314. *See, e.g.*, DELOITTE, REGULATORY DEVELOPMENTS FOR FOREIGN BANKING ORGANIZATIONS (2018), https://www2.deloitte.com/us/en/pages/regulatory/articles/fbo-peer-landscape-for-year-three-of-enhanced-prudential-standards.html [https://perma.cc/E7W2-PPA3] (noting that consolidated U.S. organization management reporting and U.S.-wide compliance frameworks remain a challenge for foreign banking organizations).

315. Under the framework proposed in this Article, a foreign bank that is not a GSIB could still operate a U.S. IHC and U.S. branches with less than $25 billion in total U.S. assets.

this way, compulsory subsidiarization would enhance oversight of foreign banks' U.S. operations and thereby mitigate safety-and-soundness risks.

b. Facilitate Resolution if a Foreign Bank Fails

In addition to reducing the likelihood that a foreign bank's U.S. operations experience distress, mandatory subsidiarization would facilitate the orderly resolution of such operations if they were to fail. Under existing law, the United States lacks a satisfactory mechanism for resolving a failed foreign bank branch in a way that limits economic fallout to U.S. counterparties and the broader financial system. Compulsory subsidiarization, however, would ensure that the United States could handle the failure of a large foreign bank's U.S. operations in an orderly fashion through the traditional bank resolution process.

As currently structured, the U.S. regulatory framework is not well suited to resolve a distressed foreign bank branch. As Professor Steven Schwarcz has written, when foreign banks fail, "their U.S. operations and assets are subject to a confused, and confusing, patchwork of insolvency laws . . . ."[316] The liquidation of a failed foreign bank's U.S. branch is governed by federal or state bank insolvency law, depending on the branch's charter.[317] These insolvency laws, however, are limited in their efficacy. For example, federal bank insolvency law does not impose a credible stay on creditors, nor does it reliably distinguish between a foreign bank and its branches for purposes of identifying assets subject to the proceeding.[318] The matter is even more complicated if the bank has operations in multiple states, in which case more than one authority could assert jurisdiction over the same assets.[319] This haphazard insolvency framework intensifies the risk that the failure of a large foreign bank branch—for example, Deutsche Bank or Barclays—could impose losses on U.S. counterparties and propagate distress through the broader financial system.

Although the post-2008 cross-border bank resolution framework aims to keep an insolvent foreign bank's branches open through a single-point-of-entry (SPOE) strategy—and thereby avoid insolvency proceedings—many observers doubt whether this framework will work in practice. In an SPOE proceeding, the foreign bank's home-country supervisor would resolve and recapitalize the firm's top-tier holding company, while all of its subsidiaries and foreign branches remain operational.[320] Numerous

316. Schwarcz, *supra* note 154, at 81.

317. *See id.* at 85–88.

318. *See id.* at 88–89 (asserting that "federal banking insolvency law is not well developed").

319. *See id.* at 89.

320. *See* Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76,614, 76,623 (proposed Dec. 18, 2013).

experts, however, have cast doubt on whether a complicated cross-border SPOE resolution will work in practice.[321] For example, Professors Patrick Bolton and Martin Oehmke assert that national regulators may have incentives to disregard cross-border cooperation to protect domestic interests.[322] If a foreign bank's SPOE proceeding were to break down, then the disorganized U.S. insolvency framework would govern its domestic liquidation.

Mandatory subsidiarization offers a better approach to resolving a foreign bank's U.S. operations. Requiring a large foreign bank to conduct its domestic activities through locally incorporated subsidiaries would simplify the process of selling off the bank's U.S. business lines when it experiences distress.[323] Further, for a foreign bank subject to the IHC requirement, mandatory subsidiarization would allow U.S. authorities to focus on resolving only the IHC, instead of both the foreign bank's IHC and its branches.[324] Additionally, mandatory subsidiarization would subject the foreign bank's depository activities to U.S. limitations on transactions with affiliates, thereby impeding a distressed foreign bank's ability to repatriate financial resources to its home country, out of reach of domestic claimants.[325] In such ways, mandatory subsidiarization would substantially simplify foreign bank resolution and thereby protect U.S. counterparties and the domestic financial system.

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321. *See, e.g.*, John Crawford, *"Single Point of Entry": The Promise and Limits of the Latest Cure for Bailouts*, 109 NW. U. L. REV. ONLINE 103, 110–12 (2014) (expressing skepticism that SPOE framework will work as intended); Roberta S. Karmel, *An Orderly Liquidation Authority is Not the Solution to Too-Big-to-Fail*, 6 BROOK. J. CORP. FIN. & COM. L. 1, 6 (2011) (discussing problems with the SPOE regime); Stephen J. Lubben & Arthur E. Wilmarth, Jr., *Too Big and Unable to Fail*, 69 FLA. L. REV. 1205, 1223–43 (2017) (discussing shortcomings of SPOE); Steven L. Schwarcz, *Beyond Bankruptcy: Resolution as a Macroprudential Regulatory Tool*, 94 NOTRE DAME L. REV. 709, 718–19 (2018) (questioning SPOE's efficacy); David Zaring, *A Lack of Resolution*, 60 EMORY L.J. 97, 145–53 (2010) (proposing improvements to cross-border resolution framework). *But see* Jeffrey N. Gordon & Wolf-Georg Ringe, *Bank Resolution in the European Banking Union: A Transatlantic Perspective on What it Would Take*, 115 COLUM. L. REV. 1297, 1367–68 (2015) (suggesting that an effective SPOE framework could mitigate the need for the United States' IHC requirement).

322. *See* Patrick Bolton & Martin Oehmke, *Bank Resolution and the Structure of Global Banks*, 32 REV. FIN. STUD. 2383, 2384–87 (2019).

323. *See* FIECHTER ET AL., *supra* note 45, at 236–37.

324. When the Federal Reserve initially proposed the IHC requirement, it asserted that an IHC structure would "help facilitate the resolution or restructuring of the U.S. subsidiary operations of a foreign banking organization by providing one top-tier U.S. legal entity to be resolved or restructured." Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77 Fed. Reg. 76,628, 76,637 (Dec. 28, 2012) (codified at 12 C.F.R. pt. 252 (2020)). The same is true of subsidiarizing a foreign bank's U.S. branches beneath the IHC.

325. *See supra* note 291 (discussing affiliate transaction limits).

c. Reduce Procyclicality and Transmission of Macroeconomic Shocks

Mandatory subsidiarization would not only safeguard the U.S. financial system from insolvent foreign banks, it would also prevent *solvent* foreign banks from disrupting the U.S. economy. This is because foreign bank subsidiaries are less likely than foreign bank branches to inflate credit bubbles and transmit macroeconomic shocks. Subsidiarization, therefore, would require large foreign banks to participate in the U.S. economy in a safer and more sustainable way.

In contrast to branches, foreign bank subsidiaries do not contribute disproportionately to the creation and sudden collapse of credit bubbles. Recall that foreign bank lending in the United States is procyclical—it increases more rapidly during expansionary periods and falls more rapidly during contractions than domestic bank lending.[326] Foreign bank branches, however, are the key drivers of this procyclicality. Foreign bank branch lending increases more quickly than other forms of lending in good economic conditions but evaporates more quickly than other types of credit during downturns.[327] Foreign bank subsidiaries, by contrast, behave even less procyclically than domestic banks, thereby helping to stabilize the U.S. economy.[328] Compared to foreign bank branches, foreign bank subsidiaries may lend more consistently throughout the business cycle because local management is able to make better-informed underwriting decisions.[329] In addition, foreign bank subsidiaries may be less likely to deleverage during economic contractions since they are separately capitalized and limited in their ability to repatriate resources to their home countries.[330] Thus, mandatory subsidiarization would ensure that foreign banks do not exacerbate fluctuations in the U.S. business cycle.

Not only are foreign bank subsidiaries less likely than foreign branches to amplify domestic economic cycles, they also are less likely to import macroeconomic shocks from their home-countries. For example, Professors Peek and Rosengren's research on the 1990s Japanese banking crisis demonstrated that while Japanese banks' U.S. branches substantially curtailed lending in the United States, the decline

326. *See supra* Section III.A.3.

327. *See, e.g.*, Hoggarth et al., *supra* note 230, at 5–10 (finding that foreign branch lending to domestic borrowers increased by more than foreign subsidiary lending between 2006 and 2007 and fell by more than subsidiary lending between 2008 and 2009).

328. *See* INT'L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT APRIL 2015: NAVIGATING MONETARY POLICY CHALLENGES AND MANAGING RISKS 73–74 (2015) (concluding that lending by foreign bank subsidiaries is more stable than lending by domestic banks during domestic economic crises).

329. *See supra* Section V.A.1.a (discussing benefits of local management).

330. *See supra* notes 291, 325 and accompanying text (discussing foreign branches' exemption from limits on inter-affiliate transactions).

in Japanese banks' U.S. subsidiary lending was much smaller.[331] Similarly, economic modeling has shown that pervasive subsidiarization of foreign banks' U.S. operations would have mitigated the decline in U.S. lending by foreign banks during the European sovereign debt crisis that occurred between 2010 and 2012.[332]

In sum, mandatory subsidiarization would insulate the U.S. economy from disruptions caused by foreign banks. Not only would subsidiarization stop foreign banks from amplifying domestic economic cycles, it would also ensure that such banks do not import economic shocks from their home countries. Accordingly, subsidiarization would compel large foreign banks to make their U.S. operations safer and more sustainable.

d. Bring Foreign Banks into Deposit Insurance System

As yet another advantage, mandatory subsidiarization would bring more foreign bank activity in the United States within the federal deposit insurance system. Recall that the vast majority of foreign bank branches in the United States are excluded from the U.S. deposit insurance system under the FBSEA.[333] Mandatory subsidiarization would reverse this exclusion.[334] Bringing large foreign banks into the deposit insurance system would have two primary benefits. First, it would require such banks to contribute to the DIF and thereby help offset the systemic risks they create. Second, since all large foreign banks that operate in the United States would be eligible to accept insured deposits, it could increase competition in retail markets currently dominated by "too-big-to-fail" domestic banks.

Including large foreign banks in the federal deposit insurance system would force such banks to internalize more of the costs of their risk taking. If foreign banks were required to subsidiarize, they would have to pay annual assessments to the DIF on the activities they currently conduct in their uninsured U.S. branches.[335] Based on current financial

331. *See* Peek & Rosengren, *The International Transmission of Financial Shocks: The Case of Japan*, *supra* note 235, at 495–96.

332. *See* Josè L. Fillat et al., *What Are the Consequences of Global Banking for the International Transmission of Shocks? A Quantitative Analysis* 30 (Nat'l Bureau of Econ. Rsch., Working Paper No. 25203, 2018) ("[S]ince subsidiaries' activities are independent from their parents, subsidiarization prevents the transmission of the European shock to the U.S. economy . . . . This result is not surprising since branching is the organizational form that most facilitates the transmission of shocks across countries.").

333. *See supra* notes 98–99 and accompanying text.

334. *See* 12 U.S.C. § 1815(a) (establishing procedures for depository institutions to become insured by the FDIC).

335. *See id.* § 1817(b) (establishing risk-based assessments for insured depository institutions). While foreign banks could conceivably move some U.S. branch activity to nonbank

statements, large foreign banks would be required to contribute—at a minimum—an additional $282 million per year to the DIF if their branch activities were conducted in insured depository institution subsidiaries.[336] These foregone assessments represent a subsidy to large foreign banks that operate in the United States through branches. Mandatory subsidiarization, however, would eliminate this subsidy and require large foreign banks to help offset the costs of insolvencies that drain the DIF.[337] Moreover, since the FDIC sets higher assessment rates for banks that are deemed to be riskier, bringing large foreign banks into the deposit insurance system would incentivize them to reduce their risk taking and thereby lower their annual contribution to the DIF.

In addition, bringing large foreign banks into the federal deposit insurance system could create much-needed competition for the biggest U.S. banks in retail markets. Currently, uninsured foreign bank branches are limited to accepting deposits over the federal deposit insurance limit—$250,000—typically from commercial clients.[338] If large foreign banks' U.S. operations were subsidiarized and brought within the federal deposit insurance system, however, they would be able to accept retail deposits under $250,000.[339] Compulsory subsidiarization could therefore generate renewed competition in the retail market, which has experienced significant consolidation since the 2008 crisis.[340] Increasing competition for the largest U.S. banks could reduce their systemic importance and

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subsidiaries, their deposit-taking activities would have to be conducted through U.S. depository institution subsidiaries.

336. Recall that a U.S. bank's deposit assessment base is its average consolidated total assets minus its average tangible equity. *See supra* note 194 and accompanying text. A bank's assessment base is then multiplied by an assessment rate that depends on its confidential supervisory rating in order to calculate its annual assessment. *See* 12 C.F.R. § 327.4 (2020). In total, foreign GSIBs and foreign banks with more than $25 billion in branch currently have $1.9 trillion in U.S. branch assets. FEDERAL RESERVE STRUCTURE DATA—BY TYPE, *supra* note 56. Assuming that each of these banks would be subject to the lowest possible assessment rate—1.5 basis points—they collectively would have to pay $282 million in annual assessments based on their branch activities. *See* 12 C.F.R. § 327.10 (establishing assessment rate schedule). By contrast, if all large foreign banks were subject to the highest possible assessment rate—40 basis points—they would have to pay up to $7.5 billion in annual assessments based on their branch activities. *See id.*

337. *See supra* notes 240–42 and accompanying text (discussing how foreign banks threaten the DIF).

338. *See supra* note 56 and accompanying text.

339. To be sure, some foreign banks might not want to participate in the U.S. retail market. However, if foreign banks are required to pay deposit insurance assessments anyway, at least some foreign banks may compete for retail deposit market share.

340. *See, e.g.*, Rachel Louise Ensign, *Biggest Three Banks Gobble Up $2.4 Trillion in New Deposits Since Crisis*, WALL ST. J. (Mar. 22, 2018, 7:16 PM), https://www.wsj.com/articles/biggest-three-banks-gobble-up-2-4-trillion-in-new-deposits-since-crisis-1521711001 [https://perma.cc/F5PU-9VJJ] (noting that the proportion of U.S. deposits held by JPMorgan, Bank of America, and Wells Fargo increased from 20% in 2007 to 32% in 2017).

create market pressure to improve pricing and product quality.[341] Accordingly, bringing large foreign banks into the federal deposit insurance system through subsidiarization would not only help safeguard those firms, it could also have indirect, salutary effects on domestic banks.

In sum, mandatory subsidiarization would strengthen the U.S. regulatory framework for large foreign banks in many ways. Subsidiarization would not only improve the United States' micro-prudential oversight of individual foreign banks but also its macro-prudential supervision and regulation of the broader financial system, thereby helping to prevent a repeat of the 2008 crisis. By contrast, potential arguments against subsidiarization are not persuasive, as the next Section demonstrates.

2. Dispelling Subsidiarization Myths

Critics are likely to raise several objections to mandatory subsidiarization, but their concerns are unfounded. This Section dispels four myths about mandatory subsidiarization. First, that it will lead to harmful balkanization or "de-globalization." Second, that it would violate the national treatment principle. Third, that it will hurt U.S. banks by provoking foreign regulators to retaliate against them. And fourth, that it will increase foreign banks' systemic risks by trapping capital and liquidity in their U.S. subsidiaries. As this Section demonstrates, each of these claims lacks merit.

a. Subsidiarization Will Not Lead to Harmful "De-Globalization"

Contrary to popular perception, mandatory subsidiarization will not cause damaging balkanization of global financial markets. Observers commonly warn that stricter regulation by host countries incentivizes foreign banks to retrench to their home jurisdictions and curtail cross-border activities.[342] The evidence for this claim, however, is limited, at best. Further, even if large foreign banks were to curtail some cross-border activities in response to subsidiarization, they would likely reduce their risky short-term capital flows while preserving socially productive lending. Accordingly, to the extent that subsidiarization leads to some balkanization, this fragmentation would not be detrimental to the global financial system.

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341. *See, e.g.*, Allen N. Berger & Timothy H. Hannan, *The Price-Concentration Relationship in Banking*, 71 REV. ECON & STAT. 291, 291–99 (1989) (demonstrating that increased banking market concentration is associated with non-competitive pricing behavior).

342. *See, e.g.*, *The Great Unravelling*, THE ECONOMIST (Apr. 20, 2013), https://www.economist.com/finance-and-economics/2013/04/20/the-great-unravelling [https://perma.cc/WHB8-ELJ4] (referring to the Federal Reserve's IHC proposal as the "anti-globalisation rule").

There is little reason to believe that large foreign banks would retrench to their home countries in response to mandatory subsidiarization in the United States. Consider an International Monetary Fund (IMF) study that interviewed bankers about their decisions to operate abroad through subsidiaries or branches.[343] According to the IMF, some bankers reported that a subsidiarization requirement would induce their banks to exit the local market.[344] The IMF noted, however, that the bankers provided no evidence that compulsory subsidiarization would impair a parent bank's profits from its foreign operations.[345] The IMF's study therefore suggests that bankers' dire claims are merely rhetorical ploys to dissuade policymakers from imposing subsidiarization mandates. Further, the available data cast doubt on predictions that subsidiarization would lead to retrenchment and balkanization. Indeed, cross-border bank activity has surged in recent years despite the United States and other host countries strengthening regulation of foreign banks.[346] There is scant evidence, therefore, that foreign banks would respond to a subsidiarization mandate by leaving the United States.

To the extent that subsidiarization would balkanize some financial markets, the ensuing fragmentation would likely enhance global stability. The capital flows most likely to be curtailed in response to widespread subsidiarization are short-term debt transactions between foreign bank branches and their parent companies.[347] These transactions created vulnerabilities during the 2008 crisis and are of dubious societal value—what former UK Financial Services Authority Chairman Adair Turner referred to as "too much of the wrong sort of capital flow."[348] Subsidiarization would rein in these sorts of capital flows by imposing limits on the extent to which foreign bank subsidiaries may transact with their parent companies.[349] As Lord Turner asserted, "[s]ome balkanization of short-term international debt markets could be a good thing," in that it would reduce the extent to which foreign banks focus their overseas activities on short-term, speculative capital markets

343. FIECHTER ET AL., *supra* note 45, at 237 n.18.

344. *See id.*

345. *Id.*

346. *See* BANK FOR INT'L SETTLEMENTS, STATISTICAL RELEASE: BIS INTERNATIONAL BANKING STATISTICS AT END-DECEMBER 2019, at 1 (2020), https://www.bis.org/statistics/rppb2004.pdf [https://perma.cc/F8JJ-MRBT] (reporting that banks' global cross-border claims were five percentage points higher in 2019 compared to the average of the previous five years); Jeremy C. Kress, *Domesticating Foreign Finance*, CLS BLUE SKY BLOG (Jan. 11, 2021), https://clsbluesky.law.columbia.edu/2021/01/11/domesticating-foreign-finance/ [https://perma.cc/26HA-6B8S] (explaining how U.S. policymakers strengthened regulation of foreign banks after the 2008 financial crisis).

347. *See* Turner, *supra* note 34, at 3, 27–28.

348. *Id.* at 2.

349. *See supra* notes 280, 325 and accompanying text.

investments.[350] Accordingly, some fragmentation of volatile capital markets would be a welcome consequence of mandatory subsidiarization.

By contrast, mandatory subsidiarization would be unlikely to impair socially productive lending by foreign banks in their host jurisdictions. As Lord Turner asserted, subsidiarization requirements "would not limit useful capital flows: global banking groups would be free to make equity investments in subsidiary bank operations … [and] fund local subsidiary expansion via medium term debt issuances."[351] Foreign bank subsidiaries could therefore continue safely deploying capital in the United States for productive uses. To the extent that large foreign banks previously engaged in socially productive lending through U.S. branches, they could simply transfer these operations to new or existing subsidiaries.

The foregoing discussion paints a clear picture: mandatory subsidiarization would curtail large foreign banks' speculative capital markets investments but not significantly impair their domestic retail or commercial lending in the United States. Thus, it is unsurprising—and instructive—that, in the IMF study cited above, retail bankers reported that they generally support a subsidiarization requirement, while only investment bankers opposed it.[352] The current U.S. regulatory framework for foreign bank branches needlessly favors socially dubious capital markets transactions.[353] By contrast, mandatory subsidiarization would, by design, limit some socially harmful cross-border capital flows while preserving traditional banking activities.

b. Subsidiarization Will Not Violate the National Treatment Principle

Despite claims to the contrary, compulsory subsidiarization would not contravene the national treatment principle. In the past, U.S. authorities have resisted a subsidiarization mandate on national treatment grounds.[354] For example, when the Treasury Department proposed compulsory subsidiarization in the early 1990s, Federal Reserve Chairman Alan Greenspan protested that subsidiarization "may be viewed as denying national treatment because it prohibits foreign banks from branching in the United States from their head offices when U.S. banks would have that authority."[355] This objection, however, is

350. *See* Turner, *supra* note 34, at 28. Lord Turner continued, "Policy should not be driven by an axiomatic confidence that . . . market liquidity will by definition deliver value, but by the empirical reality that short-term global capital flows, particularly in debt form, can increase the dangers of financial instability." *Id.*

351. *Id.* at 27.

352. *See* FIECHTER ET AL., *supra* note 45, at 241–42 tbl.11.1.

353. *See supra* Section IV.B.

354. *See supra* notes 275–76 and accompanying text.

355. Alan Greenspan, Chairman, Bd. of Governors of the Fed. Rsrv. Sys., Testimony Before the Comm. on Banking, Fin., & Urban Affairs, U.S. House of Representatives (June 11, 1991), *in* 77 Fed. Res. Bull. 644, 649 (1991).

misleading. When interpreted appropriately, mandatory subsidiarization is in fact fully consistent with the national treatment norm.

Chairman Greenspan's objection is inapposite because he ignores the limiting clause in the national treatment principle: foreign banks should be treated similarly to domestic banks *in like circumstances*.[356] While U.S. banks may branch in the United States from their head offices as Greenspan noted,[357] foreign banks are not similarly situated to U.S. banks in this comparison. Foreign banks' head offices are subject to different regulatory requirements, different supervisory systems, and different resolution regimes.[358] Most importantly, unlike a domestic bank, a foreign bank that establishes a branch in the United States need not maintain loss-absorbing capital in the United States to offset its financial stability risks.[359] In light of these differences, therefore, it is not the case that national treatment requires foreign banks be allowed to operate branches in the United States.

To the contrary, mandatory subsidiarization is fully consistent with the national treatment norm. Since many foreign countries use some variation on the universal banking model—wherein banks may engage in a wide range of nonbanking activities—the appropriate comparison for this purpose is between a foreign bank and a U.S. BHC.[360] U.S. law requires that a U.S. BHC conduct its domestic banking activities through insured depository institution subsidiaries.[361] Further, a U.S. BHC must maintain the proceeds of its U.S. banking activities in its depository subsidiaries, subject to limitations on affiliate transactions.[362] Thus, genuine national treatment would require foreign banks to establish subsidiaries for their U.S. banking activities and to maintain their U.S. banking assets in those subsidiaries, subject to affiliate transaction restrictions. In sum, therefore, the national treatment principle does not necessitate foreign bank branching and, in fact, weighs in favor of mandatory subsidiarization.

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356. *See supra* note 277 and accompanying text.

357. *See* 12 U.S.C. § 36(c).

358. *See generally* RODRIGO COELHO ET AL., FIN. STABILITY INST., CONVERGENCE IN THE PRUDENTIAL REGULATION OF BANKS–WHAT IS MISSING? (2020), https://www.bis.org/fsi/publ/insights24.pdf [https://perma.cc/TT99-PBTE] (discussing persistent divergences in prudential bank regulation across international jurisdictions).

359. *See supra* note 51 and accompanying text.

360. *See* Richard J. Herring & Anthony M. Santomero, *The Corporate Structure of Financial Conglomerates*, 4 J. FIN. SERVS. RSCH. 471, 481–87 (1990) (discussing variations on banks' corporate structures across jurisdictions).

361. *See* 12 U.S.C. § 378(a)(1).

362. *See id.* § 371c.

c. Subsidiarization Will Not Provoke Retaliation That Disadvantages U.S. Banks

For decades, U.S. banks have opposed stronger foreign bank regulation out of concern that such measures might provoke other jurisdictions to retaliate against U.S. banks' international operations.[363] The fear of retaliation, however, is not a compelling justification for the United States to forego subsidiarization for three reasons. First, U.S. banks are less internationally oriented than their competitors and would be relatively unaffected by widespread subsidiarization mandates. Second, several foreign jurisdictions have already adopted subsidiarization requirements, so the fear of retaliation may be overblown. Finally, even if other jurisdictions respond to the United States' subsidiarization mandate by imposing their own subsidiarization requirements, universal adoption of compulsory subsidiarization would enhance global financial stability.

Even if other countries responded to the United States' subsidiarization mandate by imposing comparable requirements, U.S. banks would be relatively unaffected because they are more domestically oriented than their foreign peers. Systemically important EU banks, for example, have traditionally been heavily internationally focused, with two-thirds of their assets in other countries.[364] By contrast, systemically important U.S. banks have less than one-third of their assets in overseas offices.[365] Thus, a substantially smaller portion of U.S. banks' operations would be affected if other countries reacted to the United States' subsidiarization mandate by forcing foreign banks to establish local subsidiaries.

Moreover, the United States should not fear retaliation by other jurisdictions because many countries have already implemented subsidiarization requirements or strict "ring-fencing" rules for foreign

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363. *See U.S. Banks Join Foreign Banks in Drive to Kill Subsidiary Effort*, *supra* note 37 (describing U.S. banks' opposition to the U.S. Treasury Department's mandatory subsidiarization proposal in the early 1990s).

364. *See* Stijn Claessens et al., *A Safer World Financial System: Improving the Resolution of Systemic Institutions*, *in* GENEVA REPORTS ON THE WORLD ECONOMY 33–34 (2010). EU banks partially retrenched to their home jurisdictions in response to the European debt crisis in the early 2010s. *See supra* notes 166, 171–172 and accompanying text. Even after this retrenchment, however, European banks remain more internationally oriented than U.S. banks. For example, according to the United Nations Conference on Trade and Development's Geographical Spread Index, systemically important European banks continue to be more internationally focused than systemically important U.S. banks, based on their number of foreign affiliates and host countries. *See* U.N. CONF. ON TRADE & DEV., WORLD INVESTMENT REPORT 2018, at 6, fig.I.6 (2018), https://unctad.org/system/files/official-document/wir2018_en.pdf [https://perma.cc/DHL2-5C7V] (illustrating higher foreign direct investment outflow numbers in European countries than in the United States).

365. *See* Claessens et al., *supra* note 364, at 33–34.

bank branches. U.S. banks that operate in Brazil, Mexico, and New Zealand already must do so through local subsidiaries.[366] Further, other countries—including Argentina, Chile, India, and Korea—subject foreign bank branches to local capital and liquidity requirements identical to those applied to subsidiaries.[367] In still other countries—such as France, Germany, and Switzerland—foreign banks already operate primarily through subsidiaries, even though not required to do so by law.[368] The prevalence of subsidiarization abroad therefore alleviates the threat of retaliation if the United States were to require subsidiarization.

Finally, widespread subsidiarization could benefit U.S. banks by enhancing global financial stability. Before the 2008 crisis, both home-country and host-country regulators failed to appreciate systemic risks posed by internationally active banks.[369] This weak oversight ultimately damaged U.S. banks when the market crashed in 2008.[370] By intensifying foreign regulators' scrutiny of international banks' local operations, universal subsidiarization could help prevent a repeat of the 2008 crisis and thereby benefit U.S. banks in the long run.[371] Thus, even if other countries adopted subsidiarization in response to the United States' mandate, the ensuing stabilizing effect on global financial markets would benefit U.S. banks, rather than disadvantaging them.

In sum, the fear of retaliation is a red herring. Subsidiarization requirements would not harm U.S. banks relative to their peers, have already been implemented in many countries, and would help U.S. banks by enhancing global financial stability. The specter of retaliation is therefore not a convincing justification for the United States to forego subsidiarization.

d. Subsidiarization Will Not Increase Systemic Risk by Trapping Capital and Liquidity

Despite claims to the contrary, mandatory subsidiarization will not intensify systemic risks by preventing large foreign banks from reallocating resources within their global conglomerates. Recall that under the branch model, a foreign bank manages its capital and liquidity

366. *See* Katia D'Hulster & Inci Ötker-Robi, *Ring-Fencing Cross-Border Banks: An Effective Supervisory Response?*, 16 J. BANKING REG. 169, 176 (2015).

367. *See* FIECHTER ET AL., *supra* note 45, at 224 n.4.

368. *See id.* at 231 fig.11.1 (showing that more than three-quarters of foreign banking activity in France, Germany, and Switzerland occurs in subsidiaries).

369. *See* Tarullo, *supra* note 116, at 8.

370. *Id.*

371. Indeed, the Federal Reserve appeared to encourage foreign jurisdictions to adopt their own IHC requirements in order to enhance global stability. *See* Coley, *supra* note 280, at 732 (noting that Federal Reserve Governor Daniel Tarullo "signaled that the Fed would welcome such retaliatory measures with open arms").

centrally.[372] Thus, a bank that operates through foreign branches may fortify weaker segments by transferring financial resources from stronger segments.[373] The subsidiary model, by contrast, limits a bank's ability to shift financial resources freely throughout its organizational structure.[374] Accordingly, critics contend that mandatory subsidiarization would increase systemic risks by trapping capital and liquidity in locally incorporated entities and prohibiting banks from reallocating financial resources where they are most needed.[375] These warnings, however, are unfounded. Subsidiarization opponents overstate the benefits of centralized management and, in any event, mandatory subsidiarization would not eliminate banks' ability to redeploy financial resources efficiently.

As an initial matter, the financial stability benefits of centralized management through the branch model are likely overstated. Most glaringly, the purported efficiencies of centralized management failed to avert the global financial crisis in 2008. As one observer put it, "If centralized management of globally active banks had been capable of providing a natural capital and liquidity buffer to their U.S. operations, then the Fed would not have been forced to inject hundreds of billions of dollars in loans" to foreign banks.[376] Moreover, while centralized management may permit banks to reallocate financial resources efficiently under normal conditions, international regulators have strong incentives to ring-fence foreign branch assets when a crisis hits.[377] Thus, even if centralized management could enhance financial stability in theory, such benefits would likely be eliminated in stressful economic conditions.

Second, mandatory subsidiarization would not prevent large foreign banks from efficiently allocating financial resources within their corporate structures. Under Basel III, a systemically important foreign bank is subject to a global systemically important bank—or GSIB—capital surcharge.[378] The foreign bank must maintain this extra capital

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372. *See supra* note 54 and accompanying text.

373. *See* Tarullo, *supra* note 3, at 7.

374. *See supra* note 49 and accompanying text.

375. *See, e.g.*, Claessens et al., *supra* note 364, at 88 ("Being unable to move assets freely across the group for legal reasons could lead to 'trapped liquidity' and cause unnecessary insolvency in some parts of the group as they become strapped for cash even though other parts of the group may be quite liquid."); *see also* Coley, *supra* note 280, at 718–19 (discussing international regulators' objections to subsidiarization requirements).

376. *See* Coley, *supra* note 280, at 731.

377. *See* Tarullo, *supra* note 3, at 7.

378. *See* BASEL COMM. ON BANKING SUPERVISION, GLOBAL SYSTEMICALLY IMPORTANT BANKS: UPDATED ASSESSMENT METHODOLOGY AND THE HIGHER LOSS ABSORBENCY REQUIREMENT 12 (2013), https://www.bis.org/publ/bcbs255.pdf [https://perma.cc/UP33-KRAV].

cushion at its top-tier parent company.[379] The GSIB surcharge, however, does not apply to a foreign bank's subsidiaries, which are subject only to baseline capital requirements in their host jurisdictions.[380] Thus, as Federal Reserve Governor Tarullo noted, "even if the global bank has local capital requirements for most or all of its foreign operations, the parent still has some flexibility as to where the additional capital buffer can be maintained."[381] Under a subsidiarization mandate, therefore, a systemically important foreign bank's capital cushion would not be trapped in sub-consolidated entities. Rather, the foreign bank would retain discretion as to how to deploy a significant portion of its capital most efficiently.

3. Trade-offs and Implementation of Subsidiarization

Despite the compelling case for mandatory subsidiarization, forcing large foreign banks to operate in the United States through subsidiaries instead of branches would not be costless. Nor would this policy change be easily achievable under existing U.S. law. This Section addresses policy trade-offs inherent in compulsory subsidiarization and analyzes the financial regulatory agencies' limited authority to implement such a requirement absent new legislation.

a. Trade-offs

As with any financial regulatory policy, mandatory subsidiarization would entail certain trade-offs. For example, forcing large foreign banks to establish subsidiaries could incrementally increase costs on such banks.[382] Indeed, empirical research suggests that banks with overseas subsidiaries generally have higher capital needs than banks with overseas branches.[383] Moreover, individual subsidiaries would likely be less diversified—and therefore more prone to financial distress—than their foreign bank parents.[384] Relatedly, mandatory subsidiarization would create the possibility that the distress or insolvency of a bank's overseas

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379. *Id.* at 14.

380. Tarullo, *supra* note 116, at 13.

381. *Id.*

382. *See id.* at 5.

383. *See, e.g.*, Eugenio Cerutti et al., *Bankers Without Borders? Implications of Ring-Fencing for European Cross-Border Banks* 1 (Int'l Monetary Fund, Working Paper No. 10/247, 2010), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1750736 [https://perma.cc/R2ME-FUBE] ("Our simulations show that under stricter forms of ring-fencing, sample banking groups have substantially larger needs for capital buffers at the parent and/or subsidiary level than under less strict (or in the absence of any) ring-fencing.").

384. *See The Federal Deposit Insurance Corporation Holds a Forum for Discussion of the Dodd-Frank Resolution Plan–News Conference*, FIN. MKT. REG. WIRE, Nov. 4, 2010. Factiva Doc. No. FMRW000020101104e6b4000ji (discussing diversification of parent companies relative to subsidiaries).

subsidiary could trigger a contagious run on the parent bank.[385] In sum, large foreign banks could be expected to incur some additional costs as a result of mandatory subsidiarization.

In practice, however, the downsides of mandatory subsidiarization may not be especially severe. For one, many large foreign banks are already subject to the GSIB capital surcharge, as noted above.[386] As a result, a top-tier foreign bank could meet the demand for capital in its U.S. operations without increasing its aggregate capital levels by redeploying some of this buffer.[387] Further, while a foreign bank's U.S. subsidiary might be vulnerable to correlated risks, the foreign parent company would remain diversified on a global basis.[388] In addition, even if a foreign bank's U.S. operations were susceptible to local risks, subsidiarization ensures that it would have local capital and liquidity to withstand such stresses.[389]

Moreover, limiting the subsidiarization mandate to GSIBs and foreign banks with large U.S. operations would allow most foreign firms to continue maintaining modest U.S. branches. This Article recommends mandating subsidiarization for foreign GSIBs and any other foreign bank that has more than $25 billion in U.S. branch assets.[390] Under this approach, only 31 foreign banks—at most—would be required to subsidiarize.[391] By comparison, more than 100 other foreign banks operate modestly sized U.S. branches and would be unaffected by the subsidiarization mandate.[392] These foreign banks—many of which specialize in U.S. dollar clearing for their home-country clients—generally do not raise the same systemic risk concerns as large foreign banks.[393] As a result, the United States could allow them to continue

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385. *See* Claessens et al., *supra* note 364, at 88.

386. *See supra* notes 378–81 and accompanying text.

387. *See supra* notes 378–81 and accompanying text.

388. *Cf.* Ralph de Haas & Iman van Lelyveld, *Multinational Banks and the Global Financial Crisis: Weathering the Perfect Storm?*, 46 J. MONEY, CREDIT & BANKING 333, 334–35 (2014) (noting that internationally diversified banks performed better in their home-country compared to domestic banks without international operations during the 2008 crisis).

389. *Id.* at 334.

390. *See supra* note 298 and accompanying text.

391. Twenty foreign GSIBs currently operate U.S. branches. *See* FIN. STABILITY BD., *supra* note 29; FEDERAL RESERVE STRUCTURE DATA—BY COUNTRY, *supra* note 13 (indicating that all foreign GSIBs except HSBC and ING Bank have U.S. branches). Eleven other foreign banks currently maintain U.S. branches with more than $25 billion in assets. FEDERAL RESERVE STRUCTURE DATA—BY COUNTRY, *supra* note 13. Of those eleven banks, five have less than $30 billion in U.S. branch assets and could consider shrinking their branches to avoid subsidiarizing. *See id.*

392. *See* FEDERAL RESERVE STRUCTURE DATA—BY COUNTRY, *supra* note 13.

393. *See supra* notes 68–71 (discussing dollar-clearing branches); *cf.* Simone Varotto & Lei Zhao, *Systemic Risk and Bank Size*, 82 J. INT'L MONEY & FIN. 45, 53–54 (2018) (concluding that a bank's size, while not determinative, is the primary driver of its systemic riskiness).

servicing their customers through U.S. branches. Given the relatively limited scope, therefore, the disadvantages of a subsidiarization mandate are unlikely to be as problematic as some may fear.

In sum, while mandatory subsidiarization may impose some costs on foreign banks, these costs are likely to be limited, and the trade-offs are well worth making to attain the benefits of subsidiarization discussed above. The downsides of subsidiarization would be similar to the trade-offs inherent in the United States' IHC requirement. When finalizing the IHC rule in 2014, the Federal Reserve explained as follows: "While the proposed requirements could incrementally increase costs . . . of internationally active banks . . . they would increase the resiliency of the U.S. operations of a foreign banking organization, the ability of the U.S. operations to respond to stresses in the United States, and the stability of the U.S. financial system."[394] The same rationale is equally true of a subsidiarization requirement. Thus, while compulsory subsidiarization may indeed involve some trade-offs, the systemic benefits are highly likely to outweigh any costs.

b. Implementation

While compulsory subsidiarization would be socially desirable, new legislation is probably needed to implement an enforceable subsidiarization mandate. Under current law, the federal regulatory agencies likely lack authority to compel subsidiarization directly. Indeed, the Federal Reserve noted in its IHC rule that "Congress has permitted foreign banking organizations to establish branches and agencies in the United States if they meet specific standards, and has chosen not to require foreign banks to conduct their banking business in the United States only through subsidiary U.S. depository institutions."[395] That said, the Federal Reserve may be able to implement subsidiarization indirectly, even if it cannot compel it directly.

The Federal Reserve's existing legal authority to institute a subsidiarization mandate is rather limited. The IBA grants the Federal Reserve power to terminate foreign banks' U.S. offices.[396] However, this termination authority requires a relatively high standard—the Federal Reserve must show that the foreign bank office engaged in an "unsafe or unsound banking practice" or poses a "risk to the stability of the United

394. *See* Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17,240, 17,266 (Mar. 27, 2014) (codified at 12 C.F.R. § 252.153 (2020)).

395. *See* Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77 Fed. Reg. 76,628, 76,638 (Dec. 28, 2012) (codified at 12 C.F.R. pt. 252 (2020)).

396. *See* 12 U.S.C. § 3105(e).

States financial system."[397] The agency is unlikely to be able to make such a showing for all large foreign bank branches. The IBA and Bank Holding Company Act grant the Federal Reserve relatively wide latitude to oversee and regulate foreign banks' offices.[398] However, the agency would probably find it difficult to use these general provisions to override Congress' specific grant of authority allowing foreign banks to operate U.S. branches.[399]

Even if it cannot mandate subsidiarization, however, the Federal Reserve could strongly encourage it. Using its general regulatory authority, the Federal Reserve could establish such stringent safety-and-soundness standards for large foreign bank branches that operating a U.S. branch would become uneconomical. In this way, a large foreign bank that wants to operate in the United States would, in effect, have to establish a U.S. subsidiary instead of a branch.

The Federal Reserve may understandably hesitate to use its general safety-and-soundness authority to compel subsidiarization indirectly. In that case, if Congress fails pass legislation mandating subsidiarization, the Federal Reserve should enhance its oversight of foreign banks' U.S. branches—not to encourage subsidiarization, but to protect the U.S. financial system—as the next Section describes.

B. *Enhanced Oversight of Branches*

Despite compelling justifications for mandatory subsidiarization, powerful interests—including both foreign and domestic banks—will undoubtedly resist such a significant reform.[400] If compulsory subsidiarization proves infeasible, improving the oversight of foreign banks' U.S. branches would be the next-best alternative. Specifically, the United States could apply stronger prudential safeguards to and mandate federal chartering of foreign banks' domestic branches. While not as effective as mandatory subsidiarization, enhancing branch oversight in this way would achieve at least some of the same objectives.

1. Stronger Prudential Standards

If the United States permits foreign banks to continue operating domestic branches, policymakers should substantially toughen the safety-and-soundness standards for such offices. In doing so, U.S. policymakers

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397. *Id.* § 3105(e)(1)(B)–(C). The Federal Reserve can also terminate a foreign bank office if it finds that the foreign bank is not subject to comprehensive, consolidated supervision or regulation by its home-country. *See id.* § 3105(e)(1)(A).

398. *See id.* § 3106(a) (subjecting foreign banks that operate in the United States to the Bank Holding Company Act); *id.* § 1844(b) (authorizing the Federal Reserve to issue regulations to implement the Bank Holding Company Act).

399. *See supra* note 395 and accompanying text.

400. *See supra* note 37 (describing opposition to mandatory subsidiarization in 1990s).

should focus on liquidity rules that require foreign branches to maintain minimum amounts of high-quality assets, such as cash and Treasury securities, in the United States. Since a U.S. branch is legally part of its foreign bank parent and does not maintain an independent capital cushion, liquidity rules are the strongest prudential tool that local authorities can use to safeguard foreign bank branches.[401] In the United States, however, the Federal Reserve's liquidity rules are troublingly inadequate. The Federal Reserve should therefore enhance oversight of foreign bank branches by establishing standardized liquidity requirements, as it has long promised to do.

The Federal Reserve tried to strengthen liquidity requirements for foreign bank branches after the 2008 crisis, but it did not go far enough to protect the U.S. financial system. Recall that in 2014 the Federal Reserve implemented a requirement that a foreign bank's U.S. branch must maintain a buffer of highly liquid assets in the United States at least equal to its liquidity needs for fourteen days, as measured by an internal liquidity stress test.[402] This rule generally increased the quantity of liquid assets foreign bank branches had to hold in the United States and introduced an element of risk-sensitivity to branch liquidity standards.[403] However, the Federal Reserve's branch liquidity requirements are substantially weaker than the comparable requirement for U.S. IHCs, which must maintain a thirty-day liquidity buffer.[404] Furthermore, the Federal Reserve has exempted foreign banks' U.S. branches from standardized liquidity requirements applicable to U.S. IHCs that serve as a backstop to liquidity stress tests.[405]

Internal liquidity stress tests, on their own, are insufficient to safeguard foreign bank branches. Regulatory requirements based on banks' internal models are subject to manipulation and mis-estimation. Indeed, the models-based Basel II capital framework failed to prevent the 2008 crisis in part because banks had incentive to manipulate their models and thereby artificially improve their reported capital ratios.[406] Thus, as the Federal Reserve acknowledged, "firms' own models may overestimate cash flow sources or underestimate cash flow needs arising from a particular business line" and thereby understate a foreign bank's actual liquidity needs.[407]

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401. *See supra* note 51 and accompanying text (explaining that foreign bank branches are not separately capitalized).

402. *See supra* notes 209–13 and accompanying text.

403. *See* 12 C.F.R. § 252.157(c)(3)(i) (2020).

404. *See id.* § 252.157(c)(2)(i).

405. *See supra* note 212 and accompanying text.

406. *See* Gerding, *supra* note 162, at 375.

407. *See* Changes to Applicability Thresholds for Regulatory Capital Requirements for Certain U.S. Subsidiaries of Foreign Banking Organizations, 84 Fed. Reg. 24,296, 24,313–14 (May 24, 2019) (codified in scattered sections of 12 C.F.R.).

To correct this deficiency, the Federal Reserve should adopt standardized liquidity requirements for foreign bank branches similar to those for domestic banks and U.S. IHCs. The most prominent standardized liquidity rule, known as the liquidity coverage ratio (LCR), requires a banking organization to maintain a certain amount of high-quality liquid assets based on a formula established by the Federal Reserve to measure the organization's unique funding vulnerabilities.[408] Applying the standardized LCR to foreign bank branches would complement liquidity stress tests and prevent branches from manipulating or mis-estimating its liquidity needs.[409]

The Federal Reserve has long promised to adopt standardized liquidity requirements for foreign bank branches, but it has never fulfilled its commitment. When the Federal Reserve implemented the LCR for domestic banks in 2014, it indicated that it would propose similar rules for foreign banks in a future rulemaking.[410] Five years later, the Federal Reserve proposed to apply the LCR to foreign banks' U.S. IHCs and requested comment on whether to apply the rule to foreign banks' U.S. branches.[411] The Federal Reserve ultimately adopted the LCR for U.S. IHCs but declined to do so for branches, asserting that it expects to "engage in further discussion and evaluation of the issue at an international level."[412] In a rare move, Federal Reserve Governor Lael Brainard voted against the final rule because it failed to address liquidity risks of foreign bank branches.[413]

If the United States does not mandate subsidiarization, it is critical that the Federal Reserve adopt standardized liquidity requirements for foreign bank branches as it has long promised. Among other things, applying the LCR to branches would reduce foreign banks' incentives to engage in regulatory arbitrage by shifting assets from their IHCs and into branches.[414] Further, standardized liquidity requirements would mitigate the risk that foreign bank branches experience funding runs that

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408. *See* 12 C.F.R. § 249.10 (2020).

409. *See* Changes to Applicability Thresholds for Regulatory Capital Requirements for Certain U.S. Subsidiaries of Foreign Banking Organizations, 84 Fed. Reg. at 24,313 (noting that standardized liquidity requirements complement internal liquidity stress tests).

410. *See* Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17,240, 17,290–91 (Mar. 27, 2014) (codified at 12 C.F.R. § 252.153 (2020)).

411. *See* Changes to Applicability Thresholds for Regulatory Capital Requirements for Certain U.S. Subsidiaries of Foreign Banking Organizations, 84 Fed. Reg. at 24,313–26.

412. *See* Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements, 84 Fed. Reg. 59,230, 59,257 (Nov. 1, 2019) (codified in scattered sections of 12 C.F.R.).

413. *See* Press Release, Bd. of Governors of the Fed. Rsrv. Sys., Statement by Governor Lael Brainard (Oct. 10, 2019), https://www.federalreserve.gov/newsevents/pressreleases/brainard-statement-20191010.htm [https://perma.cc/UE2U-9JMW].

414. *See supra* Section II.B (discussing regulatory arbitrage).

necessitate damaging fire sales.[415] These protections are especially important given how heavily foreign bank branches rely on short-term wholesale funding—roughly twice as much as U.S. IHCs.[416] In sum, applying standardized liquidity requirements to foreign bank branches would substantially reduce the risks they pose to U.S. financial stability.

While strengthening prudential standards for U.S. branches would be an improvement over the status quo, it would still be suboptimal relative to mandatory subsidiarization. Applying the LCR to large foreign bank branches would close the gap in regulatory treatment between branches and IHCs—but not eliminate it. Most significantly, a foreign bank branch would still not be required to maintain a capital cushion in the United States to absorb potential losses.[417] Moreover, in contrast to an IHC, a branch would retain flexibility to repatriate financial resources to its home jurisdiction during times of stress, putting those resources out of the reach of U.S. authorities.[418] Finally, if a foreign bank were to become insolvent, a liquid asset buffer could help facilitate an orderly resolution, but the insolvency framework for the foreign bank's branch would remain significantly more complicated than for a U.S. subsidiary.[419] Thus, while enhancing safety-and-soundness regulation for foreign bank branches is a reasonable fallback option, it would be less effective than subsidiarization.

2. Mandatory Federal Chartering

Finally, if the United States allows large foreign banks to continue operating domestic branches, policymakers should insist that those branches be chartered by the federal government. Recall that a foreign bank seeking to operate a branch in the United States has a choice: it can obtain a federal charter from the OCC or a state charter from one of the states.[420] This charter choice, however, creates challenges for both safety-and-soundness and national security.[421] Accordingly, the United States should insist that large foreign banks' branches are federally chartered for three reasons.

First, mandatory federal chartering would preserve federal supremacy in areas of national concern. For example, federal chartering would

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415. *See supra* note 118 and accompanying text (discussing fire sales).

416. *See* Bd. of Governors of the Fed. Rsrv. Sys., *supra* note 413.

417. *See supra* note 51 and accompanying text (explaining that foreign bank branches are not separately capitalized).

418. *See supra* notes 220, 330 and accompanying text.

419. *See supra* notes 316–19 and accompanying text (discussing foreign branch insolvency).

420. *See supra* note 87 and accompanying text. Today, state-chartered branches and agencies outnumber federally chartered branches and agencies by approximately three-to-one. *See* FEDERAL RESERVE STRUCTURE DATA—BY TYPE, *supra* note 56.

421. *See supra* notes 97, 100 and accompanying text.

ensure that states do not become implicated in issues of foreign affairs. In the past, when individual states have taken enforcement actions against foreign banks, observers alleged that state regulators were infringing on the federal government's authority to conduct foreign relations.[422] Mandatory chartering by the OCC would ensure that states do not become embroiled in such issues. In addition, federal chartering would preserve exclusive federal oversight of the U.S. dollar market. Indeed, the Comptroller of the Currency is specifically charged with overseeing money creation,[423] making the OCC the appropriate chartering entity for foreign bank branches.

Second, compulsory federal chartering would improve safety-and-soundness oversight. Currently, there is a disconnect between domestic and foreign bank supervision in the United States. The OCC has traditionally supervised large U.S. banks, but most large foreign bank branches are chartered and regulated by the states.[424] Mandatory federal chartering would rationalize this disconnect—and thereby improve bank supervision—by consolidating oversight of all big banks within the OCC. Compulsory federal chartering would also obviate the significant differences between state and federal branch insolvency regimes, removing a potential source of confusion if a foreign bank were to collapse.[425]

Finally, mandatory federal chartering would eliminate a large foreign bank's ability to "charter shop" for its U.S. branches. Recall MUFG, which strategically switched its state charter to a federal charter to escape a money laundering investigation by the NYDFS.[426] This form of regulatory arbitrage was possible only because MUFG had multiple options for a chartering authority. Mandatory federal chartering would eliminate this optionality and thereby reduce foreign banks' leverage to seek lighter supervision or regulation by switching its charter.

In sum, policymakers must overhaul the U.S. regulatory framework to protect the domestic financial system from the risks of foreign banks. Mandatory subsidiarization of large foreign bank branches would be the optimal approach. It would enhance supervision of large foreign banks'

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422. *See, e.g.*, Kenneth S. Rosenzweig, *Regulation of Foreign Banks Operating in the United States: A State Regulator's Controversial Pursuit of a London-Based Bank*, 18 FORDHAM J. CORP. & FIN. L. 1021, 1032–34 (2013) (questioning whether a state regulator should be involved in regulating a foreign bank's U.S. operations when the bank is accused of violating federal laws that involve issues of foreign policy).

423. *See* Lev Menand, *Why Supervise Banks? The Foundations of the American Monetary Settlement*, 74 VAND. L. REV. 951, 960 (2021) (discussing the monetary basis of bank supervision).

424. *See* BARR ET AL., *supra* note 2, at 174 (noting that large banks tend to be chartered by the OCC); *supra* note 420 (noting that most foreign bank branches are chartered by the states).

425. *See supra* notes 316–19 and accompanying text (discussing foreign bank branch insolvency regimes).

426. *See supra* notes 257–62.

U.S. operations and generally protect the U.S. economy, without having significant negative consequences. As a fallback, policymakers could substantially strengthen oversight of foreign bank branches and mandate that large branches be chartered by the federal government. Whichever approach policymakers choose to adopt, addressing the risks of foreign banks would correct a dangerous vulnerability in the U.S. financial regulatory framework that persists more than a decade after the 2008 crisis.

CONCLUSION

Foreign banking has changed dramatically over the past fifty years, and U.S. financial regulatory policy has not adapted appropriately. What was originally a traditional banking sector morphed into a high-risk, capital-markets-focused business. The 2008 crisis laid bare the risks of foreign banks' U.S. operations: they rely heavily on risky funding sources, externalize costs on other market participants, and amplify fluctuations in the U.S. economic cycle. Nonetheless, the United States' regulatory response neglected the riskiest foreign bank operations. The requirement that foreign banks establish U.S. IHCs for their domestic subsidiaries helps safeguard those entities, but it unintentionally exacerbates financial stability risks by incentivizing the largest foreign banks to shift assets to their lightly regulated branches. To safeguard the U.S. financial system, therefore, policymakers must address the risks of foreign bank branches, lest they trigger a repeat of the 2008 crisis.

This Article has proposed a framework for mitigating foreign banks' risks through mandatory subsidiarization. Requiring large foreign banks to conduct business in the United States through separate subsidiaries would enhance oversight of foreign banks' domestic activities while allowing them to continue providing socially beneficial banking services to U.S. clients. By adopting mandatory subsidiarization, the United States could retain the benefits of foreign banking, minimize financial stability risks, and maintain consistency with longstanding international regulatory norms. In doing so, mandatory subsidiarization would achieve a long-needed rebalancing of the United States' regulatory objectives to prioritize financial stability without sacrificing economically productive financial integration.