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The New Autarky?

How U.S. and UK Domestic and Foreign Banking Proposals Threaten Global Growth

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Executive Summary

Since the 2007–08 financial crisis, global regulators have engaged in a lengthy struggle to reshape the international financial system to make it more resilient under stress. The purpose of this paper is to evaluate two recent and transformative proposals: the "Foreign Banking Organization" proposal of the U.S. Board of Governors of the Federal Reserve System and the United Kingdom's "ring-fencing" plan. Both of these proposals are intended to protect national financial systems from the risks posed by a failure of one or more global, interconnected banking organizations operating within national borders.

We analyze whether the proposals are likely to meet their own stated objectives and consider their likely effect on the global financial system. We argue that these measures amount to little more than a mandatory, inefficient shuffling of corporate entities and business units that will not help ward off future financial crises. At the macro level, both proposals interfere with the ability of global banks to allocate capital and liquidity in the manner they determine to be most efficient. We find that the proposals, therefore, threaten to increase financial instability and dampen economic growth and signal an unfortunate step in the wrong direction.

These proposals underscore the problems with national regulators adopting a parochial, protectionist, or "home country first" approach to regulation. We argue that even poorer outcomes would have resulted from the prior crisis had these proposals been in place at the time. We contend that regulators should instead focus their attention on creating a credible, coordinated resolution process for globally significant firms.

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Introduction

> The five or six years since the outbreak of the financial crisis have seen signs of a reversal of some aspects of the greater openness we had seen in the 1980s and 1990s. And probably none more so than the decline in cross-border bank lending . . . . International wholesale banking is . . . an important part of maintaining and developing the world economy, just as it was in the 19th century. Yet, we have to recognize that . . . [since] the crisis we have gone backwards.

So lamented Andrew Bailey, the deputy governor of the United Kingdom's new Prudential Regulatory Authority, in a recent speech to the British Bankers Association.[1] And he is not alone in his concerns.[2] Since 2008, commentators, industry professionals, regulators, and elected officials have made numerous, often contradictory, suggestions about how to deal with, or avoid, large bank failures. These suggestions range from "bailing in" creditors (explained below), to making banks smaller (whether through size caps or limitations on acquisitions), to limiting the activities that banks undertake (the "Volcker Rule" and similar initiatives), to imposing increasingly stringent regulations on larger organizations. Increasingly, however, regulators across the globe are looking inward, trying to insulate their domestic banking sectors from external shocks.[3]

This policy report does not purport to assess the costs and benefits of the multitude of rules and regulations that have been imposed on global banks in the wake of the 2008 financial crisis. Rather, we have chosen to focus on two specific proposals that we believe are indicative of the general trend described above. Both of the proposals discussed in this paper—the United States' "Foreign Banking Organization" (FBO) proposal and the United Kingdom's "ring-fencing" plan—are intended to protect national financial systems from the risks posed by a failure of one or more global, interconnected banking organizations operating within national borders. Because neither proposal has yet been implemented, it is difficult to measure the attendant costs, so we have instead focused on the *likely* outcomes and whether each proposal can reasonably be expected to meet its stated aims as well as some of the potential downfalls that are suggested by parallel examples from history.

The FBO proposal is the Federal Reserve's suggested implementation of Sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 for foreign banks.[4] Sections 165 and 166 require the Federal Reserve to impose enhanced prudential standards and early remediation requirements on "systemically significant" firms.[5] The FBO proposal would cover foreign banking organizations that either operate a branch or agency office in the United States or own a U.S. bank or "commercial lending company" subsidiary.

The UK's ring-fencing plan grew out of the recommendations of its Independent Commission of Banking,[6] which was constituted in the wake of the effective nationalization of the Royal Bank of Scotland Group (RBS) and Lloyds Banking Group.[7] Under the proposal, UK banks would handle traditional retail banking activities such as deposits and overdrafts in separate subsidiaries. Those subsidiaries would be ring-fenced from the investment banking divisions and would have their own independent corporate boards and be required to meet higher capital requirements.

Both the U.S. and UK proposals evince a common theme: the belief that the current structures of large banking groups are themselves a threat to financial stability, and those structures are required to be fundamentally altered to enhance financial stability.[8]

The Federal Reserve's FBO proposal represents a seismic shift in the regulation of U.S.-based subsidiaries and operations of foreign banks. Since the passage of the International Banking Act of 1978, foreign banks

seeking to operate in the United States have been afforded considerable flexibility in selecting the structure of their U.S. operations. Such banks may establish branch or agency offices.[9] They may also control bank subsidiaries insured by the Federal Deposit Insurance Corporation (FDIC), subject to certain conditions.[10] In addition, they may control subsidiaries engaged in a wide range of nonbanking activities (such as securities brokerage, underwriting, and dealing) either inside or outside a bank-holding company chain.[11] The Federal Reserve itself notes that this framework historically has allowed foreign banking organizations to structure their U.S. operations "in ways that promote maximum efficiency of capital and liquidity management at the consolidated level."[12]

In addition, since 2001, a U.S. bank holding company that is a subsidiary of a foreign bank[13] has not been required to comply with the Federal Reserve's capital adequacy requirements if the foreign bank is deemed "well-capitalized" and "well-managed."[14] This exception is justified on the basis that a well-capitalized and well-managed foreign parent is an appropriate source of financial and managerial strength for the U.S. subsidiary.[15]

The Federal Reserve would now change this approach for important market players. Those affected are foreign banks with $50 billion or more in total global consolidated assets and $10 billion or more in total consolidated non-branch or agency assets in the United States. Foreign banks meeting these thresholds—26 in the Federal Reserve's estimation—will need to organize all of their U.S. non-branch and agency operations under a single intermediate holding company (IHC). This would require foreign banks to transfer their U.S.-based operations to an existing holding company or to a newly created one.[16] Once this transfer is complete, the IHC would be required to comply with U.S. capital and liquidity standards as well as U.S.-specific requirements such as single counterparty credit limits, enhanced risk management practices, and early remediation requirements.[17]

The Federal Reserve offered several justifications for this change. First, it argued that during the financial crisis, large intra-firm, cross-border funding flows created vulnerabilities for the U.S. operations of foreign banks. Foreign banks that relied heavily on short-term dollar funding were forced to deleverage their dollar assets rapidly or to rely too heavily on currency swaps.[18] Second, although no foreign bank with U.S. operations failed in a destabilizing manner, the Federal Reserve provided temporary liquidity to branches, agencies, and broker-dealer subsidiaries of foreign banks.[19] Third, in some international failures, capital and liquidity were trapped in the home country entity, with foreign depositors and other foreign creditors shouldering the risk of loss.[20] Fourth, in the Federal Reserve's view, "resolution regimes and powers remain nationally based," complicating the resolution of firms with large cross-border operations.[21] In addition, the Federal Reserve notes that certain other jurisdictions are considering proposals to safeguard home country creditors at the expense of foreign creditors.[22]

In the UK, the Coalition Government has followed the recommendations of the *Final Report of the Independent Commission on Banking* (nicknamed the "Vickers Report") by introducing draft ring-fencing legislation.[23] Although the legislation is still being considered by Parliament, the *Final Report* recommended a "structural separation" of domestic retail banking services from global wholesale and investment banking operations. So while all entities could still form part of the same corporate group, domestic retail subsidiaries would be "legally, economically and operationally separate from the rest of the banking groups to which they belonged."[24]

The ring fence would seek to isolate banking services that policymakers deem "imperative" and for which "customers ha[d] no ready alternative."[25] Such services include most traditional retail banking functions such as deposit-taking and overdraft facilities provided to individuals and small and

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medium-sized entities (SMEs). These services would be distinguished from activities that would "directly increase the exposure of the ring-fenced bank to global financial markets, or . . . significantly complicate its resolution or otherwise threaten its objective."[26] To the extent such activities took place in a ring-fenced entity, they would have to be reassigned to the investment banking or wholesale entity.[27] Examples of such activities are services to customers outside the European Economic Area, "trading book" activities, services related to secondary markets activity, and derivatives trading (except as necessary for the retail bank to manage its own risk prudently).[28] The ring-fenced entity would then be required to meet standalone regulatory requirements for capital, liquidity, funding, and large group exposures.[29]

The Independent Commission also recommended that the ring-fenced bank have independent corporate governance to enforce the arm's length relationship.[30] The parent or other non-ring-fenced affiliates could, however, move capital into the retail entity as a source of financial strength.[31]

According to the Independent Commission, ring fencing brings advantages that outweigh any attendant costs. The *Final Report* noted that structural separation should make it easier and less costly to impose an orderly resolution or liquidation process on banks that fail. This "orderly" resolution should avert contagion and avoid taxpayer liability while ensuring the provision of necessary retail banking services.[32] Central to this argument is the premise that structural separation would make it easier to allow the wholesale or investment-banking subsidiary to fail, reducing the need for taxpayer support.[33] The Independent Commission also argued that separation would insulate retail banking from external financial shocks, particularly from large and complex international exposures.[34] In addition, separation would allow heightened UK capital standards to be imposed on the retail bank, while the international wholesale operations could conform to global standards.[35] Finally, separation would allow for better "targeting of macro-prudential regulation" because it would "assist the monitoring of banking activities by both market participants and the authorities."[36]

A Leap in the Wrong Direction

As policy initiatives, the FBO and ring-fencing proposals suffer from many of the same flaws as well as each having some unique failings.

At the macro level, both interfere with the ability of global banks to allocate capital and liquidity in the manner they determine to be most efficient. The FBO proposal would trap a material amount of capital and liquidity inside the U.S. subsidiary, rendering it unusable for the rest of the institution. A horizontal liquidity trap is also created under the UK scheme because the ring-fenced retail banking operations would need to meet standalone capital and liquidity requirements. Ironically, the Federal Reserve itself noted the benefits of its traditional approach to foreign bank supervision in the preamble to the FBO proposal: "[T]he structural diversity and consolidated management of capital and liquidity permitted under th[is] approach has facilitated cross-border banking and increased global flows of capital and liquidity."[37]

But the corollary is also true. If such flows stimulate economic growth, any reduction in those flows is likely to inhibit growth and prolong recessionary or sluggish tendencies. This seems a major drawback to a proposal introduced at a time when both the Federal Reserve and the Bank of England are engaged in unprecedented expansionary monetary policies to stimulate growth. Both proposals' respective approaches to the regulation of global banks are highly likely to constrict the availability of credit by requiring multiple tranches of capital and liquidity to be maintained throughout such institutions. At the very least, therefore, the

proposals will impose a drag on the overall economy.

In addition, at a time when much of the global economy is suffering from stagnant growth and high long-term unemployment, externally imposed artificial constraints on the availability of credit raise financial stability risks by delaying recoveries and exacerbating downturns. Despite the monetary policies of the Federal Reserve and Bank of England, the economic growth rate in the first two quarters of 2013 continued to be sluggish, with growth rates negative in the Eurozone in the first quarter.[38] Poor economic performance, in turn, results in rising numbers of nonperforming loans and the weakening of bank balance sheets, each a destabilizing factor. One observer, for example, has estimated that in the Eurozone, total nonperforming loans as a percentage of total loans will have increased from 5.6 percent in 2011 to 6.8 percent in 2012 to 7.6 percent in 2013, reaching a Euro-era high of €932 billion.[39] By restraining credit growth in the UK and the United States, the proposals threaten to prolong economic weakness, leading in turn to weaker bank balance sheets.[40]

In the case of the FBO proposal, trapping capital and liquidity in particular jurisdictions or corporate entities is also likely to make large banks less resilient in times of crisis. It is precisely when markets are threatening to collapse that it is most important for such financial institutions to be able to deploy capital and liquidity to troubled entities. The Federal Reserve seems to recognize this, noting that certain foreign banks were helped—not harmed—"by their ability to move liquidity freely during the [financial crisis]."[41]

Although the Federal Reserve's proposal may protect creditors of the U.S. operations of foreign banks *in resolution*, it will also deprive foreign banks of resources that could be used to ward off resolution in the first place. Surely it is better policy to allow global banks to avoid resolution where possible, provided they are not relying on taxpayer support.

A similar criticism may be leveled at the ring-fencing plan. The proposal assumes that investment banking affiliates are a more likely source of weakness during a financial crisis. Yet, in the UK itself, two of the earliest victims of the financial crisis were, in fact, retail institutions—Northern Rock and Bradford and Bingley—whose respective demises were caused, in part, by poor underwriting of home mortgages.[42] Retail mortgage exposures also severely harmed the banking and insurance firm HBOS before the UK government orchestrated its merger with Lloyds.[43] And just this summer, poor retail lending decisions and other managerial weaknesses that had nothing to do with "casino banking" resulted in substantial losses and a government-mandated recapitalization of the UK's Co-operative Bank.[44] Indeed, retail banks' capital has frequently been depleted by poor lending decisions, and if the wholesale bank is required to comply with its own capital requirements, a financial group will be limited in making that capital available to the retail bank should the need arise.

The same problem arises *even if* it is the investment banking operations that run into trouble. Even if the retail bank remains strong, the ring fence precludes the use of its capital and liquidity to shore up the wholesale operations. Because wholesale operations are ineligible to accept core deposits, they are generally more dependent on other forms of volatile short-term funding. Preventing the retail bank from providing temporary liquidity would be destabilizing in a time of crisis and may result in an otherwise avoidable failure of the investment banking operations.

Under the ring-fencing plan, investment and retail banking operations would still form part of the same banking group. A large investment bank failure would affect market perceptions of the affiliated retail banking operations, especially in the case of publicly traded financial groups that report losses on a consolidated basis. Substantial losses at the wholesale bank therefore may well precipitate a run on retail deposits—precisely the situation the ring fence is designed to avoid.

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Traditionally, the UK has not given any statutory, legal, or regulatory preference to depositors when a retail bank fails. That means that a significant drop in the share price of a consolidated entity is likely to result in significant depositor withdrawals at the bank level, a fact pattern that was borne out in the financial crisis. But the correlation between dropping share prices and deposit withdrawals has also held true in the United States, where authorities do give preference to depositors in the event of bank insolvency. The 2008 "silent" runs on Wachovia and Washington Mutual are cases in point. Therefore the introduction of a UK depositor preference regime would not necessarily mitigate this tendency.

Indeed, in the case of a large, global UK bank subject to both the Federal Reserve's FBO proposal and the ring fence, capital and liquidity would be trapped in two entities, the UK retail bank and the U.S. intermediate holding company, making it doubly difficult for such banks to respond during a crisis.[45] We believe it is more sensible policy to allow capital and liquidity resources to move freely within the global banking group at the onset of a crisis with a view to avoid insolvency and contagion.

Both proposals are also troubling because they signify a move toward domestic capital protectionism in financial services. In justifying the FBO proposal, the Federal Reserve took the position that it was merely responding to international developments that signal a move toward protecting home country creditors at the expense of creditors in other jurisdictions. It even cited the UK ring-fencing plan as an example of these new protectionist measures,[46] with some justification. Because certain UK banks control large U.S. broker-dealer subsidiaries as part of their wholesale operations, a scheme that protects the UK domestic retail operations while making the liquidation of the wholesale arm more likely makes it easier for the UK government to protect domestic operations and depositors at the expense of U.S. operations, creditors, and employees.

The Federal Reserve, however, ignores the likely effect of its own proposal. Using the same reasoning, the FBO proposal would likely further encourage additional protectionist measures to be taken by foreign regulators. These measures could include retaliatory actions against U.S. banking organizations with significant international operations. Many foreign supervisors have raised concerns about the Federal Reserve's proposal during the public comment process, and they may well take more drastic actions if the FBO proposal is retained.[47] Indeed, if the United States' principal "systemic" regulator takes the position that ex ante ring-fencing of the U.S. operations of foreign banks is necessary to safeguard the U.S. financial system, why would other home country regulators not follow suit? And if they do, we will see a domino effect where host countries impose inefficient individual capital and liquidity requirements or move to required full subsidiarization.[48]

In fact, on this score, the FBO proposal is far more troubling than the UK one. The ring-fencing plan is, essentially, a reaction to domestic developments in the UK during the financial crisis. In particular, it is a reaction to the use of significant public funds to keep the banking sector afloat. It affects cross-border banking only secondarily (through the implication that the UK authorities would give domestic retail operations special treatment in the event of a bank failure). By contrast, the Federal Reserve's FBO proposal *explicitly* questions the principle of international cooperation that has been at the heart of cross-border bank supervision and regulation for decades:

> Actions by a home country to constrain a banking organization's ability to provide support to its foreign operations, as well as the diminished likelihood that home-country governments of large banking organizations would provide a backstop to their banks' foreign operations, have called into question one of the fundamental

> elements of the [Federal Reserve's] current approach to supervising foreign banking organizations—the ability of the [Federal Reserve], as a host supervisor, to rely on a foreign banking organization to act as a source of strength to its U.S. operations.[49]

Following the financial crisis, certain national regulators may have taken a more parochial view and adopted a "home country first" approach to regulation. But they have almost certainly harmed their domestic banking markets in the process. In addition, the situation represents the classic "prisoner's dilemma": the more countries that adopt this protectionist view, the greater the incentive for others to join them. The cumulative impact of these measures is to reduce significantly the chance of reaching a globally optimal solution in the event that a large banking organization runs into trouble.

The other likely effect of growing protectionism is a retreat by internationally active banks to their home markets. By requiring additional capital and liquidity to be maintained in the United States, the Federal Reserve's FBO proposal will raise the cost of doing business in the United States for those foreign banks that are required to restructure. Given the restructuring costs, the costs of trapping capital and liquidity in the U.S. subsidiary, and the costs of complying with Dodd-Frank,[50] debanking from the United States or reducing the size of operations could well be a preferable economic alternative for a number of internationally active foreign banks.[51]

A reduction in the number of significant banking and broker-dealer entities in the United States will almost certainly lead to reduced competition. This comes on top of the already significant barriers to entry into the U.S. banking market. Any gaps created by the downsizing of the U.S. operations of foreign banks therefore will not likely be filled by new domestic entrants, but rather by the existing large U.S. institutions—institutions that have been criticized loudly (albeit unfairly) for having increased in size following the financial crisis.[52] The resulting market concentration will mean fewer choices available to the consumers of financial products, higher costs for businesses, and arguably more restricted access to credit. This, in turn, has a chilling effect on growth.

If other countries adopt the Federal Reserve's approach, large U.S. banking organizations that have substantial operations abroad may retreat from certain jurisdictions in the same manner as foreign banks retreat from the United States, resulting in less geographically diversified—and therefore weaker—operations.[53] This may be the source, though inadvertent, of significant systemic risk within the U.S. banking sector. Large organizations, in the absence of a vibrant internationally competitive market, will have a larger share of the home market, but may arguably be operationally weaker and less diversified. Ironically, this makes them more susceptible to failure. The end result will be a global decrease in competition for financial services, weaker institutions, and higher prices paid by financial services consumers worldwide.

There is a further concern. The FBO proposal will substantially increase the cost of foreign banks' maintaining a U.S. presence. In doing so, it may indirectly reduce the number of potential institutions that could come to the aid of a U.S. institution should such an institution experience a future crisis. Foreign banks provided crucial support to U.S. financial institutions during the 2007–08 financial crisis, thereby strengthening the U.S. financial system and avoiding further concentration in the market for banking services.[54]

In addition, both the FBO and ring-fencing proposals conflict in principle—if not yet in practice—with the United States' proposed approach to resolving large banks that fail. This "single point of entry" (SPE) approach has been developed by the FDIC and recently endorsed by senior staff at the Bank of England.[55] Under this approach, the top-level or holding company of a banking group

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would be placed into receivership. A shell or "bridge" bank would be created to acquire the operating subsidiaries of the group (such as banks, asset managers, and broker-dealers). This would preserve the going-concern value of those subsidiaries while the holding company's shareholders would likely be wiped out and its unsecured bondholders would be "bailed-in"; that is, they would become shareholders in the bridge bank once necessary haircuts to their interests had been applied.[56] In theory, this would minimize the need for taxpayer support to maintain essential bank functions.

In the case of a foreign bank with substantial U.S. operations, those operating subsidiaries would likely be valuable commercial banking or broker-dealer subsidiaries that the home country regulator would wish to preserve as subsidiaries of a bridge bank. Under the FBO proposal, however, it would be possible for a large U.S. IHC of a failing foreign bank to be placed into "orderly liquidation" under Title II of Dodd-Frank and thus be seized by the FDIC. Such an action would conflict with the resolution process of the foreign bank in its home country and would impair the ability of the home country regulator to maximize the going concern value of the failed institution.[57] This undermines the concept of comity (legal reciprocity between jurisdictions) and could well result in retaliation that would hamper the success of the SPE approach when applied to a U.S. bank with significant global operations.[58]

The ring-fencing plan allows for the insolvency of the wholesale or investment-banking arm of a UK banking group. This approach is in direct conflict with the concept of resolution at the group or holding company level. It is worth noting that the drafters of the *Final Report* did not have the benefit of considering the SPE scheme as a means of minimizing systemic risk, whether operational or contagious. SPE was developed only after the Independent Commission released its findings and had not been widely publicized as a possible option to keep retail functions afloat.

One may legitimately question the implicit assumption that retail banking is somehow "safer" than wholesale banking, when the retail operations of so many UK banks were clearly troubled during the crisis. That aside, the clear goal of UK authorities is to liquidate the wholesale banking arm of a large banking group while maintaining the group's retail operations. In contrast to the SPE approach, the government would not place the top-tier holding company of the group into receivership. Only the non-retail operations would be liquidated, while the ring fence of separate capital, liquidity, and governance would preserve the retail operations. It follows that there would then be no way to maximize going-concern value for the wholesale bank, and resolution will be costlier than in the absence of a ring fence. Therefore, as with the FBO proposal, the ring-fencing plan threatens to diminish enterprise value in the event of a failure. As noted previously, this "wholesale liquidation" approach clearly conflicts with more recent statements by senior Bank of England officials suggesting that "single point of entry" will be the preferred approach to resolution.[59]

Both the Federal Reserve's FBO and the UK ring-fencing proposals impose additional onerous restructuring requirements on an industry already overburdened by cumbersome new regulations. The cumulative effects of all these proposals have yet to be measured or fully understood.

In the United States, a foreign bank that has more than $50 billion in assets globally and more than $10 billion in U.S. non-branch/agency assets will be subject to a multitude of new bank regulations even in the absence of the corporate restructuring that the FBO proposal would impose. These include

- Branches and agencies will be subject to heightened liquidity standards and single-counterparty credit limits under Section 165 of Dodd-Frank as well as early remediation under Section

166 of Dodd-Frank.

- U.S. subsidiaries, branches, and agencies will be subject to the Volcker Rule's limitations on proprietary trading and sponsoring and investing in hedge funds and private equity funds.
- U.S. bank subsidiaries, branches, and agencies will be subject to the "swaps push-out" rule contained in Section 716 of Dodd-Frank.
- The foreign bank itself will be subject to "living will" requirements in its home jurisdiction and the United States.
- The foreign parent will itself be subject to the heightened capital requirements of Basel III as implemented by its home country regulator, as well as a new liquidity coverage ratio and net stable funding ratio.
- If the U.S. subsidiary is a bank holding company that has more than $50 billion in assets, this entity will be subject to U.S. Basel III capital requirements (including the so-called "Collins Amendment," which phases out capital instruments like trust-preferred securities, or TruPS). The bank holding company will also be subject to the aforementioned increased liquidity and early remediation requirements, single counterparty credit limits, Dodd-Frank's Title I capital planning and stress testing requirements, and the Volcker Rule.[60]

Similarly in the UK, the ring-fencing plan is only a component of the Independent Commission's recommendations for making the UK financial system sounder. Other requirements and proposals include

- The Basel III capital requirements and, for retail institutions, UK capital requirements above international norms. They include tightened risk-weights and a leverage ratio, plus a surcharge for "globally systemically important banks" (G-SIBS).
- The new liquidity coverage ratio and net stable funding ratio.
- Greater loss absorbency in the form of increased equity capital, plus bail-in bonds or contingent capital.
- Resolution planning.
- A new depositor preference regime.[61]

The ring-fencing plan would also impose restrictions on certain transactions among ring-fenced and non-ring-fenced entities in the same corporate group. These restrictions are comparable to the United States' restrictions on transactions between insured depository institutions and their investment banking affiliates.[62] Among the restrictions:

- Transactions should be "arm's-length," i.e., on terms no less favorable to the ring-fenced entity as transactions with a third party.
- The ring-fenced entity's exposures to the rest of the group should be subject to large exposure limits, and no waivers should be granted.
- There would be restrictions on the ability of the ring-fenced entity to make dividend payments to its parent company.
- Additional limits and high-quality collateral requirements should be placed on secured exposures of the ring-fenced entity to the rest of the group.
- Guarantees and similar commitments by the ring-fenced entity to the rest of the group should be subject to the large exposure limits.
- Limits will be placed on the total amount of intraday exposures between the ring-fenced entity and the rest of the corporate group.[63]

The discussion above lists only the relevant bank regulatory initiatives. In both the UK and the United States, there are a host of new proposed rules relating to derivatives trading and banker compensation.[64]

In our view, imposing mandatory and burdensome corporate restructuring re-

Burdensome corporate restructuring requirements make banks more inefficient and less capable of speedy adjustments during crisis periods.

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quirements, in addition to the heightened "safety and soundness" regulation, threatens to make financial firms—and their regulators—more inefficient and less capable of speedy adjustments during crisis periods. New corporate structures and new corporate governance regimes are not built overnight and raise complicated tax and other business issues. Resolving these issues will require significant institutional resources at a time when both banking institutions and their regulators are suffering from post–financial crisis burnout.

Each proposal also has its own unique flaws. The ring-fencing plan has three principal objectives:

- To make it easier to liquidate or resolve "both ring-fenced banks and non-ring-fenced-banks which get into trouble, without the provision of taxpayer-funded solvency support."[65]
- To "insulate vital banking services on which households and small businesses depend from problems elsewhere in the financial system."[66]
- To "curtail government guarantees, reducing the risk to the public finances and making it less likely that banks will run excessive risks in the first place."[67]

Our view is that the proposal's required structural separation does not achieve these desired ends.

Globally, there is no identifiable connection between structural separation and the absence of taxpayer-funded bailouts of financial institutions. In the United States, structural separation remains a dominant feature of the marketplace even after the partial repeal of Glass-Steagall. Yet, in the financial crisis, authorities argued that taxpayer-funded programs such as the Troubled Asset Relief Program were necessary to avoid a contagious panic among shareholders, bondholders, depositors, and other creditors of financial firms. Policymakers feared that this panic would bring down many other significant financial institutions, either because of those institutions' exposures to the failed firm (interconnectedness)[68] or because of panic spreading through the market (contagion). The ring-fencing plan does not address these risks, as it focuses entirely on relations between ring-fenced and non-ring-fenced entities (retail and wholesale businesses) in the same corporate group. In concept, it seeks to safeguard the retail businesses from losses at the wholesale level, but it does not address the effects on other similarly situated wholesale institutions in the UK.

Proponents of ring fencing argue that if a large UK banking firm runs into trouble, the ring-fencing plan would protect UK banks with similar portfolios and funding models from a loss of depositor and investor confidence.[69] Thus the authorities would not need to bail out the wholesale arm of the failed firm, reducing reliance on the taxpayer. The links underpinning this argument seem tenuous at best. If the authorities preserve the ring-fenced bank but leave the wholesale bank to fail, it does not follow that this will reduce panic in either the retail arm or at other institutions. In fact, as noted above, it may well precipitate a run on deposits in the retail arm of the troubled bank itself and a short-term funding crisis in the wholesale arms of other, similar institutions. Additionally, by restricting the ability of banks to channel liquidity to the subsidiaries that need it, the plan would seem to increase the likelihood of a bank failure and, consequently, the need for taxpayer support.

If the ultimate policy goal of reform is the elimination of public support in the event of a bank failure, there are more effective ways to achieve it. The most obvious is a legislative prohibition on the use of taxpayer funds and a limitation on government borrowing ability for resolution purposes—that is, a stronger version of the public support limitations contained in Title II of Dodd-Frank.[70]

On the second stated aim, insulating vital financial services from problems elsewhere in the financial system, the ring-fencing plan does have an intuitive appeal.

That said, it is questionable how effective it will be in practice. The proposal focuses on protecting only the "vital" services performed by the retail bank. It ignores that the problems underpinning the recent failure or near-failure of many financial institutions have frequently had their roots in the retail parts of the business, as was the case in the 2007–08 financial crisis. In the UK, the first victim of the crisis was Northern Rock, a retail mortgage lender, and the retail banking operations of both HBOS (bought by Lloyds) and RBS suffered significant losses in 2008. In the United States, many thrifts and community and retail banks failed because of loans to small- and mid-sized businesses engaged in real estate development, and larger institutions collapsed because of imprudent mortgage lending.[71] The ring-fencing plan runs counter to this history. The proposal also overlooks that there are other ways to maintain the essential functions of a large depository bank without requiring complete structural separation, including through resolution planning and creditor "bail-in" mechanisms.

In addition, there is no proven correlation between structural separation and eliminating excessive risk taking. Indeed, recent studies have indicated little or no correlation exists between "nontraditional" (or nonretail) activities and excessive risk taking.[72] The proposal suggests that structural separation will lead to better risk management by eliminating the perception that large financial institutions will receive public support when they falter. As we have argued, however, it is unlikely that the ring-fencing plan will prevent authorities from channeling public funds to a failing institution in a crisis. In addition, most banks affected by the ring-fencing plan are part of corporate groups that report their results on a consolidated basis. Under the ring-fencing plan, the retail arm would be required to maintain higher levels of capital.[73] The consolidated group, however, would still have every incentive to maximize its return on capital. If the consolidated group is subject to higher costs than international peers because of constraints on the retail side of the ring fence, management on the wholesale side may well be pressured to balance the outcomes by taking on excessive risk in order to generate higher returns. Again, therefore, the ring-fencing plan undermines rather than addresses the policy goal it seeks to achieve.

The argument that the ring-fencing plan is, at best, a very indirect means of achieving the prescribed outcomes is borne out in the Independent Commission's own analysis, in particular its findings on the failures or near-failures of HBOS, Lehman Brothers, Northern Rock, and RBS.

The Independent Commission notes that HBOS relied too heavily on wholesale short-term funding and had a very thin layer of equity capital. When the crisis hit, the bank was unable to replace maturing funding.[74] The Independent Commission concludes, "Liquidity reforms would have made [HBOS] more resilient to a liquidity crisis."[75] The *Final Report* also notes that a ring fence would have "complemented this" with wholesale funding restrictions, as well as by restricting the activities of HBOS's treasury function and requiring more equity.[76] But the equity and liquidity requirements are separate recommendations in the *Final Report* and can be imposed without using a ring fence. The Independent Commission also makes no attempt to show that HBOS's retail arm suffered because of a connection to an investment bank or because of its nonretail activities.[77] Rather, the underlying problems at HBOS were poor capitalization and overexposure to the property bubble, both issues that would have occurred on the retail side of a ring fence.

The causes of Northern Rock's sad demise was similar to HBOS's: the majority of its balance sheet was funded on a wholesale basis by securitizations and covered bonds.[78] When the crisis hit, the bank struggled to raise short-term funding, causing a panic among ordinary depositors and resulting in an old-fashioned bank run, the United Kingdom's first since 1866.[79] As in the case of

There is also no proven correlation between structural separation and eliminating excessive risk taking.

Implementation of the FBO proposal may well lead to an increase in the riskiness of foreign banks' U.S. operations.

HBOS, the Independent Commission states only that "[t]he ring-fence would have complemented" the report's other recommended reforms with wholesale funding restrictions and greater equity capital requirements,[80] again without noting that such requirements can be, and are being, imposed independent of structural separation.

In contrast, Lehman Brothers is a prime example of the ring-fence ideal: a standalone wholesale bank with no material retail operations. In the commission's view, it failed because "[i]t was heavily exposed to US subprime mortgages and over 30 times leveraged—a combination which led creditors to stop providing funds as large losses began to materialize."[81] The commission then states that "in the UK, the ring-fence would have insulated vital banking services of universal banks from contagion through their global banking and markets operations."[82] We do not believe that this conclusion necessarily follows. As noted before, if a large wholesale failure like Lehman results in a loss of confidence in other banks' wholesale operations, that would put pressure on any retail affiliate, with or without a ring fence.

Only at RBS, therefore, does the commission arguably make a case for the ring fence: "[A fence] would have isolated [UK and European Economic Area] banking operations from its global markets activities where most of its losses arose."[83] But this conclusion too is open to question, as RBS's near-failure was the result of a number of poor decisions that went far beyond losses in its global markets activities. As with Northern Rock and HBOS, RBS had relied too heavily on short-term funding markets, and its capital position was far weaker than its published regulatory capital ratios suggested. In addition, it acted as the leader of a consortium of banks that acquired the troubled Dutch bank ABN AMRO, based on due diligence that was inadequate in scope and depth given the scale of the acquisition and the major risks involved, and it borrowed heavily on the short-term markets to finance the acquisition.[84] The view that a ring fence would have prevented RBS's collapse is therefore not persuasive.

A key concern with the FBO proposal, if implemented, is that it will lead to riskier banking practices. Currently, foreign banks are not required to comply with a separate leverage ratio for their U.S. operations. However, once an intermediate holding company is established, this entity must maintain the U.S.-mandated leverage ratio for bank holding companies to avoid triggering Dodd-Frank Section 166's early remediation requirements.[85] This would be in addition to the foreign parent meeting any applicable leverage requirements in its home jurisdiction. Yet subjecting an institution to multiple leverage ratios may provide an incentive for the institution to increase balance sheet risk because assets that do not draw a risk-based capital charge as a result of their relative safety do incur a capital cost.[86] Since there is an increased cost to holding significant amounts of cash and other cash-substitutes, which do not provide robust returns particularly in a period of low interest rates, management has an incentive to shift the institution's holdings to higher-yielding but riskier assets. For foreign banks operating in the United States, therefore, the FBO proposal may well lead to an increase in the riskiness of their U.S. operations.

In addition, the FBO proposal's requirement that foreign banks establish an intermediate holding company is at odds with the Federal Reserve's own position on developments in the structure of the U.S. operations of foreign banks and the global regulatory environment. The Federal Reserve has claimed that the proposal responds to five developments:

- Originally, the U.S. operations of foreign banks were net recipients of funding from their home operations and confined their business to traditional lending activities. But over time their key role developed into raising dollar funding (often short-term dollar funding) to be used for activities

abroad. Those activities included investing in risky U.S. asset-backed securities, which resulted in financial instability when the sources of dollar funding evaporated.[87]

- The increasing complexity of foreign bank operations led to the totality of the risk profile of their U.S. operations being obscured.[88]
- U.S. operations of many foreign banks have focused on capital markets activities, with five of the top 10 U.S. broker-dealers being currently owned by a foreign bank.[89]
- Some home country supervisors have engaged in pro-cyclical ring-fencing, trapping capital and liquidity at the home entity.[90]
- Since the crisis, some jurisdictions have modified or are considering modifying their regulatory regimes in ways that constrain the ability of foreign banks to provide support to their U.S. operations.[91]

We believe that none of these developments justify the imposition of an intermediate holding company structure on foreign banks present in the United States. Assume that foreign banks continue to use their U.S. operations primarily as vehicles for channeling dollar funding to operations abroad. Requiring a holding company structure is, at best, an indirect way to address the risks to financial stability this may create, if any. And forcing all banks to adopt the same structure when there is no evidence that the bank holding company model is superior to other forms of bank organization may itself be a source of long-term systemic weakness.[92] An IHC requirement does not impose any limitations on the amount of dollar funding that may be provided to a foreign bank's non-U.S. operations. Nor does it affect the activities of a foreign bank's U.S. branches or agencies (the most likely entities to borrow U.S. dollars). It also does not preclude an over-reliance on short-term funding (the Federal Reserve identified this phenomenon as a significant "destabilizing" pre–financial crisis practice by the U.S. operations of foreign banks).[93]

Indeed, Section 165 of Dodd-Frank refers specifically to "short-term debt limits" as an "enhanced" standard that the Federal Reserve is authorized to establish for foreign banks.[94] It is curious that the FBO proposal does not contain a standard that (1) directly addresses the foreign regulatory practice that the Federal Reserve has identified as most destabilizing, and (2) is expressly authorized by Dodd-Frank. This "oversight" suggests that the overreliance on short-term dollar funding by foreign banks is *not* in fact the motivating force behind the FBO proposal.

There is also no correlation between the structure of a foreign bank's U.S. operations and the ability of supervisors to obtain greater clarity on the "risk profile" of those operations. According to the Federal Reserve, the factor obscuring such risk profiles in recent years was the practice of foreign banks using their U.S. operations to fund activities outside the United States (such as purchases of U.S. dollar-denominated asset-backed securities and international project finance).[95] Rolling up a foreign bank's U.S. operations under an IHC structure does not necessarily allow for greater transparency at the global level. Indeed, given the statements of home country regulators since the release of the FBO proposal, it appears that the FBO proposal may, in fact, undermine the Federal Reserve's ability to receive timely information on the global operations of foreign banks.[96]

Further, the FBO proposal is not an appropriate policy response to the growth in the size and scope of foreign banks' U.S.-based broker-dealer activities. The Federal Reserve did not cite any evidence that broker-dealers owned by foreign banks pose greater risks to U.S. financial stability than those owned by U.S. bank holding companies.[97] A U.S. broker-dealer owned by a foreign bank would benefit from the foreign bank's consolidated capital and liquidity. Similarly, a broker-dealer owned by a U.S. bank holding

Forcing all banks to adopt the same structure may itself be a source of long-term systemic weakness.

The FBO proposal could increase pro-cyclicality in future crises, rather than reduce it.

company benefits from the company's consolidated capital and liquidity.[98] Therefore there is no valid policy justification for treating foreign banks differently.

The FBO proposal is also a counterproductive answer to the "pro-cyclical ring fencing" that the Federal Reserve identified as likely to occur in certain jurisdictions. The intention of the proposal seems to be to create a standalone U.S. group that may be put into resolution in the event of a foreign bank's insolvency. This would insulate the U.S. subsidiary in the United States from ring-fencing actions by the home country bank or regulator that would cut off its liquidity support. However, the likely effect of this ex ante ring fencing will be to encourage the home country regulators of foreign banks to "plac[e] restrictions on the cross-border movement of assets at the moment of a crisis."[99] This is because foreign regulators may reasonably anticipate that the United States will be the first jurisdiction to pull the resolution trigger. The FBO proposal, therefore, could increase pro-cyclicality in future crises, not reduce it.[100]

As a factual matter, many foreign banks, especially those whose failure would materially affect the U.S. economy, consider the United States a significant—if not the most significant—market outside their home jurisdictions. One would assume that the aim of any reasonable foreign regulator would be to maximize the value of the failed bank's assets. Such a regulator would not seek to alienate U.S. investors and market participants or cut loose one of the brightest jewels in a foreign bank's crown. For this reason, the Federal Reserve should not so easily doubt the willingness of home country regulators to provide support to U.S. operations in times of trouble.

Finally, the Federal Reserve makes no attempt to quantify the effects of its proposal on the subset of those foreign banks subject to the proposal or the economy as a whole. Rather, the Fed leaves the heavy-lifting on this score to public comment. Specifically, the proposal asks:

> What, if any, tax consequences, international or otherwise, could present challenges to a foreign bank . . . seeking to (1) reorganize its U.S. subsidiaries under a U.S. [IHC], and (2) operate on an ongoing basis in the United States through a U.S. [IHC]. . . . What other costs would be associated with forming a U.S. [IHC]? Please be specific and describe accounting or operating costs.[101]

This implies that the Federal Reserve staff did not carry out even a basic analysis of the likely economic impact of the proposal, despite staff comments to the contrary. This is surprising given the likely costs associated with such large-scale restructuring exercises.

By contrast and to its credit, the UK's Independent Commission engaged in lengthy economic analysis of its proposals. The commission attempted to quantify not only the costs likely to be imposed on banks if the proposals were adopted, but also the effect of the proposals on credit spreads and gross domestic product.[102] The Commission indicated that a significant restructuring of bank groups would be worthwhile only if the benefits of doing so outweighed the attendant costs.[103] We hope that, as the Federal Reserve considers comments on its proposal, it will undertake an economic analysis similar to that of the Independent Commission and also consider the impact of the proposal on global capital flows both during and outside of a crisis situation. It should also consider the effect on U.S. institutions of the potential (and likely) retaliatory measures by non-U.S. host country regulators.

A Lesson from the Past: Revisiting the1930s

As we noted, several commentators and industry experts have drawn a parallel between the current climate in global financial regulation and the relations that characterized trade politics among the world's largest

economies in the early 1930s, with Deputy Governor Bailey the most recent.[104] Particular attention has been paid to measures that have protectionist implications or serve to encourage the further Balkanization of financial services, such as the ring-fencing and FBO proposals. Despite some regulators downplaying this risk,[105] we believe the comparison is well made.

In June 1930, Congress passed the Tariff Act, colloquially known as "Smoot-Hawley" after its two Republican sponsors. Smoot-Hawley raised tariffs on approximately 20,000 imported products to unprecedentedly high levels.[106] Ostensibly, the act's purpose was to protect U.S. industries, workers, and prices in the wake of the stock market crash of 1929, but its medium- and long-term effects were dire. Although imports accounted for only 4 percent of U.S. gross domestic product at the time, Smoot-Hawley had significant, if concentrated, regional effects and in particular served to further weaken the United States' already-struggling banking system.[107]

Dartmouth economist Douglas Irwin notes that in the two years following the passage of Smoot-Hawley, the volume of U.S. imports fell 40 percent. This was due in part to a decline in domestic demand, but Irwin estimates that at least a quarter of this decline can be directly attributable to the act itself.[108] In addition, retaliatory actions against the United States resulted in a decline of 60 percent in U.S. exports in the 1930s, and Irwin notes this discrimination against U.S. products persisted for decades.

In addition, Smoot-Hawley encouraged other countries—most notably Germany—to institute retaliatory measures, leading to a worldwide trade freeze that exacerbated hardships for local consumers and almost certainly contributed to the increasingly Balkanized international environment in the period leading up to World War II.

Following a crisis, the natural inclination for any regional authority is to attempt to erect walls around local industries and operations to make it easier—at least theoretically—to address problems at a local level. Usually this also serves to meet the demands of local interest groups harmed by the crisis. But for U.S. and UK regulators, the lesson from the Smoot-Hawley experience should be clear: this approach "works" only in the immediate term, if at all, and is far outweighed by the negative effects of retaliation. As the world's two leading financial services economies, the United States and UK have a disproportionate effect on the global financial sector and are likely to spur retaliatory actions elsewhere in the world. When it comes to the regulatory "marketplace," these two countries are "price-setters" and ought to lead by example.

Indeed, our great fear is that the response to the 2007–08 financial crisis in the United States and the UK may be a classic example of regulators throwing the baby out with the bathwater. In this case it is global capital flows—as with global trade flows in the 1930s—that could potentially suffer a steep decline in the wake of the measures adopted to address the perceived problems in the financial services industry. Although the increased size, depth, liquidity, and complexity of financial markets have received widespread criticism, including being labeled as a "cause" of the crisis, in our view this criticism is misplaced. It overlooks the significant global benefits that fluid and highly developed capital markets have accrued—benefits that have not come close to being wiped out even in the wake of the financial crisis.[109]

In the only detailed study released to date on the effect of post-crisis reforms on global capital flows, the McKinsey Global Institute (a division of the consulting firm McKinsey and Co.) found that since 2008, cross-border capital flows have fallen dramatically as banks and borrowers deleverage.[110] The firm estimates that cross-border capital flows have declined 60 percent since 2007.[111] Financial assets had been increasing by close to 8 percent per annum since the early 1990s, but they are now growing at under 2 percent.[112] At the same time, government debt securities have increased by more than $15.4 trillion worldwide. The authors note:

As the world's two leading financial services economies, the United States and UK have a disproportionate effect on the global financial sector and are likely to spur retaliatory actions elsewhere in the world.

> For three decades, capital markets and banking systems rapidly expanded and diversified, but now that process—called financial deepening—has largely ground to a halt. . . . Today, global financial markets are at an inflection point. One path leads to a more balkanized structure that relies primarily on domestic capital formation and concentrates risks within local banking systems.[113]

In Europe, the situation is particularly dire. The study demonstrates that financing from the European Central Bank (and other public institutions) now accounts for more than 50 percent of capital flows within Europe (a gap that has not been filled by banks in other parts of the developed world) and notes that facing new regulations on capital and liquidity as well as pressures from shareholders and regulators to reduce risk, many banks in advanced economies are winnowing down the geographies and business lines in which they operate. Since early 2007, commercial banks have sold off more than $722 billion in assets and operations, with foreign operations accounting for almost half of this total. Regulators in many countries are moving to exert more control over the foreign banks that remain active in their jurisdictions, in some cases requesting that banks operate as subsidiaries rather than branches.[114]

Although the FBO and ring-fencing proposals may stop short of requiring full subsidiarization, the likely chilling effect on global capital is the same. The McKinsey Global Institute study concludes with the warning that regional differences in the availability of capital could emerge and that regions with high savings rates could find themselves with surplus capital and a shortage of good investment opportunities, while other countries could find themselves short of capital and facing lower growth.[115]

Any regulatory measures that have the effect of hastening the decline in capital flows should be approached with extreme caution.

Undoubtedly, there are many factors contributing to the collapse of global capital flows post-2008, not least the European public debt crisis, the weaknesses in the Chinese financial sector, and a general lack of investor confidence worldwide. Nonetheless, any measures on the part of U.S. or UK regulators that have the effect—whether intentional or incidental—of hastening the decline of such flows should be approached with extreme caution. This is especially true when it is unclear whether the measures will deliver their promised benefits.[116]

A Better Path Forward?

We have discussed what we consider to be the principal weaknesses of the FBO and ring-fencing proposals. At this point we think it is worthwhile to describe an alternative method of addressing the perceived lingering policy challenges raised by the failure of large globally active banks. The principal challenge remaining in both the United States and the UK is how to allow large institutions to fail in a way that does not compromise overall financial stability, all while avoiding or minimizing the use of taxpayer funds in the process. Even if they agree on nothing else, home and host country regulators need to come to an agreement on the bankruptcy, liquidation, or other resolution methods they intend to use in the event of the failure of a global bank, and on their respective powers and responsibilities. Focusing attention on this issue would be a far better use of scarce regulatory resources than using them to mandate and monitor expensive and speculative corporate restructuring exercises.

In the United States, the large banks are ahead of their regulators on forging solutions to the problems raised by cross-border insolvency. The largest institutions are in their second year of "resolution planning" and are attempting to address the challenges posed by cross-border insolvency.[117] The FDIC has entered into several memoranda of understanding with foreign regulators relating to the resolution of firms with cross-border operations.[118] This is a promising start, but similar "supervisor" agreements

will need to be implemented in other jurisdictions to give creditors, investors, and other market participants more certainty on how these issues will be addressed. That way, these constituencies can price their risk and will be less likely to panic in times of crisis. Such agreements will also enhance certainty on the unresolved legal issues raised by a global bank's failure—issues such as the treatment of multi-branch derivative contracts and their attendant collateral.

Conclusion

In his speech, Deputy Governor Bailey noted that we should "not design the world as if fragmentation and balkanization are inevitably always likely to be with us."[119] In our view, however, that is exactly what the ring-fencing and FBO proposals do. Unlike capital and liquidity standards, which can be adjusted on an ongoing basis, large-scale corporate restructuring is costly and time-consuming. If it fails to meet its objectives, it cannot be easily undone. In the end, we believe that the Federal Reserve and the UK Parliament, responding to loudly voiced public concerns over the costs of the financial crisis, are succumbing to the politician's logic of choosing to "do something" because of the perceived need that "something must be done."[120] Given the clear adverse effects on the availability of credit, global capital flows, and the world economy that will flow from the FBO proposal and the ring-fencing plan, we believe it to be far better policy to heed the contrarian advice that "doing the wrong thing is worse than doing nothing."[121]

Notes

1. Andrew Bailey. "Regulating Global Banks," Speech before the British Bankers Association, October 17, 2013, www.bankofengland.co.uk/publications/Pages/speeches/default.aspx.

2. See, e.g., Davis Polk & Wardwell LLP, "Governor Tarullo Foreshadows Proposal to Ring-Fence Large U.S. Operations of Foreign Banks," Client Memorandum, New York December 2, 2012; Alex Barker and Tom Braithwaite, "EU Warns US on Financial Protectionism," *Financial Times*, April 22, 2013, http://www.ft.com/cms/s/0/6d599a10-ab59-11e2-ac7100144feabdc0.html. H. Rodgin Cohen of Sullivan & Cromwell LLP and Hal Scott of Harvard Law School have also made this point.

3. For a recent discussion of this phenomenon in Europe, see Sonia Sirletti and Yalman Onaran, "Banking Balkanization Prevails in Europe on Eve of Review," *Bloomberg*, October 23, 2013, http://mobile.bloomberg.com/news/2013-10-22/banking-balkanization-prevails-in-europe-on-eve-of-review.html.

4. 12 U.S.C. §§ 5365, 5366.

5. Ibid.

6. *Independent Commission on Banking, Final Report: Recommendations* (September 2011), http://www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/inquiries1/parliament-2010/icb-final-report/).

7. At this writing, the UK government owns 81 percent of RBS and 39 percent of Lloyds.

8. These complex corporate structures, of course, have evolved largely in response to other government-created considerations and incentives, such as tax efficiency.

9. 12 U.S.C. § 3102(a), 3105(d).

10. In particular, the foreign bank must be subject to "comprehensive supervision or regulation on a consolidated basis by the appropriate authorities in the bank's home country." Ibid at § 1842(c)(3)(B).

11. Ibid. at §§ 1843(c)(8)(h)(1).

12. *Federal Register* 77, no. 249 (December 28, 2012), p. 76629.

13. Using the Foreign Banking Organization (FBO) proposal's terminology, an "intermediate holding company."

14. Ibid.

15. Federal Reserve, Supervision and Regulation (SR) Letter 01-01.

16. 12 C.F.R. Part 252 (proposed).

17. Ibid.

18. *Federal Register* 77, no. 249, p. 76630.

19. Ibid.

20. Ibid. In fact, no U.S depositors and creditors were meaningfully impacted by any foreign bank failures.

21. Ibid.

22. Ibid.

23. HM Treasury and Department for Business, Innovation, and Skills, *Policy: Creating Stronger and Safer Banks*, September 10, 2013, https://www.gov.uk/government/policies/creating-stronger-and-safer-banks.

24. *Final Report*, p. 11.

25. Ibid.

26. Ibid.

27. Ibid.

28. Ibid.

29. Ibid., p. 12.

30. Ibid.

31. Ibid.

32. Ibid., p. 9.

33. Ibid.

34. Ibid., p. 10.

35. Ibid.

36. Ibid.

37. *Federal Register* 77, no. 249, p. 76629.

38. News Wires, "Eurozone Recession Ends with 0.3% Growth in Second Quarter," *Agence France-Presse* September 4, 2013, http://www.france24.com/en/20130904-eurozone-economy-grew-0-3-percent-second-quarter-end-recession.

39. Ernst & Young, "Bad Loans and Regulation Will Squeeze Eurozone Banks in 2013," January 7, 2013, www.ey.com/GL/en/Newsroom/News-releases. See also, e.g., Lorenzo Totaro, "Italian Corporate Bad Loans Rising on Slump, Central Bank Says," *Bloomberg Businessweek*, April 29, 2013, www.businessweek.com/news/2013-04-29.

40. See, e.g., Paul Carrel, "Euro Zone Loan Slump Puts Onus on ECB to Keep Rates Low," Reuters, August 28, 2013, www.reuters.com/article/2013/08/28/us-eurozone-m-idUSBRE(&R0DD20130828. Carrel notes that the number of private sector loans in July 2013 shrank by 1.9 percent from the amount in July 2012.

41. *Federal Register* 77, no. 249, p. 76630.

42. British Broadcasting Corporation, "B&B Nationalisation Is Confirmed," September 29, 2008, http://news.bbc.co.uk/2/hi/business/7641193stm; HM Treasury, *The Nationalisation of Northern Rock*, March 20, 2009, http://www.nao.org.uk/wp-content/uploads/2009/03/0809298.pdf).

43. Samuel Dale, "Banking Commission Says HBOS' Focus on Specialist Mortgages Drove Losses," *MoneyMarketing*, April 5, 2013, http://www.moneymarketing.co.uk/politics/banking-commission-says-hbos-focus-on-specialist-mortgages-drove-losses/1068934.article).

44. Steve Slater, "Co-op Boss Says Sorry for Big Bank Loss," Reuters, August 29, 2013, http://uk.reuters.com/article/2013/08/29/bank-coop-results-idUKL6N0GU0OE20130829.

45. And this does not take into account the potential ring-fencing effects of the EU's Liikanen proposal relating to the walling off of proprietary trading activities. See e.g. Michael Watt, "Double Trouble: UK Banks Face Threat of Twin Ring Fences," *Risk Magazine*, March 25, 2013.

46. *Federal Register* 77, no. 249, p. 76631.

47. Letter from Michel Barnier, Commissioner for Internal Market and Services, European Commission, to Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, April 18, 2013.

48. It is worth noting this trend is already underway in some European countries (e.g., Spain). See Jonathan Fiechter et al., "Subsidiaries or Branches: Does One Size Fit All?" IMF Staff Discussion Note, Washington, March 2011,http://www.imf.org/external/pubs/ft/sdn/2011/sdn1104.pdf.

49. *Federal Register* 77, no. 249, pp. 76628, 76631.

50. For example, under the FBO proposal, the foreign bank will be required to comply with Section 165's single counterparty credit limits imposed at multiple levels of the organization.

51. Compare with Paul J. Davies, "UniCredit not trading in OTC with US groups," *Financial Times*, April 29, 2013, p. 16, noting a trend among foreign banks to decide not to trade swaps with U.S. banks because of the costs of Dodd-Frank compliance.

52. See, e.g., David Cho, "One Year After Crisis, 'Too Big to Fail' Banks Have Grown Even Bigger," *Washington Post*, August 28, 2009, http://www.washingtonpost.com/wp-dyn/content/discussion/2009/08/28/DI2009082801337.html.

53. See, e.g., Suzanne Kapner, "Citi's Profit Soars as Shift Pays Off," *Wall Street Journal*, April 15, 2013, http://online.wsj.com/article/SB10001424127887324345804578424352331419788.html), noting that increased profits from Citigroup's international operations allowed it to offset slowing growth in the United States in the first quarter of 2013.

54. For example, Banco Santander acquired 100 percent of Sovereign Bank in the fall of 2008 when the latter was experiencing a steep drop in share price and deposit withdrawals.

55. Statement of James R. Wigand, director, Office of Complex Financial Institutions, *Improving Cross Border Resolution to Better Protect Taxpayers and the Economy*, Subcommittee on National Security and International Trade and Finance, U.S. Senate, May 15, 2013. See also speech by Paul Tucker, deputy governor for financial stability at the Bank of England, "Remarks Delivered at the INSOL International World Conference," The Hague, May 20, 2013, https://www.bis.org/review/r130606a.pdf.

56. Ibid.

57. Duncan Wood, "US Foreign Bank Plans Threaten Bail-In System, Says FINMA," *Risk Magazine*, April 5, 2013.

58. The "Orderly Liquidation Fund"—the pool of money used to provide temporary liquidity to and otherwise fund the orderly wind-down of the failed firm—is statutorily required to be industry-funded (by other U.S. banks). Therefore, forcing a U.S. subsidiary of a foreign bank into a U.S. resolution proceeding could potentially put U.S. banks on the hook financially for the failure of a foreign competitor.

59. Speech by Paul Tucker, Deputy Governor for Financial Stability at the Bank of England. Remarks delivered at the INSOL International World Conference, The Hague, May 20, 2013, https://www.bis.org/review/r130606a.pdf, contrasting the single-point-of-entry and multiple-point-of-entry approaches to resolution.

60. 12 C.F.R. Part 252 (proposed); Dodd-Frank Act, §§ 165, 166, 171, 619 & 716.

61. *Final Report*, p. 30.

62. These restrictions are contained in Sections 23A and 23B of the Federal Reserve Act.

63. Ibid., pp. 71–74.

64. For an interesting discussion on the recent evolution of the UK's regulatory framework and potential pitfalls see Terry Arthur and Philip Booth, "Does Britain Need a Financial Regulator?" The Institute of Economic Affairs, London, July 2010.

65. Ibid., p. 35.

66. Ibid.

67. Ibid.

68. Some academics and policymakers have criticized the focus on "interconnectedness," arguing that in fact cross-institutional connections did not contribute meaningfully to the 2007–08 financial crisis. They argue that it is unlikely that the failure of even a large counterparty, such as AIG, alone would have been sufficient to bankrupt another large financial institution and that the post-crisis response was largely about limiting contagion. The failure of Lehman Brothers resulted in only one direct institutional failure, that of the Reserve Primary Fund, a money market fund that "broke the buck" the day after Lehman's collapse. For a thorough discussion of the distinction between interconnectedness and contagion in the 2007–08 financial crisis, see Hal S. Scott, "Interconnectedness and Contagion," Harvard Law School working paper, November 20, 2012, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2178475.

69. "Furthermore, the ring-fence would mean that UK retail banking services would in [the] future be materially less exposed to collapses like that of Lehman Brothers, or to the volatility this created." *Final Report*, p. 46.

70. 12 U.S.C. § 5390(n)(6).

71. The best examples of the latter category are Washington Mutual and Wachovia.

72. See, for example, Robert DeYoung and Gökhan Torna, "Nontraditional Banking Activities and Bank Failures during the Financial Crisis," *Journal of Financial Intermediation* 22 (2013): 397–421. The authors found that banks that that took excessive risks in their nontraditional activities also tended to take risk in their traditional lines of business, suggesting the appetite for risk-taking is institution-specific rather than correlated with activities. The authors also found that the higher the fee income from nontraditional activities, the lower the overall risk of bank failures.

73. *Final Report*, p. 13.

74. Ibid., p. 32.

75. Ibid.

76. Ibid.

77. Ibid.

78. Ibid.

79. "The Bank that Failed," *The Economist*, September 20, 2007, http://www.economist.com/node/9832838.

80. *Final Report*, p. 33.

81. Ibid., p. 32.

82. Ibid.

83. Ibid.

84. RBS purchased ABS AMRO as part of a consortium along with Fortis and Banco Santander. Fortis and RBS both ran into trouble as a result of the acquisition and Fortis was nationalized by the Dutch government in October 2008. For a discussion on the causes and consequences of the RBS failure, see the House of Commons' and Treasury Committee, *The FSA's Report into the Failure of RBS*, London, October 16, 2012, http://www.publications.parliament.uk/pa/cm201213/cmselect/cmtreasy/640/640.pdf.

85. 12 C.F.R. Part 252 (proposed).

86. See, e.g., Daniel Schafer, "Fix the Contradictory Rules Pushing Banks to be Riskier," *Financial Times*, August 6, 2013, noting that certain foreign banks are reducing the amount of their cash and government securities holdings considerably in order to boost their leverage ratios.

87. *Federal Register* 77, no. 249, p. 76630.

88. Ibid.

89. Ibid.

90. Ibid.

91. Ibid., p. 76631.

92. The bank holding company structure is quite unique to the United States. Indeed, as Margaret Tahyar and Saule Omarova note, the bank holding company structure initially developed in the private sector as a way for banks to circumvent historical restrictions on interstate banking (though it later became a regulatory tool to separate banking and commerce) but, prior to the passage of Dodd-Frank, was described as largely obsolete, having "outlived its usefulness." Margaret Tahyar and Saule Omarova, "That Which We Call a Bank," *Review of Banking and Financial Law* 31 (2012), pp. 122–27, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1925431.

93. Ibid. p. 76630. Since banks are in the business of "maturity transformation" (borrowing short and lending long), it is hard to see how reliance on short-term funding could ever be eliminated. It can certainly be reduced by increasing capital and liquidity requirements, but this approach is not cost-free, reducing the availability of credit and pushing banks to secure higher marginal returns in potentially riskier areas. We are not suggesting that the Federal Reserve adopt measures to restrict the use of short-term funding or to otherwise limit cross-border capital flows.

94. 12 U.S.C. § 5365(b)(1)(B). Like the other Section 165 standards, if such a standard were established, it would be required to be applied in a tailored manner to foreign banks on a case-by-case basis reflecting the risk level of their U.S. operations and the lack of risk mitigation provided by their home country standards.

95. *Federal Register* 77, no. 249, p. 76631.

96. See, e.g., Huw Jones, "EU's Barnier Warns U.S. of Tit-for-Tat Action over Banks," Reuters, October 17, 2013.

97. Although, as the preamble to the FBO proposal notes, 5 of the 10 largest U.S. broker-dealers are currently owned by foreign banks and those foreign banks are all headquartered in countries with highly developed bank regulatory regimes.

98. Moreover, to the extent that the Federal Reserve has concerns about the capital adequacy of U.S. broker-dealers generally, its authority must be exercised consistently with congressional policy. Congress has made a clear determination that, as a general matter, a U.S. broker-dealer subsidiary of a BHC that operates in compliance with the capital standards imposed by the Securities and Exchange Commission is sufficiently capitalized for financial stability purposes. For although in Dodd-Frank Congress amended many provisions of federal banking law in an effort to strengthen U.S. financial stability, it did not amend Section 5(c)(3) of the BHC Act, which prohibits the Board from prescribing or imposing, "by regulation, guideline, order, or otherwise . . . any capital or capital adequacy rules, guidelines, standards, or requirements" on such subsidiaries. 12 U.S.C. § 1844(c)(3).

99. *Federal Register* 77, no. 249, p. 76630.

100. As such, it conflicts with the spirit of Dodd-

Frank. Section 616(a)(2) of the act requires that the Federal Reserve seek to create countercyclical capital requirements. 12 U.S.C. § 1844(a)(2).

101. *Federal Register* 77, no. 249, p. 76638.

102. *Final Report*, "Annex 3: The Economic Impact of the Commission's Stability Recommendations."

103. Ibid.

104. See, e.g., Davis Polk & Wardwell, "Governor Tarullo Foreshadows Proposal to Ring-Fence Large U.S. Operations of Foreign Banks;" Client Memorandum (New York, December 2, 2012); H. Rodgin Cohen of Sullivan & Cromwell LLP and Hal Scott of Harvard Law School have also made this point. See also Alex Barker and Tom Braithwaite, "EU Warns US on Financial Protectionism," *Financial Times*, April 22, 2013, http://www.ft.com/cms/s/0/6d599a10-ab59-11e2-ac7100144feabdc0.html.

105. See, e.g., Linda Goldberg and Arun Gupta, "Ring-Fencing and 'Financial Protectionism' in International Banking," *Liberty Street Economics*, Federal Reserve Bank of New York, January 9, 2013, http://libertystreeteconomics.newyorkfed.org/2013/01/ring-fencing-and-financial-protectionism-in-international-banking.html.

106. The Tariff Act of 1930 (19 U.S.C. ch. 4).

107. Thomas Rustici, *Lessons from the Great Depression* (Washington: Capitalism Works Publishing, January 2012).

108. Douglas Irwin, "The Smoot-Hawley Tariff: A Quantitative Assessment," National Bureau of Economic Research Working Paper 5509, March 1996, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=4916.

109. The significant gains in wealth across the globe, including the vast numbers of people lifted out of poverty in the three preceding decades, have been well documented and are attributable in no small part to the fluidity of global capital. See, e.g., Shaohua Chen and Martin Ravallion, "An Update to the World Bank's Estimates of Consumption Poverty in the Developing World," *Briefing Note*, Development Research Group, World Bank, January, 3, 2012, http://siteresources.worldbank.org/INTPOVCALNET/Resources/Global_Poverty_Update_2012_02-29-12.pdf.

110. McKinsey Global Institute, *Financial Globalization: Reset or Retreat?* March 2013, www.mckinsey.com/mgi.

111. Ibid.

112. Ibid.

113. Ibid.

114. Ibid.

115. Ibid.

116. Former U.S. treasury secretary Henry Paulson has made this point as well, warning that such post-crisis reforms could lead to "walling off markets, constricting cross-border access to capital, and conflicting requirements for global firms." See Tom Braithwaite, "Hank Paulson Warns of Regulatory Conflict," *Financial Times*, September 19, 2013.

117. This is a requirement under Section 165 of Dodd-Frank for bank holding companies with over $50 billion in U.S. assets. Details of the most recently released resolution plans are available at http://www.federalreserve.gov/newsevents/press/bcreg/20131003a.htm.

118. The FDIC is the U.S. regulator given ultimate authority for dealing with the failure of a large financial institution under Dodd-Frank's Orderly Liquidation Authority provisions. See, e.g., FDIC and Bank of England, *Memorandum of Understanding Concerning Consultation, Cooperation and the Exchange of Information Related to the Resolution of Insured Depository Institutions with Cross-Border Operations in the United States and the United Kingdom*, January 22, 2010, http://www.mofo.com/docs/pdf/FDIC_and_BOE_Memorandum_of_Understanding.pdf.

119. Ibid.

120. Antony Jay and Jonathan Lynn, "A Politician's Logic," *Yes Minister*, British Broadcasting Corporation, 1980.

121. Ibid.

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