

## Banking Trends

# How Foreign Banks Changed After Dodd-Frank

The Great Recession and the Wall Street Reform and Consumer Protection Act of 2010 both affected how foreign banks operate in the U.S.

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BY JAMES DISALVO

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 substantially changed how foreign banking organizations (FBOs) operating in the United States are regulated. Previously, most of the regulation of an FBO fell on its primary regulator in its home country, and there were few restrictions on either the capital or organizational structure of its U.S. operations.<sup>1</sup>

Dodd-Frank's new regulations changed that. Foreign banks above a certain size now have to organize their U.S. subsidiaries under a holding company subject to the same regulations as domestic bank holding companies (BHCs) and financial holding companies (FHCs). The new regulations also attempt to ensure that only banks that are regulated up to certain standards in their home countries can open or operate branches or agencies in the U.S. The higher regulatory costs and the differential regulation of subsidiaries and foreign branches could encourage FBOs to withdraw from U.S. markets or change the structure of their U.S. operations.

This paper examines how FBOs operate in the U.S., describes the regulatory changes due to Dodd-Frank, and provides some preliminary evidence about how FBOs have changed their operations following passage of the law. I find evidence that FBOs have shifted activities away from the U.S. market. But the changes have not been dramatic, and other factors like the European financial crisis probably played a significant role.

### How Do FBOs Operate in the United States?

As of year-end 2018, 130 FBOs engaged in banking operations in the U.S., either by direct ownership of a state-chartered or federally chartered bank, or by establishing a branch or agency (Figure 1).

A directly owned chartered bank can be either acquired or formed de novo (i.e., as a startup operation), and it can engage in the same activities as other domestic banks. This directly owned chartered bank is run and regulated pretty much like

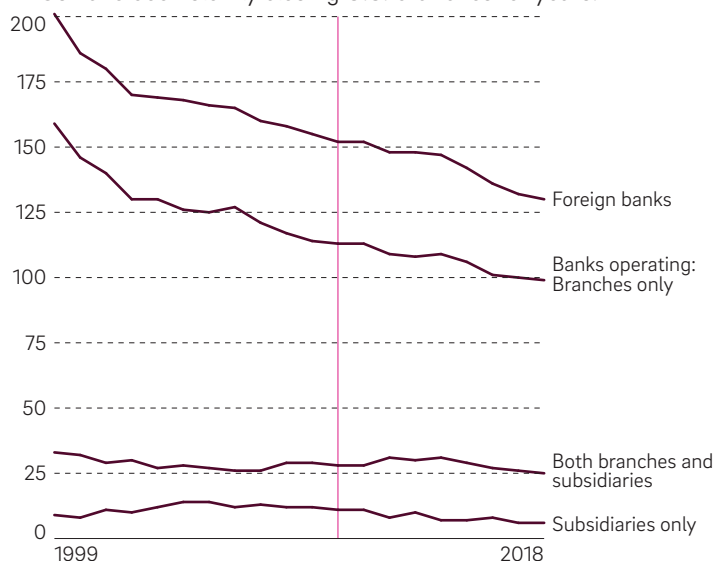
any other domestic bank, although a foreign-owned U.S. bank with domestic assets exceeding \$50 billion must be organized as a BHC and is therefore subject to regulation by the Federal Reserve. As of year-end 2018 there were 37 domestic banks owned by FBOs.

There's an important difference between FBO-owned domestic banks and other domestic banks: Even though an FBO's U.S. bank subsidiary may be relatively small, the FBO is almost always quite large and therefore might be considered important to the stability of either the global or the domestic financial system. Regulators might thus designate these FBOs as global systemically important financial institutions (G-SIFIs) or domestic systemically important financial institutions (D-SIFIs).<sup>2</sup> Of the 37 foreign-owned

FIGURE 1

### Foreign Banks Operating in the U.S.

FBOs have been slowly closing U.S. branches for years.



Source: National Information Center.

U.S. banks mentioned above, 21 are owned by G-SIFIs or are themselves D-SIFIs.

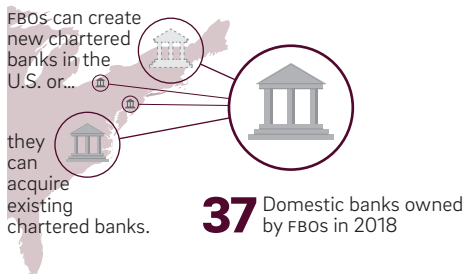
The other way to operate in the U.S. is through a branch or agency (Figure 2). Both branches and agencies are offices of the FBO that conduct business on behalf of the FBO outside its home country. One important part of their business is to provide banking services for client companies located in their home country but doing substantial business here. In addition, branches compete with U.S. banks to provide a wide range of banking services for companies not from their home country.

FIGURE 2

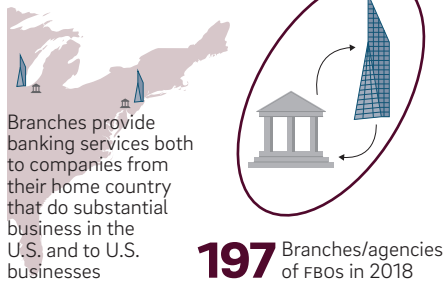
### Two Models for FBOs in the U.S.

FBOs can operate subsidiaries or branches/agencies.

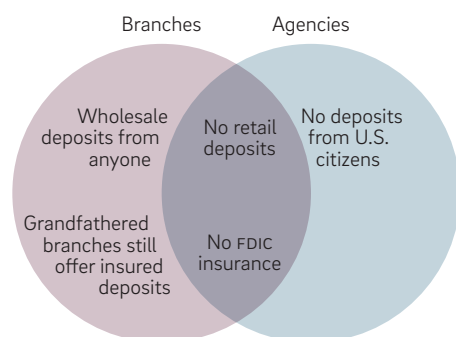
#### Bank Subsidiary Model



#### Branch/Agency Model



#### Differences Between Branches and Agencies



Source: National Information Center.

There are currently 197 branches/agencies of FBOs in the U.S., mainly in New York, Los Angeles, and Miami.<sup>3</sup>

There are some important differences between branches and agencies. Neither can accept retail deposits, but, while a branch can accept wholesale deposits from anybody, an agency can't accept deposits from U.S. citizens.<sup>4</sup> It is illegal for either a branch or an agency to have FDIC insurance, but some branches offer insured deposits because their deposits were insured before, and are thus grandfathered by, the Federal Deposit Insurance Corporation Improvement Act of 1991.

### New Incentives Under Dodd-Frank

When Congress enacted the Dodd-Frank Act of 2010, it brought the regulation of FBOs more in line with the way domestic banks are regulated. One major change was that an FBO with a large presence in the U.S. must put all of its U.S. subsidiaries under a BHC or FHC. The BHC/FHC is then regulated as if it were a domestically owned institution. An FBO is not required to house its branches or agencies in the holding company, although the law does impose some new requirements on the foreign regulators of FBOs that operate branches in the U.S.

See *How Dodd-Frank Changed the Regulation of Foreign Banks.* →

As a consequence of these and other changes, Dodd-Frank may have created incentives for FBOs to change how they operate in the U.S. First, Dodd-Frank imposed more stringent regulations, capital standards, and other regulatory costs on large banks, likely raising the cost of operating in the U.S. The higher costs may have induced FBOs to cut back on their overall U.S. operations. Furthermore, the lower regulatory costs for branches may have created incentives for FBOs to shift operations from subsidiaries to branches.

### FBOs Since Dodd-Frank

Because of branch closings and consolidations, the number of FBOs operating in the U.S. has been declining for a while. However, this trend quickened after the financial crisis of 2007-2008, and

Dodd-Frank may have accelerated this trend. Since passage of Dodd-Frank in 2010, 26 firms have exited the U.S. entirely, and three more have converted their branches into representative offices.<sup>5</sup> A plurality of these firms is from the euro zone.<sup>6</sup> In addition, 18 firms cut back their U.S. operations, mainly by closing some but not all of their U.S. branches (Figure 3).

This is consistent with the view that FBOs cut their U.S. operations due to regulatory costs, but confounding factors make it very difficult to disentangle the influence of Dodd-Frank. A closer examination of exiting FBOs suggests that the European financial crisis was an important cause of exits. Seven (mostly European) banks failed and were either nationalized or closed, with the resultant closing of their foreign branches. Three other banks merged with or were acquired by banks that also have a presence in the U.S.<sup>7</sup> Furthermore, the postcrisis period is not uniformly a story of FBOs leaving the U.S.: Twelve banks entered the U.S. market, and eight more expanded their presence.

The postcrisis period also witnessed slowing growth of FBO holdings in the U.S. From 1999 to 2008, real assets (of branches/agencies and bank subsidiaries) increased from \$1.8 trillion to \$3.4 trillion (in 2016 dollars), an annual growth rate of 7.33 percent (Figure 4). From 2008 to 2009 these assets shrank substantially. Thereafter, real assets grew from \$3.2 trillion to \$3.5 trillion, an annual growth rate of only 1.66 percent. FBO assets also declined as a percentage of total U.S. banking assets, from 22.4 percent to 19.4 percent (Figure 5). Most of this decline was due to a decrease in the assets of FBO branches/agencies. The slower growth of FBOs provides some evidence that they have responded to higher regulatory costs, but we do not find evidence that FBOs evaded the more stringent regulation of their U.S. subsidiaries by shifting activities to their branches.

In a more limited sample of large foreign banks, FBOs' U.S. holdings also decreased as a share of their worldwide operations (Figure 6). In aggregate, the share of FBOs' total assets that are in the U.S. declined modestly between 2011 and 2017, from 2.3 percent to 1.6 percent. Again, this was driven mostly by a decrease in branch/agency assets.

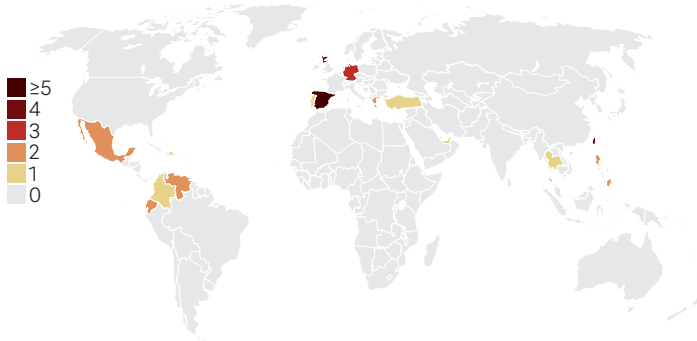
FIGURE 3

## FBOs Exiting and Entering the U.S. Since Dodd–Frank

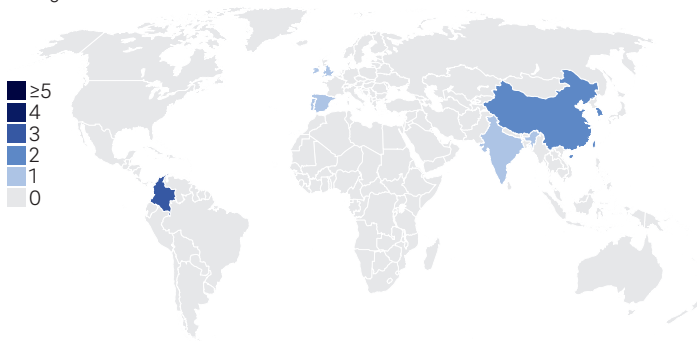
Many euro zone banks have left, while more Asian banks have moved in.

Branches and subsidiaries, 2010–2018

Foreign banks that **exited** the U.S.



Foreign banks that **entered** the U.S.



Source: National Information Center.

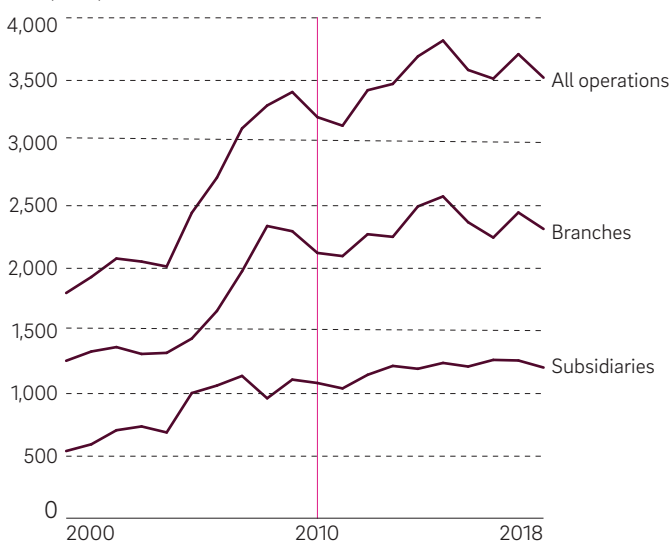
**Note:** All National Information Center data tables of FBOs operating in the U.S. are available for download from [https://philadelphiafed.org/-/media/research-and-data/publications/economic-insights/2019/q3/ei2019q3\\_addendum.pdf](https://philadelphiafed.org/-/media/research-and-data/publications/economic-insights/2019/q3/ei2019q3_addendum.pdf).

FIGURE 4

## Total FBO Assets in the U.S.

Growth slows during and after the Great Recession.

Real (2016) U.S. dollars, in billions



Source: FFIEC Call Reports, forms FFIEC002 (for branches), FFIEC031, FFIEC041, and FFIEC051 (for bank subsidiaries).

## How Dodd–Frank Changed the Regulation of Foreign Banks

### Branches

Dodd–Frank didn’t change the operations or activities of branches, but it did force federal regulators to look closer at how their home countries regulate them. If an FBO is found to present a risk to the financial stability of the U.S.—i.e., is designated a global systemically important financial institution (G-SIFI) or a domestic systemically important financial institution (D-SIFI)—the Federal Reserve Board must take into account whether the FBO’s home country has installed or made “demonstrable progress” toward installing a system of financial regulations to mitigate such risk when it reviews applications to open branches/agencies.<sup>13</sup> Such a system is consistent with the Basel Accords and includes periodic examinations, standardized financial statements, and guidelines for capital adequacy and risk exposure.

The Federal Reserve can close a branch or agency of an FBO if its home country fails to adopt or make “demonstrable progress” toward adopting regulations that mitigate systemic risk.

### Bank Subsidiaries

Home country regulators must meet the same guidelines that apply to branches. Additionally, there is a sliding scale based on an FBO’s financial assets in the U.S. and worldwide. Banks with U.S. assets between \$10 billion and \$50 billion must pass home country stress tests on capital, form a risk committee for their U.S. operations, certify that they meet their home country’s capital standards and that those are consistent with Basel, and run their own stress tests.

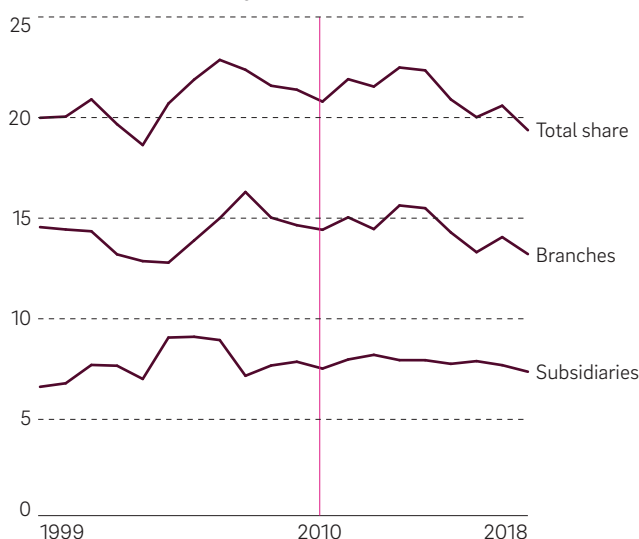
Additionally, if the bank has assets greater than \$50 billion worldwide, it has to run separate stress tests on U.S. operations.<sup>14</sup>

As of year-end 2018 this requirement for bank subsidiaries affected four banks. In addition to the above requirements, banks with greater than \$50 billion in U.S. assets must form a bank or financial holding company (BHC or FHC) and place all their U.S. holdings (not necessarily including branches/agencies) under it. The BHC/FHC must meet the same regulatory requirements as domestic BHCs and FHCs, including capital guidelines, leverage limits, liquidity requirements, and living wills. As of year-end 2018 these requirements affected 12 banks.

FIGURE 5

### Share of U.S. Banking Assets Held by FBOs

FBO assets decline as a percentage of total U.S. banking assets. Percent of total U.S. banking assets, 1999–2018



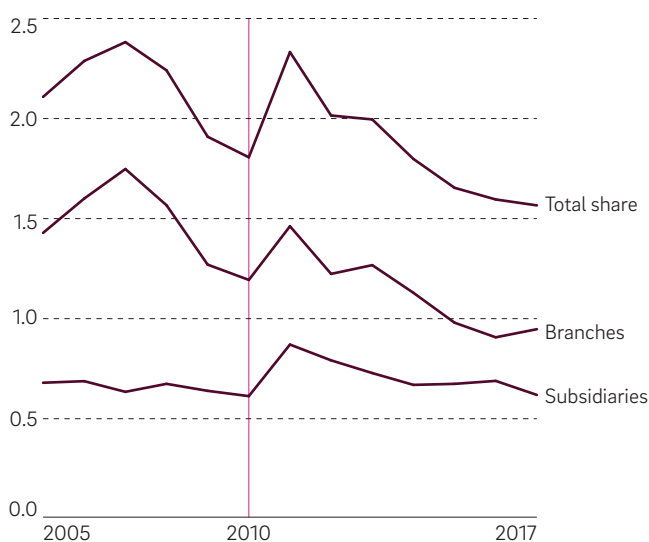
Source: FFIEC Call Reports, forms FFIEC002 (for branches), FFIEC031, FFIEC041, and FFIEC051 (for bank subsidiaries).

FIGURE 6

### Share of FBO Assets in the U.S.

Aggregate FBO assets in U.S., as share of worldwide assets, have declined modestly.

Percent of total worldwide assets, 2005–2017



Source: S&P Global Market Intelligence (formerly SNL Securities) and FFIEC Call Reports, forms FFIEC002 (for branches), FFIEC031, FFIEC041, and FFIEC051 (for bank subsidiaries).

Note: Data on foreign banks' total assets were only available for some banks, and most of them from 2011 and after. The data presented here represent an average of about 90 banks per year. Data for previous years are for a substantially smaller number of institutions.

In addition to slowing the growth of their U.S. operations, the composition of FBO assets changed, particularly at branches. FBOs increased their cash holdings dramatically following the financial crisis (Figure 7), due mainly to a combination of regulations imposed under Dodd–Frank and changes in the Fed's conduct of monetary policy.<sup>8</sup>

During the crisis, the Fed began paying interest on funds placed in reserve accounts with Federal Reserve Banks to both domestic banks and foreign banks. Because most U.S. branches of FBOs are not allowed to take insured deposits, they get their funding by taking uninsured wholesale deposits and, thus, do not pay FDIC insurance. Furthermore, foreign branches are not covered by the capital requirements or liquidity requirements imposed on U.S. banks.<sup>9</sup> This gave foreign banks an advantage in facilitating a regulatory arbitrage in which institutions not eligible for interest on reserves can effectively receive that interest, albeit at a cost. Since foreign branches can deposit funds in a reserve account with the Fed, it became profitable to borrow from institutions that could not receive interest on reserves—primarily federal home loan banks and other government sponsored enterprises—and to deposit these funds with the Fed. Indeed, foreign branches could do this more profitably than could U.S. banks because foreign branches face lower regulatory costs of borrowing to fund deposits at the Fed.

After the striking rise during the financial crisis and continuing through the European crisis, there is a modest reversal in cash holdings and an increase in commercial lending. With the recovery in Europe and the U.S., business loans have become relatively more attractive investments. Nonetheless, foreign branches continue to profit from regulatory arbitrage.

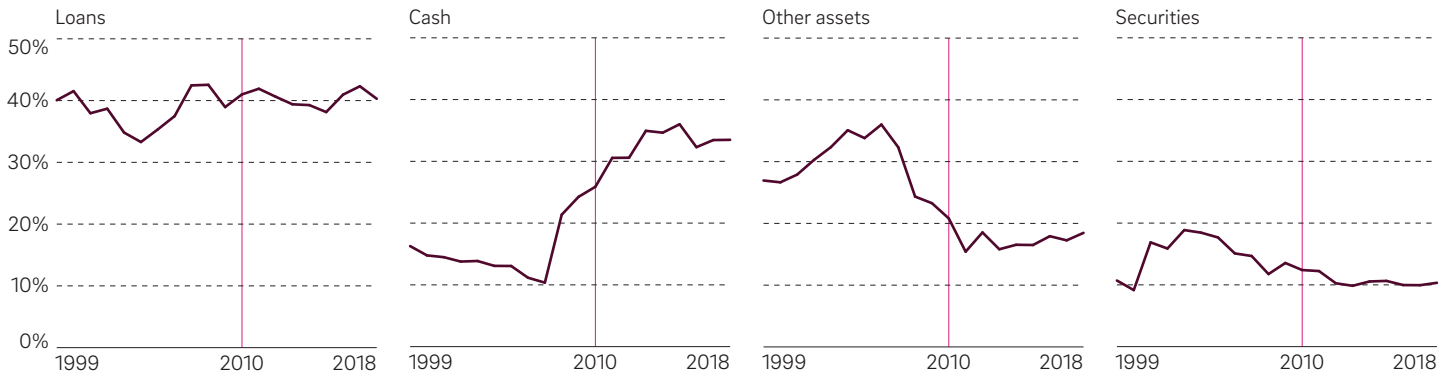
### Further Regulations Proposed

The Federal Reserve and other regulators recently proposed additional regulations for large and complex U.S. intermediate subsidiaries of FBOs. In 2013 the regulators adopted liquidity coverage standards for the largest banks and BHCs, and in 2016 they adopted standards on stable sources of funding for the same organizations.<sup>10</sup> The new proposal tightens those standards for some FBOs' U.S. subsidiaries that have over \$100 billion in assets, depending on their size and complexity.<sup>11</sup> It also adds additional capital requirements for the largest and/or most complex U.S. subsidiaries of FBOs.

FIGURE 7

## Distribution of Assets in Branches

FBOs increased cash holdings dramatically following financial crisis. Percent of total assets, 1999–2018



Source: FFIEC Call Reports, Form FFIEC002.

Note: "Other Assets" includes trading assets, Fed funds sold and repos, transactions with related parties, and all other assets.

The net effect of these new rules will likely be to raise the regulatory costs of the largest and most complex FBO operations in the U.S., but it will also lower such costs for other FBOs. As it's now written, these new rules would apply only to FBOs' holding companies and bank subsidiaries, not their branches and agencies. However, the regulators did ask for comments as to if and how the rule should be applied to branches and agencies of FBOs.<sup>12</sup>

## Conclusion

Overall, although tighter postcrisis regulation of FBOs in the U.S. may have increased the cost of operating here, we have not observed dramatic changes in their operations. Consistent with predictions that the Dodd-Frank regulations would lead FBOs to reduce their presence in the U.S., FBOs have either exited or contracted their U.S. operations, mainly by closing branches. However, it appears that factors other than regulatory changes in the U.S. played a major role in those closures, and the evidence doesn't support predictions that foreign banks would shift operations from their subsidiaries to their branches. The branch closures have slowed the growth of FBO operations somewhat, and foreign banks' share of U.S. assets has declined. Foreign banks are also holding more cash postcrisis due to regulatory changes and changes in the way the Fed conducts monetary policy.

Of course, this evidence is purely descriptive, and preliminary to a formal attempt to disentangle the precise role of Dodd-Frank from a host of factors that may have affected FBOs' U.S. operations since the financial crisis. ■

## Notes

1 See Berlin (2015).

2 Systemically important financial institutions (SIFIs) are those of sufficient size, importance, and interconnectedness that their failure might cause another financial crisis. Domestic SIFIs are designated by the Federal Reserve Board and the Financial Stability Oversight Council (FSOC), which was established by Dodd-Frank. Further information on the FSOC and its activities can be found at <https://home.treasury.gov/policy-issues/financial-markets-financial-institutions-and-fiscal-service/fsoc>. There's no set definition, but global SIFIs are designated by the Financial Stability Board, which is hosted and funded by the Bank for International Settlements. Further information on the Financial Stability Board can be found at <http://www.fsb.org/>.

3 There is no limit on the number of branches/agencies an FBO can have, so several have multiple branches.

4 Retail deposits are deposits less than \$250,000, while wholesale deposits are equal to or greater than \$250,000 and therefore uninsured.

5 Representative offices are back-office facilities that can neither make loans nor accept deposits. These are counted as exits because the FBO no longer conducts banking in the U.S.

**6** The breakdown is 12 European banks, eight Asian banks, four from South and Central America, two from Mexico, and three from Turkey and the Middle East.

**7** Two of these mergers were of Spanish banks that merged with other banks as part of government rescues.

**8** See Lester (2019).

**9** A U.S. bank funded by insured deposits would have to pay fees for FDIC insurance as a percentage of the bank's assets. In addition, a U.S. bank would have to hold capital against the money deposited in the reserve account. Neither of these requirements applies to branches of FBOs.

**10** See Regulation WW.

**11** The Liquidity Coverage Ratio is the ratio of high-quality liquid assets (cash and assets that are easily convertible to cash) to projected net cash outflows for each 30-day period. The Net Stable Funding Ratio is calculated by weighting various liabilities for the numerator and various assets for the denominator.

**12** For the full proposal, see the Board's website; for a summary, see Quarles (2019).

**13** See Regulation K.

**14** See Regulations K and YY.

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Lester, Benjamin. "Implementing Monetary Policy in a Changing Federal Funds Market," Federal Reserve Bank of Philadelphia *Economic Insights* (Second Quarter 2019), pp. 15-20.

Quarles, Randal. Board Memo from Vice Chairman Quarles to the Board of Governors, Federal Reserve Board (April 1, 2019), <https://www.federalreserve.gov/aboutthefed/boardmeetings/files/foreign-bank-board-memo-20190408.pdf>.

Regulation K, 12 CFR part 211.21(b), and (e), Federal Reserve Board.

Regulation WW, 12 CFR part 249, Federal Reserve Board.

Regulation YY, 12 CFR part 252, Federal Reserve Board.