NOTE

U.S. Regulation of Cross-Border Banks: Is It Time to Embrace Balkanization in Global Finance?

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This Note analyzes the international controversy surrounding the U.S. effort to regulate cross-border banks in the aftermath of the global financial crisis. It proceeds as a case study of the Federal Reserve's ("The Fed's") "Enhanced Prudential Standards," implemented in 2014 for the purpose of increasing the resiliency of the largest banks (both domestic and foreign) operating in the United States. The Fed's rulemaking has ruffled feathers internationally because one of the key provisions imposes a structural "ring-fencing" requirement on foreign banking organizations that does not apply to domestic ones. The rule requires foreign banks of a certain size to create intermediate holding companies in the United States, which are then subject to the Fed's prudential regulation as independent entities. Banks, central bankers, and national regulators from around the world have criticized the rule for discriminating against non-U.S. actors, deviating from international norms, and putting the global financial system at risk.

Drawing primarily on comment letters submitted to the Fed in response to the rulemaking, this Note identifies a deeply held hostility toward "balkanization" in international finance — i.e., the fragmentation of capital and liquidity along geographical lines, as well as the proliferation of regulatory bodies charged with overseeing those pools of capital and liquidity. The principal contribution of the Note is to shed light on a serious deficiency in this anti-balkanization rhetoric: namely, that arguments against balkanization implicitly support greater consolidation in global finance. However, this conclusion is problematic because it is in tension with the post-crisis effort to end or mitigate the "Too Big to Fail" phenomenon — the situation in which a bank becomes so large that a government bailout is virtually guaranteed during times of stress. In view of this tension, the Note controversially suggests that the Fed should be applauded for resisting the anti-balkanization ideology that took hold in the decades leading up to the financial crisis. Contrary to the "common sense" view of influential banking jurisdictions and standard-setting bodies like the Basel Committee, the Note ultimately suggests that it may be time to embrace balkanization in global finance.

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INTRODUCTION

National borders were helpless to contain the virus that infected U.S. mortgage markets in the summer of 2007. By 2008, the subprime crisis had evolved into a global financial crisis that "froze up credit markets, threatened the largest global institutions, and jeopardized the banking system worldwide."[1] While the collapse of storied Wall Street firms Bear Stearns and Lehman Brothers dominated headlines domestically, [2] institutions in the United Kingdom, Germany, France, Ireland, Switzerland, the Netherlands, and Belgium also failed or were bailed out

1 . HAL S. SCOTT & ANNA GELPERN, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION 36–37 (19th ed. 2012).

2. *See, e.g.*, Adam Shell, *Lehman Bros. Collapse Triggered Economic Turmoil*, USA TODAY (Sept. 11, 2009), http://usatoday30.usatoday.com/money/markets/2009-09-10-lehman-triggers-financial-chaos_N.htm ("The collapse of [Lehman] was so shocking it triggered a financial tsunami of such size and scope that it was compared to the Great Depression."); *Bearing All*, THE ECONOMIST (Mar. 3, 2009), http://www.economist.com/node/13226308 (review of book analyzing Bear Stearns's collapse, which "marked the moment when Wall Street was knocked to its senses").

by their respective taxpayers.[3] Distress in financial markets caused ramifications in the real economy, sending national economies into a deep recession from which recovery has been painfully elusive.[4]

History tells us that the financial regulatory system in the United States was, over the course of 150 years, largely built in response to crisis.[5] It is a broadly observed regularity that when mischief or instability in the financial markets causes harm to the real economy, political forces will conspire to counteract the harmful practices and mitigate key risks. The aftermath of the crisis of 2007–2009 proved no different in this respect. In 2010, the U.S. Congress made its signature contribution to the reform effort when it enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), a titanic piece of legislation that represents the "greatest change in the financial landscape in decades."[6] Among its principal goals are increasing the safety and soundness of the largest banks, enacting a sweeping new consumer protection scheme, bringing accountability to the credit rating industry, cleaning up mortgage underwriting standards and practices, and reforming over-the-counter derivatives trading.[7] Yet five years after President Obama signed Dodd-Frank into law, implementation has been conspicuously spotty: according

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3. *See* Mark Carney, Governor, Bank of Can. & Chairman, Fin. Stability Bd., Address at the Thomas d'Aquino Lecture on Leadership, Richard Ivey School of Business: Rebuilding Trust in Global Banking (Feb. 25, 2013), http://www.bis.org/review/r130226c.pdf.

4. The United States's economy contracted by 0.3% in 2008 and 3.5% in 2009. SCOTT & GELPERN, *supra* note 1, at 43. In 2009, the median contraction in output among developed countries was nearly 5%, while the world economy shrunk by 1.7% in the same year. *See* U.N. Dep't of Econ. & Soc. Affairs et. al, *World Economic Situations and Prospects 2015*, at 1, 6 (2015), http://www.un.org/en/development/desa/policy/wesp/wesp_archive/2015wesp_full_en.pdf. On the painful economic recovery, see, e.g., Matt O'Brien, *Will We Ever Fully Recover From the Great Recession?*, WASH. POST (June 10, 2014), http://www.washingtonpost.com/blogs/wonkblog/wp/2014/06/10/will-we-ever-fully-recover-from-the-great-recession/.

5. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-216, A FRAMEWORK FOR CRAFTING AND ASSESSING PROPOSALS TO MODERNIZE THE OUTDATED U.S. FINANCIAL REGULATORY SYSTEM, 5–15 (2009); *see also* Lawrence A. Cunningham & David Zaring, *The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response*, 78 GEO. WASH. L. REV. 39, 39 (2009) ("The third part of any financial crisis is reform."); Eilís Ferran & Niamh Moloney, *The Regulatory Aftermath of the Global Financial Crisis* (Apr. 30, 2013), http://blogs.law.harvard.edu/corpgov/2013/04/30/the-regulatory-aftermath-of-the-global-financial-crisis/ ("As John C. Coffee argues, financial system regulation typically follows a 'regulatory sine curve', increasing in intensity after a crisis — which provides reformers with a space within which legislative inertia can be overcome — before falling back.").

6. *See* Davis Polk & Wardwell LLP, Dodd-Frank Resource Center, http://www.davispolk.com/dodd-frank/. If nothing else, the sheer volume of rules and regulations produced by national governments, regulatory agencies, and international bodies in the aftermath of the crisis is breathtaking. In the United States, Congress's signature piece of post-crisis legislation is the Dodd-Frank Act, weighing in at 848 pages and containing almost 400 directives ordering agencies to promulgate implementing regulations of their own. *See Too Big Not to Fail*, THE ECONOMIST (Feb. 16, 2012), http://www.economist.com/node/21547784.

7. *See generally* Morrison & Foerster LLP, *Dodd-Frank: A Cheat Sheet* (2010), http://media.mofo.com/files/uploads/images/summarydoddfrankact.pdf.

to a 2014 study, federal agencies had completed only 52% of the 398 rulemakings required by statute.[8]

International complexities offer one reason (among many) why the reform effort has been so protracted. Indeed, if the raft of bank failures across Europe and the concomitant worldwide economic slump have taught us anything, it is that finance does not exist in a domestic vacuum. Since finance itself is global,[9] it is no surprise that financial regulation must be global in scope as well.[10] As a consequence, the national regulators (such as the Federal Reserve ("the Fed"), SEC, FDIC, Treasury, and many others) charged with implementing Dodd-Frank represent a small subset of the full ensemble of actors who are involved in the regulation of finance across the globe. In addition to influential national regulators like the United Kingdom's Prudential Regulatory Authority ("PRA") or quasi-regional bodies such as the European Commission, international finance is overseen by a number of "international standard-setting bodies" such as the G-20, the Financial Stability Board ("FSB"), and the Basel Committee on Banking Supervision ("Basel Committee" or "BCBS").[11] This creates

8. *See* Matt Egan, *Wall Street Reform Law Only Half Done*, CNN MONEY (Jul. 20, 2014), http://money.cnn.com/2014/07/20/investing/dodd-frank-progress/.

9. To get a sense of just how global finance has become, consider that the total value of international claims held by global banks reached a peak of nearly twenty-five trillion dollars in the lead-up to the crisis. NICOLE CETORELLI & LINDA GOLDBERG, LIQUIDITY MANAGEMENT OF U.S. GLOBAL BANKS: INTERNAL CAPITAL MARKETS IN THE GREAT RECESSION 1 (Fed. Reserve Bank of N.Y. Staff Reports, Aug. 11), http://www.newyorkfed.org/research/staff_reports/sr511.pdf; *see also* SCOTT & GELPERN, *supra* note 1, at 258–61.

Consider also that finance is not *inherently* international. The growth of international finance was the result of a deliberate series of policy decisions, culminating in the dismantling of the Bretton Woods system in 1971. *See, e.g.*, Council on Foreign Relations, *The Global Finance Regime* (June 25, 2013), http://www.cfr.org/financial-regulation/global-finance-regime/p20177.

10. *See* Chris Brummer, *How International Financial Law Works (and How It Doesn't)*, 99 GEO. L.J. 257, 273 (2011) ("International financial law is the product of a regulatory division of labor through which authorities across a spectrum of domestic and international institutions interact with one another both cooperatively and competitively to promulgate global rules and standards.").

11. These institutions, which Brummer describes as "the global institutions in which national authorities meet regularly to coordinate and articulate common policy approaches," have assumed a prominent role in leading the international response to the crisis, culminating in efforts such as the Basel Capital Accord (the "Basel Accord"). *See id.* at 275–78. The Basel Accord, a set of capital adequacy guidelines that "governs the reserve levels of most of the banks in the world," was promulgated by the Basel Committee, which is a committee of bank supervisors established in 1975 by the central bank governors of the G10 countries, Luxembourg, and Switzerland in response to a raft of bank failures in 1974. *See* David Zaring, *Informal Procedure, Hard and Soft, in International Administration*, 5 CHI. J. INT'L L. 547, 550, 555–60 (2005) (discussing the Basel Committee's origins and the evolution of its structure, rulemaking process, and influence on U.S. banking regulation). On one view, the Basel Committee is now considered "perhaps the most important example of a transgovernmental regulatory network that exercises vast powers, seemingly without any form of democratic accountability." Michael S. Barr & Geoffrey P. Miller, *Global Administrative Law: The View from Basel*, 17 EUR. J. INT'L L. 15, 17 (2006). The current, third iteration of the Basel Accord ("Basel III") represents a major post-crisis response to perceived flaws in bank capital adequacy standards prior to and during the financial crisis. *See* BASEL COMMITTEE ON BANKING SUPERVISION, BASEL

complexity for a national regulator like the Fed, which must walk a line between carrying out Congress's statutory instructions and respecting the United States' commitments to international agreements such as the Basel Accord.[12] Moreover, a domestic regime like Dodd-Frank will impinge on foreign interests insofar as foreign banks and financial firms conduct activity within the jurisdiction of U.S. regulators. Deciding how to treat foreign firms — especially when those firms are already subject to regulation in their home countries — is a task loaded with political and economic consequences.

The regulation of the world's largest banking organizations is one area in which the need for an internationally minded approach is most pressing. Most of the world's largest banks, some of which boast assets valued in the trillions of dollars and whose operations sprawl to all corners of the globe, are headquartered outside of the United States.[13] Yet, as the crisis revealed, weakness in a global bank's capital and liquidity planning can wreak havoc in markets far away from the bank's home country — often leaving a so-called "host country" to pick up the tab.[14] At the same time, the political salience of large banks for national economies (consider the national importance of Deutsche Bank in Germany or UBS and Credit Suisse in Switzerland) helps explain why international approaches to regulation are so difficult: even though all countries strictly prefer to avoid another crisis, and recognize that international cooperation is necessary to achieve this, each country still fights tooth and nail to preserve the competitive position of its own financial institutions and markets. This dynamic creates considerable friction between domestic rules like Dodd-Frank and international regimes such as Basel III.[15]

III: A GLOBAL REGULATORY FRAMEWORK FOR MORE RESILIENT BANKS AND BANKING SYSTEMS 1–2 (2010), http://www.bis.org/publ/bcbs189.pdf ("The Committee's comprehensive reform package addresses the lessons of the financial crisis.").

12. *See* Colby Mangels, *International Financial Regulation Since 2008: Why Implementation Delays of Basel III are Likely to Persist in the U.S. and EU*, TRAVAUX: BERKELEY J. INT'L L. BLOG (Feb. 26, 2013), http://berkeleytravaux.com/international-financial-regulation-since-2008-why-implementation-delays-of-basel-iii-are-likely-to-persist-in-the-u-s-and-eu/.

13. *See* Maria Tor & Saad Sarfraz, *Largest 100 Banks in the World*, SNL FIN. (Dec. 23, 2013), https://www.snl.com/InteractiveX/Article.aspx?cdid=A-26316576-11566.

14. Of course, this happened when the Fed began injecting dollar funding into foreign central banks that were attempting to provide liquidity to banks holding dollar-denominated assets. *See* Daniel K. Tarullo, Member, Bd. of Governors, Fed. Reserve Sys., Remarks to Yale School of Management Leaders Forum: Regulation of Foreign Banking Organizations 8 (Nov. 28, 2012), http://www.federalreserve.gov/newsevents/speech/tarullo20121128a.pdf ("Although the United States did not suffer a destabilizing failure of foreign banks, many rode out the crisis only with the help of extraordinary support from home- and host-country regulators. Following national treatment practice, the Federal Reserve itself provided substantial discount window access to U.S. branches and the opportunity to participate in the Primary Dealer Credit Facility to U.S. primary-dealer subsidiaries of foreign banks.") [hereinafter Tarullo 2012 Speech]; *see also infra* Part I.B.

15. SCOTT & GELPERN, *supra* note 1, at 86 ("The Dodd-Frank Act underscores the tension

This Note analyzes the international consequences of the U.S. effort to regulate cross-border banks under Dodd-Frank. It proceeds as a case study of an illustrative domestic regulation, the Fed's "Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations," which was implemented in 2014 for the purpose of increasing the resiliency of the largest banks (domestic and foreign) operating in the United States.[16] The rule has ruffled feathers internationally because one of its provisions imposes a restriction on foreign banking organizations ("FBOs") that is inapplicable to domestic ones. In short, the provision requires an FBO with more than $50 billion of U.S. non-branch assets to restructure its U.S. operations under a so-called intermediate holding company ("IHC").[17] The IHC is then subject to the full panoply of prudential standards — risk-weighted capital, liquidity, stress tests, etc. — that are generally applicable to large banking organizations headquartered in the United States.[18]

To see why this has drawn criticism, consider that large domestic banks, such as J.P. Morgan or Citigroup, can achieve compliance with those prudential standards by drawing on assets held *abroad* in foreign subsidiaries. The FBO, on the other hand, is at an obvious disadvantage because it must satisfy the same requirements by relying solely on the assets held in its newly-formed U.S. IHC.[19] Ultimately, this hits the FBO's bottom line because, all else equal, a bank makes money through lending and leverage, and every additional dollar allocated to regulatory capital requirements is a lost opportunity to lend or lever up. To give some sense of the rule's immediate dollar impact, a study by Oliver Wyman estimates

between domestic and cross-border regulation. While it exhorts U.S. regulators to coordinate with their foreign counterparts, it also includes enhanced powers for the United States to oversee and terminate the operations of foreign financial institutions in the United States, with potentially significant implications for the home-country and beyond.").

16. *See infra* Part I; Press Release, Bd. of Governors of Fed. Reserve Sys., Fed. Reserve Bd. Approves Final Rule Strengthening Supervision and Regulation of Large U.S. Bank Holding Cos. and Foreign Banking Orgs. (Feb. 18, 2014), http://www.federalreserve.gov/newsevents/press/bcreg/20140218a.htm.

17. *See infra* Part I.C. At the time the final rule was announced in February 2014, the Fed estimated that seventeen FBOs (but as many as twenty) would have enough U.S. non-branch assets to trigger the IHC requirement. *See* Stephanie Armour & Ryan Tracy, *Fed Sets Rules for Foreign Banks*, WALL ST. J. (Feb. 18, 2014), http://www.wsj.com/articles/SB10001424052702303945704579391244050104458; Yalman Onaran, *Fed Adopts Foreign-Bank Rule as World Finance Fragments*, BLOOMBERG (Feb. 18, 2014), http://www.bloomberg.com/news/articles/2014-02-18/fed-sets-foreignbank-capital-rules-as-world-finance-fragments.

18. For a comprehensive list of the prudential standards imposed on large banks under Dodd-Frank, see the discussion *infra* Part I.A. These requirements are separate from and additional to the risk-weighted capital and liquidity framework applicable to all banks under Basel III. *See generally* Davis Polk & Wardwell LLP, *U.S. Basel III Final Rule: Visual Memorandum* (Jul. 8, 2013), http://www.davispolk.com/sites/default/files/U.S.Basel_.III_.Final_.Rule_.Visual.Memo_.pdf.

19. *See infra* Part I.C.

that the FBO entities forced to restructure under an IHC will suffer hits to return on equity ("ROE") between roughly 0.8% and 8.0%, depending on the firm's balance sheet composition and strategy for meeting capital requirements.[20]

From the standpoint of international financial policy, the IHC provision is especially noteworthy because the Fed appeared to have promulgated it unilaterally — that is, without explicit congressional instruction or as part of a coordinated international effort. And, as the Note will elaborate, a domestic regulation that is perceived as harmful to foreign banking interests flouts a decades-long trend of increasing globalization in finance.[21] During the rulemaking, dozens of comment letters submitted by national regulators, central bankers, and international banking interest groups strenuously protested the IHC component of the proposal, urging the Fed to revise its approach to better align with norms of international finance.

These comment letters raised two especially noteworthy issues. First is the claim that the IHC requirement, if adopted, would accelerate fragmentation of the global financial system and invite retaliatory measures by other national regulators.[22] Second is the accusation that the Fed's rule discriminates against FBOs in violation of the principle of national treatment — a bulwark of international financial policy.[23] Each of these issues taps into a broader fear of *balkanization* — i.e., greater fragmentation in the operations of cross-border financial institutions, as well as in the allocation of regulatory responsibility for overseeing those institutions. This Note observes that the debate in the comment letters is focused almost exclusively on the *costs* of balkanization, with little to no discussion of the countervailing benefits. As a matter of political economy, this is hardly surprising — self-interested FBOs seek to minimize regulatory costs; central bankers and regulators are political actors seeking to protect national banking interests. The problem, however, is that adversarial

20. Oliver Wyman, *Enhanced Prudential Standards for Foreign Banking Organizations: An Impact Assessment* 20 (Apr. 30, 2013) http://www.oliverwyman.com/content/dam/oliver-wyman/global/en/files/archive/2013/2013-04-30_OW_IHC_Impact_Analysis_-_Enhanced_Prudential_Standards.pdf. Return on equity is a metric of profitability that has traditionally been the "most common measure for a bank's performance." European Central Bank, *Beyond ROE — How to Measure Bank Performance: Appendix to the Report on EU Banking Structures* 5 (2010), http://www.ecb.europa.eu/pub/pdf/other/beyondroehowtomeasurebankperformance201009en.pdf.

21. *See* Susan Lund et al., *Financial Globalization: Retreat or Reset?* 5, MCKINSEY & CO., (Mar. 2013), http://www.mckinsey.com/insights/global_capital_markets/financial_globalization. For a comprehensive discussion (and criticism) of the effort to harmonize the regulation of cross-border financial institutions through Basel, see Roberta Romano, *For Diversity in the International Regulation of Financial Institutions: Critiquing and Recalibrating the Basel Architecture*, 31 YALE J. ON REG. 1, 3–6 (2014).

22. *See infra* Part II.A.

23. *See infra* Part II.B.

jostling in the comment letters by opponents of the new prudential standards masks a dangerous implication of their position. If, as FBOs and foreign regulators insist, balkanization of liquidity and capital poses a threat to global financial stability, then it follows that greater *consolidation* in the global financial system is desirable from the standpoint of regulatory policy. An implication of this commitment to consolidation is that the merger of two unaffiliated banks — e.g., one in the United States and one in Europe — should produce a *net improvement* in global financial safety and soundness. Unfortunately, that conclusion is in direct contradiction with the lessons of the Too-Big-to-Fail ("TBTF") movement, which is predicated on the systemic dangers created by large, interconnected financial institutions. So, while commenters may have glossed over this tension for self-interested reasons, this Note will suggest that the Fed's shift toward balkanization in its treatment of cross-border banking is a regulatory development worthy of greater solicitude — and a comforting reminder that adjustments in regulatory philosophy made in the immediate wake of the crisis still have purchase with U.S. regulators.

Ultimately, the contribution of this Note is twofold: first, to outline the main contours of the international debate over the Fed's new prudential standards for FBOs, and second, to identity a major deficiency in the public conversation about balkanization in global finance and global financial regulation. Part I describes the rulemaking process and actual implementation of the Fed's new prudential standards for FBOs. Part II zeroes in on the two leading issues in the comment letters — regulatory fragmentation and the violation of national treatment — and analyzes how commenters framed their opposition to or support for the Fed's proposed rulemaking by reference to those two issues. Part III evaluates the merits of the arguments in the comment letters and offers reasons to resist the pro-consolidation, anti-balkanization line of thought based on an analogy to recent regulatory history: the failure of the SEC's Consolidated Supervised Entities program for overseeing investment bank holding companies. The Note concludes with a short summary.

I. OVERVIEW OF THE RULEMAKING AND THE RULE

A. Statutory Background

Section 165 of Dodd-Frank directs the Fed to "establish prudential standards for bank holding companies with total consolidated assets of $50 billion or more and for nonbank [SIFIs][24] in order to prevent or

24. In 2010, Congress established the Financial Stability Oversight Council ("FSOC") to act as

mitigate risks to U.S. financial stability that could arise from the material financial distress or failure, or ongoing activities of, large, interconnected financial institutions."[25] Specifically, the statute mandates that the Fed develop a core set of "required standards," while authorizing the Fed to create additional standards at its discretion.[26] The required standards include: (i) risk-based and leverage capital limits, (ii) liquidity requirements, (iii) risk-management and risk committee requirements, (iv) resolution planning requirements, (v) single-counterparty credit limits, (vi) stress-test requirements, and (vii) debt-to-equity limits for companies determined to pose a grave threat to the United States' financial stability.[27] The authorized standards may include (i) contingent capital requirements, (ii) enhanced public disclosures, (iii) short-term debt limits, and (iv) such other prudential standards as the Fed determines appropriate.[28] These requirements together constitute the *enhanced prudential standards* for large banking organizations and nonbank SIFIs.

The statutory design of § 165, in coordination with other parts of the Dodd-Frank infrastructure,[29] contemplates a tiered set of regulations that increase in stringency with the riskiness of the regulated bank or nonbank SIFI. Within this framework, Congress gave the Fed latitude to tailor the

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the nation's "systemic risk regulator." *Financial Stability Oversight Council (§ 111)*, WEIL, GOTSHAL & MANGES' FIN. REG. REFORM WORKING GRP., http://financial-reform.weil.com/systemic-risk/financial-stability-oversight-council-111/. Among its various powers, FSOC was granted the authority to designate so-called "systemically important financial institutions," or SIFIs. Heath Tarbert, Sylvia Mayer & Derrick Cepha, *Systemically Important in Three Easy Steps? FSOC Approves Final Rule for Nonbank SIFI Designations*, WEIL, GOTSHAL & MANGES LLP (Apr. 5, 2012), http://www.weil.com/~/media/files/pdfs/NY_Briefing_12_Apr_5_Financial_Regulatory_Reform.pdf. The SIFI designation is meant to identify financial institutions *outside the traditional banking sector* that nonetheless pose a systemic threat to the financial system. *See id.* Once designated by FSOC, an SIFI comes under the regulatory supervision of the Federal Reserve — the traditional regulator of the nation's large banks. This explains why § 165, despite being a "traditional" banking law, was written to cover nonbank financial companies as well.

25. Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17240, 17241 (Mar. 27, 2014) (to be codified at 12 C.F.R. pt. 252) [hereinafter Final FBO Rule]; Dodd-Frank Wall Street Reform and Consumer Protection Act § 165, 12 U.S.C. § 5365 (2012) [hereinafter Dodd-Frank]. The statute also applies to nonbank financial companies deemed systemically important by FSOC. *See id.*

26. Dodd-Frank § 165(b)(1), 12 U.S.C. § 5365(b)(1) (2012).

27. *Id.* § 165(b)(1)(A); Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77 Fed. Reg. 76628, 76631 (proposed Dec. 28, 2012) (to be codified at 12 C.F.R. pt. 252) [hereinafter Proposed FBO Rule]. The risk committee and stress-test requirements also apply to foreign banks with consolidated assets of less than $50 billion but greater than $10 billion. *See* Dodd-Frank § 165(h)(2), (i)(2).

28. Dodd-Frank § 165(b)(1)(B); Proposed FBO Rule, 77 Fed. Reg. at 76631.

29. *See, e.g.*, Press Release, Daniel K. Tarullo, Federal Reserve Board Proposes Rule to Further Strengthen the Capital Positions of the Largest, Most Systemically Important U.S. Bank Holding Companies, Opening Statement (Dec. 9, 2014), http://www.federalreserve.gov/newsevents/press/bcreg/tarullo-statement-20141209.htm (proposing capital surcharge premised on "relatively new principle that the stringency of prudential standards should be proportional to the systemic importance of regulated firms").

application of its enhanced prudential standards by differentiating among companies based on, e.g.: capital structure, riskiness, complexity, types of financial activities conducted, size, and any other "risk-related" factors.[30]

In addition, Congress made a special provision in the statute applicable only to FBOs. In § 165(b)(2), it ordered the Fed to "(A) give due regard to the principle of national treatment and equality of competitive opportunity, and [(B)] to take into account the extent to which the FBO is subject, on a consolidated basis, to home-country standards that are comparable to those applied to financial companies in the United States."[31]

B. Regulatory Background

On December 28, 2012, the Fed released its proposal for the "Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies" (the "Proposed FBO Rule" or "Rule"). The Proposed FBO Rule, which proposed prudential standards specific to foreign banks, was released in parallel to the Fed's separate rulemaking for domestic banks.[32] The Introduction to the Rule explains that the Fed's parallel rulemakings are part of a cohesive effort to mitigate the risks to U.S. financial stability created by large financial institutions — both domestic and foreign.[33] Nevertheless, the most controversial provisions of the Proposed FBO Rule, as measured by the vitriol in the comments thereto, are premised on the claim that FBOs pose *unique* challenges to U.S. financial stability that merit special supervisory treatment.

Before turning to the risks associated with FBOs, the Fed began by acknowledging the benefit side of global banking. The preamble notes the "important role that [FBOs] play in the U.S. financial sector" and that "the presence of [FBOs] in the United States has brought competitive and countercyclical benefits to U.S. markets."[34] Large FBOs make sizeable contributions to the depth and liquidity of U.S. financial markets, which presumably benefits U.S. borrowers and investors through lower borrowing costs, reduced liquidity premiums, price discovery, and lower-cost access to global pools of capital.[35] Further, because FBOs are less exposed to geographic risk in the U.S. economy, they provide "countercyclical" benefits when the capital and liquidity of domestic banks

30. *See* Dodd-Frank § 165(a)(2).
31. *Id.* § 165(b)(2).
32. *See* Proposed FBO Rule, 77 Fed. Reg. 594 (proposed Jan. 5, 2012) (to be codified at 12 C.F.R. pt. 252).
33. *See* Proposed FBO Rule, 77 Fed. Reg. at 76632.
34. *Id.* at 76629.
35. *See* Oliver Wyman, *supra* note 20, at 9.

are squeezed.[36]

While duly acknowledging that FBOs may provide competitive and countercyclical benefits, the Fed makes it clear that the Proposed FBO Rule is primarily intended to combat two sources of financial stability risks associated with cross-border banking. The first source of risk is unique to FBOs operating in the United States (as opposed to U.S. banks operating abroad). It traces back to a business-side change in the U.S. operations of FBOs in the years preceding the crisis, when "U.S. branches and agencies of [FBOs] as a group moved from a position of receiving funding from their parent organizations on a net basis in 1999 to providing significant funding to non-U.S. affiliates by the mid-2000s."[37] FBOs relied on U.S. dollars raised by their U.S. operations to finance investments in dollar-denominated asset-backed securities by their non-U.S. affiliates, as well as to fund project and trade finance across the globe.[38] Ultimately, the intra-firm funding model of large FBOs "created a degree of cross-currency funding risk and heavy reliance on swap markets that proved destabilizing."[39] When short-term dollar funding dried up in the height of the crisis, these FBOs were forced to sell their dollar-denominated assets and reduce lending rapidly — actions that further aggravated worldwide stress on credit markets.[40] The Fed notes that even though the United States did not officially suffer an FBO failure on its home turf, the liquidity squeeze nevertheless prompted "extraordinary support from home- and host-central banks and governments" — including massive infusions of liquidity by the Fed to the U.S. operations of FBOs.[41] Indeed, when

36. *See id.*

37. Proposed FBO Rule, 77 Fed. Reg. at 76630.

38. *Id.* For a comprehensive look at European investment in mortgage-backed securities, see Ben S. Bernanke et al., International Capital Flows and the Returns to Safe Assets in the United States, 2003–2007, at 12 (Bd. of Governors of the Fed. Reserve Sys., Int'l Fin. Discussion Papers No. 1014, 2011), https://www.federalreserve.gov/pubs/ifdp/2011/1014/ifdp1014.pdf ("As became apparent after the financial crisis broke, many European financial institutions were funding their purchases of U.S. assets with short-term dollar-denominated liabilities like commercial paper or bank deposits, much of which attracted U.S. investors.").

39. Proposed FBO Rule, 77 Fed. Reg. at 76630.

40. *Id.* One comment letter to the Proposed FBO Rule characterized the systemic riskiness of FBOs as follows: "Even relatively minor shocks may cause 'contagion' or run behavior with short-term funding withdrawn from banks and other financial institutions due to widespread fear of impending failure. Without government intervention, contagion forces banks and financial institutions to liquidate assets at fire-sale prices, thus exacerbating the stress on such institutions." Committee on Capital Markets Regulation, Comment Letter on Proposed Rule to Require Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Non-Bank Financial Companies 4 (Apr. 24, 2013), http://www.federalreserve.gov/SECRs/2013/April/20130430/R-1438/R-1438_042413_111084_532830428586_1.pdf [hereinafter CCMR, Comment Letter].

41. Proposed FBO Rule, 77 Fed. Reg. at 76630. For a comprehensive description of emergency funding provided by the Federal Reserve during the crisis, see SCOTT & GELPERN, *supra* note 1, at 44–54.

ranked by peak amount borrowed, four of the ten largest borrowers of Fed emergency loans during the crisis were FBOs.[42]

A second source of financial stability risk motivating the Proposed FBO Rule is not unique to FBOs (as defined in the statutory sense of *non-U.S.* banks), but rather is endemic to global banking.[43] This is the risk that the international regulatory community will be unable to coordinate the effective resolution of cross-border firms during times of stress.[44] The Fed seemed to have in mind the scenario in which a global bank is prevented from providing capital and liquidity support to its foreign operations in the host country, either because of constraints imposed by *home-country* regulators or due to *home-country* central bank policy. As described in the Introduction, "the failure of several internationally active financial firms during the crisis revealed that the location of capital and liquidity is critical in a resolution. In some cases, capital and liquidity related to operations abroad were trapped at the home entity."[45] The Fed gave the specific example of Iceland during the crisis, pointing out that Icelandic banks "held significant deposits belonging to citizens and residents of other countries, who could not access their funds once those banks came under pressure."[46] The Icelandic experience was taken to illustrate that a regulatory regime that accommodates centralized management[47] of capital and liquidity "increase[s] the chances of home and host jurisdictions placing restrictions on the cross-border movement of assets at the moment of a crisis, as local operations come under severe strain and repayment of local [host-country] creditors is called into question."[48] The Proposed FBO Rule was therefore designed with the possibility of home-country restrictions on cross-border capital and liquidity in mind: if the Fed cannot rely on home countries to act as a "backstop to their banks' foreign operations,"[49] then U.S. prudential standards for FBOs must be strengthened to compensate for the lack of a credible capital cushion from the parent.

42. *See* Better Markets, Comment Letter on Propose Rule to Require Enhanced Prudential and Early Remediation Requirements for FBOs and FNFCs 1 (Apr. 15, 2013), https://www.bettermarkets.com/sites/default/files/documents/125-%20FRS-%20CL-%20Enhanced%20Prudential%20Standards-%204-15-13.pdf.

43. This includes activities of U.S.-headquartered banks conducting international operations of their own.

44. Proposed FBO Rule, 77 Fed. Reg. at 76631.

45. *Id.* at 76630.

46. *Id.*

47. The centralized model of bank structure is characterized by "free flow of intra-group capital and liquidity with integrated organizational and risk management." IMF Staff Discussion Note, *Subsidiaries or Branches: Does One Size Fit All?* 8 (Mar. 7, 2011), http://www.imf.org/external/pubs/ft/sdn/2011/sdn1104.pdf.

48. Proposed FBO Rule, 77 Fed. Reg. at 76630.

49. *Id.* at 76631.

C. Key Aspects of the Proposal

The Proposed FBO Rule sought to implement most of the key provisions of § 165 as they relate to large FBOs.[50] First, the proposal would apply new capital, liquidity, and risk-management standards to (i) FBOs with total consolidated assets of $50 billion or more and (ii) foreign nonbank financial companies that are deemed systemically important by FSOC.[51] For purposes of the proposal, an FBO is defined as a foreign bank[52] that either: (i) operates a branch, agency, or commercial lending company subsidiary in the United States or (ii) controls a bank in the United States.[53] By limiting the scope of the Proposed FBO Rule to FBOs with $50 billion or more in worldwide assets, the Fed respected the statutory direction to "apply more stringent standards to the U.S. operations of [FBOs] that have a more significant presence in the United States."[54]

In a more controversial move — which some observers described as "the most significant aspect"[55] of the rulemaking — the Fed proposed a "supplemental" requirement applicable to FBOs but not to their U.S. counterparts. The proposal would require FBOs with total consolidated assets of $50 billion or more and U.S. non-branch assets of at least $10 billion to "form a U.S. intermediate holding company, which would generally serve as a U.S. top-tier holding company for the U.S. subsidiaries of the company."[56] These FBOs, selected in virtue of the size of their U.S.

50. Other rulemakings implement the remaining provisions of the statute. *See* Memorandum from Daniel K. Tarullo, Member, Bd. of Governors of the Fed. Reserve Sys., to the Board of Governors of the Federal Reserve System n.1 (Feb. 7, 2014), http://www.federalreserve.gov/aboutthefed/boardmeetings/memo_20140218.pdf.

51. Proposed FBO Rule, 77 Fed. Reg. at 76632.

52. The Fed's Regulation K defines "foreign bank" as "an organization that is organized under the laws of a foreign country and that engages directly in the business of banking outside the United States." 12 CFR § 211.21(n).

53. *See id.* § 211.21(o). The regulatory definition of FBO actually encompasses a third type of entity: foreign banks that control so-called "Edge corporations." *Id.* For an overview of Edge corporations, see generally George H. Bossy, *Edge Act and Agreement Corporations in International Banking and Finance*, MONTHLY REV. (May 1964), https://www.newyorkfed.org/medialibrary/media/research/monthly_review/1964_pdf/05_3_64.pdf.

54. Proposed FBO Rule, 77 Fed. Reg. at 76633. The Fed in prior rulemakings created prudential standards for FBOs with smaller numbers of worldwide and/or U.S. assets. *See* Memorandum from Daniel K. Tarullo, *supra* note 50, at n.1. The result is a tiered structure that comports with Congressional mandate. *See* Dodd-Frank § 165(a)(1); Tarullo, Press Release, *supra* note 29.

55. *See, e.g.*, Scott Petepiece & David L. Portilla, *Transactional Implications of the Federal Reserve's Intermediate Holding Company Requirement for Foreign Banks*, BLOOMBERG BNA (Oct. 22, 2013), http://www.bna.com/transactional-implications-of-the-federal-reserves-intermediate-holding-company-requirement-for-foreign-banks/.

56. Proposed FBO Rule, 77 Fed. Reg. at 76632.

operations, are effectively required to "ring-fence" capital and liquidity inside the United States.[57] Thus, an FBO such as Deutsche Bank would be forced to consolidate all of its U.S. subsidiaries — including depository institutions (such as a U.S. "bank holding company"), broker-dealers, investment advisers, insurance companies, etc. — under a single holding company structure.[58] Then the newly formed IHC would be subject to the Fed's enhanced prudential standards (i.e., the capital, leverage, liquidity, and risk management standards that are generally applicable to large banks pursuant to the Dodd-Frank rulemakings). According to the Fed, the point of the IHC requirement is to impose its prudential standards on an FBO's U.S. operations on a "consistent, comprehensive, and consolidated basis" and to facilitate better risk monitoring by U.S. regulators and by the parent FBO itself.[59] It would also simplify the resolution or restructuring of an FBO's U.S. subsidiaries in times of stress.[60]

In sum, the Fed's proposal, in conjunction with its other rulemakings under § 165, would result in an "integrated set of requirements" that "provide incentives for large [FBOs] to reduce the riskiness of their U.S. operations and to consider the costs that their failure or distress would impose on the U.S. financial system."[61]

D. Adoption of the Final Rule

In February 2014, after completion of the notice and comment period, the Fed announced its adoption of a Final Rule to implement enhanced prudential standards under Dodd-Frank § 165. In spite of "extensive" criticism from commenters — many of whom sought to remove the controversial IHC requirement altogether — the Final Rule was adopted

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57. *See Enhanced Prudential Standards for Foreign Banking Organizations: The US Approach to Ring-Fencing*, WHITE & CASE LLP, at i (Mar. 27, 2014), http://www.whitecase.com/sites/whitecase/files/files/download/publications/alert-enhanced-prudential-standards-for-foreign-banking-organizations.pdf [hereinafter *Enhanced Prudential Standards*]. Ring-fencing refers to any number of ways of "legally deconstructing a firm in order to more optimally reallocate and reduce risk." Katia D'Hulster & Inci Ötker-Robe, Ring-Fencing Cross-Border Banks: An Effective Supervisory Response? 2 (Jan. 24, 2014) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2384687. The type of ring-fencing involved in the IHC requirement is known as "geographical" or "territorial" ring-fencing, which generally has the "objective of protecting the domestic assets of a bank so they can be seized and liquidated under local law in case of failure of the whole, or other entities of, the banking group." *Id.*

58. For an illustration of how a typical FBO might be structured before and after compliance with the IHC requirement, see *U.S. Intermediate Holding Company: Structuring and Regulatory Considerations for Foreign Banks* 5–6, DAVIS POLK & WARDWELL LLP (Apr. 2, 2014), http://www.davispolk.com/publications/us-intermediate-holding-company-structuring-and-regulatory-considerations-foreign-banks/.

59. Proposed FBO Rule, *supra* note 27, at 76637.

60. *Id.* at 76636–37.

61. *Id.* at 76632.

largely as originally proposed.[62] All of the changes that were made can be characterized as victories[63] for FBOs — the actors with the most to lose from stricter regulation. By far the most important of these changes involves the asset-level threshold that triggers the IHC requirement. Under the Final Rule, the IHC requirement applies to FBOs with at least *$50 billion* U.S. nonbranch assets, up from $10 billion in the Proposed FBO Rule.[64] Simply raising the threshold to $50 billion instantly released between six and eleven FBOs from the IHC requirement.[65] Other victories for FBOs included delaying the compliance deadline for the IHC requirement by a year to July 1, 2016, relieving an FBO's IHC from applying U.S. advanced approaches to calculating risk-based capital, and pushing back compliance with home-country Basel III.[66]

II. INTERNATIONAL RESPONSE TO THE RULE

The Proposed FBO Rule invited wide-ranging criticism from influential actors in the international finance community. This Part attempts to capture the range of reactions to the Rule from key industry and regulatory stakeholders, by analyzing comment letters submitted during the rulemaking as well as other public statements that speak to the proposal. Although the Final Rule was formally promulgated in early 2014, the comment letters remain an indispensable barometer for gauging international and industry-wide attitudes towards the new prudential standards and an important source of commentary on the merits.[67]

62. *See Enhanced Prudential Standards*, *supra* note 57, at 2.

63. *First Take: Enhanced Prudential Standards*, PRICEWATERHOUSECOOPERS (Feb. 19, 2014), http://www.pwc.com/en_US/us/financial-services/regulatory-services/publications/enhanced-prudential-standards-first-take.jhtml.

64. *See* Final FBO Rule, *supra* note 25, at 17244.

65. *See* Memorandum from Board of Governors of the Federal Reserve System on Final Rules to Implement the Enhanced Prudential Standards of Section 165 of the Dodd-Frank Act, at 1 (Feb. 7, 2014), https://www.federalreserve.gov/aboutthefed/boardmeetings/memo_20140218.pdf; Institute of International Bankers, Comment Letter on Proposed Rule to Require Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Non-Bank Financial Companies 7 (Apr. 30, 2013), https://www.federalreserve.gov/SECRS/2013/May/20130502/R-1438/R-1438_043013_111113_555179652070_1.pdf [hereinafter IIB Comment Letter].

66. *See Enhanced Prudential Standards*, *supra* note 57, at 2.

67. In total, sixty-three unique comment letters were submitted in response to the proposal. Of these sixty-three letters, forty-seven were directly relevant to the substance of the proposal as it relates to global banking interests. Excluded from consideration were letters on behalf of purely non-banking interests (e.g., non-affiliated insurance companies), letters commenting on purely non-substantive aspects of the proposal (e.g., letters requesting more time for comment), and letters of de minimis value. For the list of comment letters, see *Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies [R-1438]*, BD. OF GOVERNORS OF THE FED. RESERVE SYS,. (Feb. 24, 2012), http://www.federalreserve.gov/apps/foia/ViewComments.aspx?doc_id=R-1438&doc_ver=2.

A. Balkanization in Global Financial Regulation

Much of the public response to the Rule expressed a fear that the IHC requirement will incite retaliation in the form of similar "ring-fencing" regulations in other countries, leading to a "balkanized" global regulatory regime characterized by high costs of capital and mutual distrust among national regulators. Indeed, thirty-three out of the forty-seven relevant comment letters submitted during the notice and comment period for the Rule explicitly raised the balkanization concern in one form or another. Prominent central bankers were particularly vociferous in criticism, sometimes using rhetoric that bordered on threatening. The thrust of the argument against balkanization is as follows: (1) the IHC requirement is in substance a protectivist measure that discriminates against FBOs; (2) in response to the IHC requirement, other national regulators will have an incentive to "retaliate" by enacting similar measures designed to protect their national banking interests; and (3) the result is a multiplicity of regulatory costs that diminish the benefits of a globalized financial system (as elaborated elsewhere, efficiency and stabilization through diversification of geographical risks). Many commenters voiced the additional concern that balkanization actually increases systemic risk, since it traps liquidity in jurisdictions when that liquidity could otherwise be used to bolster vulnerable parts of the system.[68]

Theorists of international financial regulation have long believed that fear of retaliation is a reason why domestic regulators such as the SEC hesitate to "[exert] extrajurisdictional influence through expansive domestic legislation."[69] Fear of retaliation from international peers thus acts as a countermeasure to efforts by regulators to expand their "regulatory turf." Of course, the Fed's imposition of an IHC requirement on foreign banks is not extrajurisdictional in the sense of a long-arm statute, reaching outside of U.S. borders.[70] However, the principle is the

68. *Id.*

69. *See, e.g.*, Chris Brummer, *Post-American Securities Regulation*, 98 CALIF. L. REV. 327, 335 (2010); *see also* Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903, 914 (1998); Jill E. Fisch, *Imprudent Power: Reconsidering U.S. Regulation of Foreign Tender Offers*, 87 NW. U. L. REV. 523, 523–24 (1993). As Brummer describes, "If the U.S. did not abide by such tradition [of limiting its extrajurisdictional influence], it could risk retaliation from foreign regulators that could pass their own laws, effectively submitting U.S. firms to their regulation." Brummer, *supra*, at 335. For a number of actual examples of retaliatory regulation passed in response to U.S. extraterritoriality, see Fisch, *supra*, at 571.

70. Under Lawrence Baxter's typology, the IHC requirement is extraterritorial in the sense that Country A imposes greater constraints on a foreign bank than would be imposed by the foreign bank's home regulator. *See* Lawrence G. Baxter, Keynote Address at Duke Law-KoGuan School of Law Financial Law Workshop: Extraterritorial Impacts of Recent Financial Regulation Reforms: A Complex World of Global Finance, at 3, 5 (June 28, 2014) http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=6044&context=faculty_scholarship.

same: a domestic regulator "defecting" from an internationally coordinated solution (in this case, Basel III) by privileging its own firms over foreign ones. Depending on the incentives of other national regulators, the self-interested response to such defection may be to defect oneself — setting off a chain of defections that results in regulatory and financial balkanization. Even if banks and other opponents of the FBO rule are bluffing, the balkanization story gives them a pedigreed theory of international regulatory cooperation with which to criticize the Fed's rulemaking and paint it as inconsistent with international norms.

1. *Nonpartisan Perspectives*

Comment letters from nonpartisan think tanks set the parameters of the debate over the balkanization threat posed by the Proposed FBO Rule. In one camp, the Committee on Capital Markets Regulation ("CCMR")[71] took a strong position against the proposal, asserting its belief that "the premises of the Proposed Rule are flawed and will engender an 'every nation for itself' attitude that will severely hamper the development of international capital markets and global economic prosperity."[72] Drawing on an IMF study, CCMR warned that adoption of "ring-fencing" measures like the IHC requirement would prevent parent banks from "taking swift action" to address financial shocks because of restrictions on moving liquidity and capital between its subsidiaries in different jurisdictions.[73] CCMR was not shy in predicting that it is "highly likely that foreign regulators will respond to the Proposed Rule by imposing their own comparable capital and liquidity requirements on the foreign operations of U.S. banks."[74] As support for its prediction, CCMR cited from a speech, discussed at length below, in which EU Commissioner Michel Barnier openly insinuated the possibility of "reciprocal measures" from European regulators.[75]

By contrast, in the few comment letters expressing support for the Fed's IHC requirement, balkanization is not viewed as a serious concern.[76] To the extent that ring-fencing is discussed at all, it is to reiterate the Fed's central justification for regulating FBOs differently from U.S. banks: to

71. CCMR, Comment Letter, *supra* note 40, at 1.
72. *Id.* at 3.
73. *Id.* at 6.
74. *Id.*
75. *Id.* at 7.
76. *See, e.g.*, Americans for Financial Reform, Comment Letter on Proposed Rule to Require Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Non-Bank Financial Companies (Apr. 30, 2013), https://www.federalreserve.gov/SECRS/2013/July/20130702/R-1438/R-1438_043013_111115_576871652850_1.pdf; Better Markets, Comment Letter, *supra* note 42.

address the *unique* risks created by FBO reliance on U.S. money markets to finance their lending activities, as well as to prevent another large-scale bailout of FBOs by the U.S. government.[77] In other words, balkanization to some degree is a necessary incident to protecting U.S. financial stability. The group Americans for Financial Reform ("AFR") articulated its defense of the IHC rule along these lines, arguing that the Fed's traditional preference for international regulatory harmonization should not take precedence over the immediate need to rein in FBO risk at home. Since international agreements like Basel fail to address the unique systemic risk problems for the U.S. economy raised by the FBO funding model, the Fed should be free to address those problems using its own independent judgment.[78]

2. *International Regulatory Response*

Prominent regulators and government officials in several jurisdictions were among the most vocal critics of the Proposed FBO rule on balkanization grounds. In a comment letter submitted on behalf of the European Commission, Michel Barnier, former Commissioner for Internal Markets and Services, painted a bleak picture of the fragmented world that a retaliatory arms race would create:

> We fear that the [Proposed Rule] could spark a protectionist reaction from other jurisdictions, which could ultimately have a substantial negative impact on the global economic recovery. Indeed, the potential retaliation effects of the new rules could end-up with a fragmentation of global banking markets and regulatory frameworks, with foreseeable consequences in terms of higher concentration of markets and lower levels of competition. These developments would translate into higher costs for banks, particularly those which are internationally active, with negative repercussions on their ability to finance the real economy and economic growth.[79]

Barnier has expressed this criticism in other venues as well. In a speech delivered to a New York audience on February 15, 2013, Barnier was even more aggressive in his critique of U.S. regulators. Asserting that "the EU

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77. *See supra* Part I.

78. *See* Americans for Financial Reform, *supra* note 76. For more discussion of a member-state's decision to deviate from international regimes like Basel, see *infra* Part III.B.

79. European Commission, Comment Letter on Proposed Rule to Require Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Non-Bank Financial Companies 3 (Apr. 10, 2013), https://www.federalreserve.gov/SECRS/2013/May/20130530/R-1438/R-1438_041913_111076_515131431183_1.pdf.

and U.S. are at a crossroads," Barnier stressed the absolute necessity of a "global reform effort."[80] Indeed, in the first half of the speech, Barnier proudly announced progress within Europe toward achieving regulatory harmonization on issues such as Basel III implementation, derivatives, and cross-border resolution.[81] He then went on to single out the United States for being out of step with the European trend toward regulatory coordination. Speaking directly to the Fed's ongoing implementation of § 165, Barnier reiterated: "I am not fully convinced by the proposed approach on Foreign Banking Organisation[s]. It seems to me to be moving away from cooperation with international partners – a cooperation which I see as absolutely necessary."[82] The foreseeable consequence: "[A] return to a fragmented system based on national or regional approaches."[83] For Barnier, the costs of fragmentation are too great to ignore: "[T]his will send the wrong signal to markets and to the rest of the world. It would increase the cost of capital, and reduce growth prospects."[84]

On February 25, 2013, Mark Carney, former Governor of the Bank of Canada and current Governor of the Bank of England and Chairman of the G20's FSB, delivered a speech before a business school audience calling for greater international cooperation in the post-financial crisis response.[85] Carney warned: "The costs are potentially enormous . . . . A global system that is nationally fragmented will lead to less efficient intermediation of savings and a deep misallocation of capital. It could reverse the process of global economic integration that has supported growth and widespread poverty reduction over the last two decades."[86] Without explicitly mentioning the Proposed FBO Rule by name, Carney's speech, given ten days after Barnier's and in the middle of the Fed's notice and comment period, left no doubt as to the target of his regulatory opprobrium: "[S]ome supervisors are moving to ensure that subsidiaries in their jurisdictions are resilient on a stand-alone basis . . . . Left unchecked, these trends could substantially decrease the efficiency of the global financial system. In addition, a more balkanized system that concentrates risk within national borders would reduce systemic resilience globally."[87] This sentiment echoes a view Carney has expressed elsewhere, that the

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80. Michel Barnier, Member, Eur. Comm'r for Internal Mkt. & Servs., Eur. Comm'n, Address at the Clearing House and Atlantic Council Luncheon: Why Global Markets Require Global Rules (Feb. 15, 2013), http://europa.eu/rapid/press-release_SPEECH-13-125_en.htm.

81. *Id.*

82. *Id.*

83. *Id.*

84. *Id.*

85. *See* Carney, *supra* note 3.

86. *Id.* at 2.

87. *Id.* at 1–2.

"main risk" to building a more resilient financial system is the global extension of the "current European trend towards fragmentation" — of which the IHC requirement is surely a prime exhibit.[88] Failure to coordinate international solutions "could encourage uncoordinated unilateral actions, leading to greater ring-fencing of capital and liquidity, and reducing the efficiencies and financial capacity of the global system."[89]

By contrast with its European peers, Japan's public response to the FBO Rule has been relatively muted. In fact, the Japanese FSA does not mention balkanization or fragmentation at all in its short comment letter to the Fed.[90] Instead, the focus is on home-host country regulatory relations — a topic more appropriately discussed in the next Subpart. It is important to realize that the FSA, in contrast to the European Commission, does not express disapproval of the IHC requirement per se. The FSA's comments are limited to technical suggestions on implementation.[91] As a first pass, this should give some indication of the divergence of interests between Japanese global banks and their European counterparts, inviting the suggestion that Japanese banks face a lighter compliance burden than their European peers.[92]

3. *The Banks' Perspective*

As a group, global banks and the trade associations representing them underscored balkanization as a primary reason for rejecting the Fed's IHC requirement. Of course, the fact that banks were uniformly unhappy with the IHC rule is not surprising: banks — and FBOs subject to the IHC requirement in particular — are the actors that stand to incur the greatest costs from the Fed's enhanced prudential standards.

88. *See* Mark Carney, Written Answers to UK Parliament Treasury Committee (Feb. 7, 2013), http://www.bankofengland.co.uk/about/Documents/treasurycommittee/appoint/carney_feb13.pdf.

89. *Id.*

90. Financial Services Agency of Japan, Comment Letter on Proposed Rule to Require Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Non-Bank Financial Companies (Apr. 30, 2013), http://www.federalreserve.gov/SECRS/2013/May/20130521/R-1438/R-1438_043013_111100_460292788900_1.pdf.

91. *See id.* at 2–3.

92. From the naïve standpoint of avoiding compliance costs, one can imagine that a bank (and, by extension, its home-country regulator) whose U.S. operations consist largely of *branches*, the assets of which do not count toward the $50-billion regulatory threshold, would show less resistance to the Proposed FBO Rule than a global bank with large U.S. subsidiaries. *See* Final FBO Rule, *supra* note 25, at 17244. Hence, Japan's subdued response to the Proposed FBO Rule may simply reflect a lower level of U.S. subsidiarization by large Japanese banks. It is beyond the scope of this Note to test this hypothesis empirically. For a comprehensive discussion of the policy and business trade-offs between a cross-border banking structure favoring branches versus subsidiaries, see IMF Staff Discussion Note, *supra* note 47, at 7–19.

Twenty-eight of the sixty-three comment letters were submitted either by banks themselves, on behalf of banks by trade associations, or in bank-commissioned studies. Of these twenty-eight comment letters, twenty-three explicitly raised some version of the balkanization argument — to varying degrees of rhetorical forcefulness. For example, the Institute of International Bankers painted a particularly bleak picture in which the trend of "every country for itself" regulation incites an "arms race" by national regulators to adopt IHC-like models, with harmful collective consequences.[93] Likewise, the International Banking Federation submitted that the IHC requirement on FBOs creates a "risk that other countries will adopt measures in response to the Proposal."[94] Such protective (or retaliatory) measures will have "implications for all global banks and their customers, including U.S.-headquartered banks conducting business abroad, thereby creating a trend that would only lead to further fragmentation of global financial services regulation."[95] Regulatory fragmentation is dangerous because it "would also lead to fragmented and concentrated financial markets in the U.S. and elsewhere, with all the negative effects this would have on the affected economies, including their financial stability."[96] The Institute of International Finance shared these concerns over the consequences of fragmentation, warning that the Fed's proposal would "lead to balkanization of global finance, the result of which would be reduced global liquidity, higher funding costs for borrowers, and a more fragile financial system, or one with different, and quite likely unanticipated, vulnerabilities."[97]

By and large, comments from individual banks reiterated the same balkanization argument. In perhaps the most contentious comment letter, Deutsche Bank asserted that the Fed's "assumed lack of cooperation and coordination among regulators will lead to unhealthy, fragmented, and nationalistic approaches."[98] It then predicted: "[The Fed's] actions could

93. IIB Comment Letter, *supra* note 65, at 11, 29.

94. International Banking Federation, Comment Letter on Proposed Rule to Require Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Non-Bank Financial Companies 2 (Apr. 30, 2013), http://www.federalreserve.gov/SECRS/2013/June/20130614/R-1438/R-1438_051313_111172_584409662965_1.pdf.

95. *Id.* at 2.

96. *Id.*

97. Institute of International Finance, Comment Letter on Proposed Rule to Require Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Non-Bank Financial Companies 3 (Apr. 30, 2013), http://www.federalreserve.gov/SECRS/2013/May/20130528/R-1438/R-1438_043013_111122_562504653776_1.pdf [hereinafter IIF Comment Letter].

98 . Deutsche Bank, Comment Letter on Proposed Rule to Require Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Non-Bank Financial Companies 3 (Apr. 29, 2013), http://www.federalreserve.gov/SECRS/2013/July/

accelerate a growing trend not only towards balkanization generally, but also towards national approaches that differ by country and that may be inconsistent in important respects. If these trends are not reversed, financial stability will suffer."[99] Deutsche Bank was hardly alone in stressing the dangers of balkanization. The Royal Bank of Canada, for example, submitted:

> Our overriding concern with the FBO proposal is the risk that it will create a more fragmented approach to regulation, particularly if other countries respond by moving forward with their own protectionist measures. A more fragmented framework will lead to regulatory conflicts and inefficiencies that will have the unintended consequence(s) of increasing systemic risk and negatively impacting economic growth.[100]

B. *Violation of the Principle of National Treatment*

In addition to balkanization, an overwhelming number of commenters (forty out of forty-seven relevant comment letters) discussed the concern that the Proposed FBO Rule is a violation of a foundational principle of international finance: the principle of national treatment. Stated simply, national treatment is the principle that "foreign firms are treated no differently than local firms and must comply with the same rules as their local counterparts."[101] As the commenters were keen to point out, Congress gave the Fed explicit instructions in § 165(b)(2)(A) to give "due regard" to national treatment concerns.[102] They also stressed that the Fed has been a proponent of national treatment historically.[103] Indeed, the principle is an important pillar of international financial regulation, forming the centerpiece of the OECD Declaration and Decisions on International Investment and Multinational Enterprises, first adopted in 1976 and boasting a subscription of thirty-four OECD countries and twelve non-OECD countries.[104]

20130705/R-1438/R-1438_042913_111104_460291695185_1.pdf.

99. *Id.* at 3.

100 . Royal Bank of Canada, Comment Letter on Proposed Rule to Require Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Non-Bank Financial Companies 1 (Apr. 29, 2013), http://www.federalreserve.gov/SECRS/2013/July/20130703/R-1438/R-1438_042913_111105_460290913960_1.pdf.

101. Chris Brummer, *Territoriality as a Regulatory Technique: Notes from the Financial Crisis*, 79 U. CIN. L. REV. 499, 504 (2010).

102. Dodd-Frank § 165(b)(2)(A).

103. *See* Gibson, Dunn & Crutcher LLP, *Farewell to National Treatment: The Federal Reserve's Section 165 Rule for Foreign Banks* (Feb. 24, 2014), http://www.gibsondunn.com/publications/Documents/Farewell-to-National-Treatment--Federal-Reserve-Section-165-Rule-for-Foreign-Banks.pdf.

104. Organization for Economic Co-operation and Development, *Declaration and Decisions on*

Many commenters argued that the IHC requirement in particular cannot be squared with the principle of national treatment, in violation of both congressional intent and the Fed's historical practice.[105] The issue can be broken apart into two components. The first is factual or empirical: does the IHC requirement in fact discriminate against FBOs in violation of the principle of national treatment? As this dispute played out in the commentary, the answer will vary depending on how one defines the relevant comparison classes. Do we analyze the impact of the Fed's prudential standards on the IHC as a *standalone entity*, or do we assess the impact on a bank at the *consolidated global level*? Is it relevant to consider the impact of the rule on U.S. banks in their overseas operations even though the rule, on its face, applies only to FBOs in the United States? Unsurprisingly, the Fed and the commenters took opposing views on these questions. The second dimension of the national treatment inquiry is derivative of the first: supposing that the proposal does violate national equality, is the Fed's rule justifiable nonetheless?

Finally, the discussion of national treatment is intimately bound up with the issue of home-country standards. Recall that in addition to national treatment, Congress also gave the Fed explicit instructions in § 165 "to take into account the extent to which the foreign financial company is subject on a consolidated basis to home-country standards that are comparable to those applied to financial companies in the United States."[106] The comment letters reveal that national treatment and home-country standards play complementary roles in international finance: as a rule, a regulator is discouraged from imposing discriminatory regulations on an FBO ("a violation of national treatment") to the extent that the FBO's home-country regulator has already established a comparable regulatory regime ("adequate home-country standards"). Stated alternatively, a violation of national treatment may be forgiven only where home-country regulation of a cross-border bank is inadequate.

1. *Regulators*

Financial regulators and central bankers from a variety of jurisdictions criticized the Proposed FBO Rule heavily on national treatment grounds. For example, Michel Barnier of the European Commission accused the Fed of placing FBOs subject to IHC-level prudential standards at a "competitive disadvantage . . . when considering their operations on a

International Investment and Multinational Enterprises, http://www.oecd.org/daf/inv/investment-policy/oecddeclarationanddecisions.htm.

105. *See, e.g.*, Association of German Banks, Comment Letter, *infra* note 121, at 4.

106. *See* Dodd-Frank § 165.

global basis."[107] This is despite the Fed's "declared intention of putting FBOs on an equal competitive footing with U.S. BHCs."[108] Here, Barnier made an argumentative move that is mirrored throughout the comment letters. He conceded that the Fed would be entitled to impose a differential burden on FBOs vis-à-vis their U.S. counterparts, *so long as* "the FBOs were not subject, on a consolidated basis, to home-country standards comparable to those of the U.S. and if the U.S. financial stability were at stake."[109] In other words, Barnier recognized that the Fed *may* sometimes be justified in discriminating against FBOs. However, the principle of national treatment prevents the Fed from singling out FBOs where home-country prudential standards are deemed sufficiently robust.

This notion of balancing home- and host-country rules draws its authoritative force from two sources. First, and most obviously, it channels Congress's statutory requirement that the Fed take into account home-country standards in formulating the rule.[110] By imposing a blanket IHC requirement based strictly on asset size, the Fed shows insufficient sensitivity to whether a particular FBO is subject to home-country prudential regulation comparable to the Fed's regulatory regime for domestic banks. The German financial regulator and its central bank, in a joint comment letter, made this appeal to statutory fidelity explicitly: "[T]he proposed rule will have a negative impact on international cooperation since it does not take appropriate account of consolidated supervision following comparable home-country standards, as is required by section 165(b)(2)(B) of the DFA."[111]

The second basis for Barnier's claim is grounded in principles of international financial cooperation. In Barnier's words, the IHC rule is problematic because of its "indiscriminate application," which frustrates "the global efforts towards harmonized rules in the area of prudential standards and cross-border resolution . . . ."[112] A commitment to international harmonization requires that, if a national regulator wants to propose rules that deviate from international standards, it must first conduct a "proper ex-ante equivalence test" to see whether the FBO is already subject to a comparable supervisory regime at home.[113] If a

107. *See* Barnier, Comment Letter, *supra* note 79.

108. *Id.*

109. *See id.*

110. Dodd-Frank, 12 U.S.C. § 5365(b)(2); *see also* Final FBO Rule, *supra* note 25, at 17241.

111. BaFin & Deutsche Bundesbank, Comment Letter on Proposed Rule to Require Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Non-Bank Financial Companies (Apr. 26, 2013), http://www.federalreserve.gov/SECRS/2013/April/20130426/R-1438/R-1438_042613_111089_571489255536_1.pdf.

112. *See* Barnier, Comment Letter, *supra* note 79.

113. *Id.*

national regulator like the Fed could impose FBO-specific regulations on an FBO that is already adequately supervised at the consolidated level, the Fed would be imposing discriminatory costs on FBOs without offsetting financial stability benefits. Effectively, the Fed would be placing its own global banks at an advantage relative to FBOs, since FBO operations in the United States will be subject to costly regulation that U.S. banks abroad are not. Thus the Barnier-type argument comes full circle: the Fed's failure to take into account home-country standards (§ 165(b)(2)(B)) links back to its alleged violation of national treatment (§ 165(b)(2)(A)). In a comment letter, Bank of France President Christian Noyer described this potential for regulatory imbalance in stark terms: "[H]aving in mind the current treatment of U.S. banks in Europe, which *benefits* from the recognition of the equivalence of the U.S. supervision, the Fed proposal would lead to asymmetrical treatment as regards to the principle of consolidated supervision."[114]

In contrast to their European peers, Japanese regulators took a different angle in their criticisms of the Proposed FBO Rule. Both the Bank of Japan and the Financial Services Agency (Japan's comprehensive financial regulator) urged that the Fed reject its "across-the-board" and "one-fits-all" approach to banking regulation.[115] Without explicitly criticizing the Fed for abandoning national treatment, the Japanese regulators focused their energy on the second prong of the Barnier argument. They urged the Fed to show "deference to home-country regulation and supervision, if the FBOs are subject to broadly comparable home-country standards of regulation and supervision based on outcome, and are closely monitored by the home authorities." But even if the Fed does impose differential treatment on FBOs, the requirements should "be proportionate and tailored to the differences in business models and risk characteristics of the relevant FBOs."[116]

2. Banks

Unsurprisingly, comment letters from global banking organizations and banks themselves were highly critical of the IHC rule on national

114. Bank of France, Comment Letter on Proposed Rule to Require Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Non-Bank Financial Companies (May 7, 2013) (emphasis added), http://www.federalreserve.gov/SECRS/2013/July/20130702/R-1438/R-1438_052213_111276_567455683925_1.pdf.

115. *See* Bank of Japan, Comment Letter on Proposed Rule to Require Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Non-Bank Financial Companies (Apr. 30, 2013), http://www.federalreserve.gov/SECRS/2013/May/20130521/R-1438/R-1438_043013_111099_460292476410_1.pdf; Financial Services Agency of Japan, Comment Letter, *supra* note 90.

116. Financial Services Agency of Japan, Comment Letter, *supra* note 90, at 1–2.

treatment grounds.

The IIF questioned the wisdom of the Fed choosing to depart from its "long-standing framework for overseeing FBOs, which has historically allowed for supervisory discretion in determining the extent to which the parent entity is capable of extending resources to its US entities."[117] In particular, the IIF pointed out that the Fed's traditional Strength of Support Assessments ("SOSA") approach to regulating U.S entities of foreign banks provides an adequate supplement to home-country consolidated supervision.[118] The SOSA framework leaves open the possibility for host-country regulatory intervention, but only after the Fed conducts a multifactor assessment to determine the adequacy of home-country supervision (and other risk-related factors).[119] By contrast, the IIF characterized the IHC requirement as flipping the presumption: "[I]t assumes the parent entity will be unable or unwilling to provide support, regardless of the many factors that inform the firm's SOSA rating."[120]

A comment letter from the Bankenverband (the Association of German Banks), illustrated a recurring interpretive problem regarding the proper application of the national treatment principle. In abstract terms, national treatment is easy to state: it requires treating foreign firms and domestic firms equally. If the Fed imposes a set of rules on U.S. banks and it imposes the same rules on the U.S. IHCs of foreign banks, is it treating the U.S. banks and foreign banks equally for national treatment purposes? The Bankenverband answered emphatically in the negative. Although it acknowledged that FBOs and U.S. bank holding companies are both subject to enhanced prudential standards — and therefore subject to the "same rules" in one sense — it warned: "[T]he principle of national treatment must not be interpreted too narrowly as identical treatment of FBOs and domestic banks, but in the sense of competitive equality from a global rather than local market perspective, taking into account comparable home-country standards of FBOs."[121] Just as Barnier and the other European regulators pointed out, the problem is that FBOs are disadvantaged at the consolidated global level. Whereas U.S. banks can meet their Dodd-Frank capital requirements by drawing on worldwide

117. IIF Comment Letter, *supra* note 97, at 9.

118. *See* FED. RESERVE SYS., BD. OF GOVERNORS, GUIDELINES FOR IMPLEMENTING THE INTERAGENCY PROGRAM FOR SUPERVISING THE U.S. OPERATIONS OF FOREIGN BANKING ORGANIZATIONS (THE FBO SUPERVISION PROGRAM) 2–9, http://www.federalreserve.gov/boarddocs/srletters/2000/sr0014a1.pdf.

119. *See id.* at 9.

120. *Id.*

121. Association of German Banks, Comment Letter on Proposed Rule to Require Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Non-Bank Financial Companies 4 (Apr. 26, 2013), http://www.federalreserve.gov/SECRS/2013/April/20130426/R-1438/R-1438_042613_111091_571489724316_1.pdf.

sources of capital, an FBO subject to the IHC requirement must comply with those prudential standards solely on the basis of its IHC assets. To the extent that U.S. banks do not face comparative "ring-fencing" requirements on their foreign operations, they benefit from regulatory arbitrage. As the Bankenverband argued,

> While it is true that [the Fed's FBO] requirements are formally similar to those proposed by the Board for larger US bank holding companies, a significant additional burden for non-US banks lies in the fact that host-country (i.e., US) rules would interfere with and claim to partly replace their home-jurisdiction rules, while US banks would be spared such treatment . . . .[122]

Here, too, the Japanese banks framed their concerns with respect to national treatment in different terms from their European peers. Mitsubishi UFJ Financial Group ("MUFG"), the fifth-largest bank in the world by assets,[123] submitted a comment letter that contained almost no overt criticism of the Proposed FBO Rule other than a request for additional time to meet the IHC requirement.[124] In the bank's six-page comment letter, there was not a single mention of national treatment or balkanization. Mizuho Financial Group, while not nearly as sanguine about the proposal as MUFG, also took a different rhetorical tack from the European banks.[125] As highlighted above, national treatment and home-country standards are often conceptually linked — i.e., discriminatory treatment is justified only where home-country standards are inadequate. In Mizuho's case, however, the focus was on home-country standards and home-country norms. It argued that the IHC requirement is unnecessary because the Japanese government stands ready to "provide going concern assistance to Japanese banks and has consistently met Board standards for comprehensive consolidated supervision."[126] In other words, Japanese banks are subject to appropriate supervisory standards on the consolidated global level, eliminating the need for imposing prudential standards at the U.S. IHC level.

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122. *Id.* at 5.

123. *See* SNL Financial, *supra* note 13.

124. Mitsubishi UFJ Financial Group, Inc., Comment Letter on Proposed Rule to Require Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Non-Bank Financial Companies 2 (Apr. 26, 2013), http://www.federalreserve.gov/SECRS/2013/May/20130521/R-1438/R-1438_042613_111090_571490193096_1.pdf.

125. *See, e.g.*, Association of German Banks, *supra* note 121, at 4.

126. Mizuho Corporate Bank, Ltd., Comment Letter on Proposed Rule to Require Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Non-Bank Financial Companies 2 (Apr. 30, 2013), http://www.federalreserve.gov/SECRS/2013/June/20130621/R-1438/R-1438_043013_111128_541334706070_1.pdf.

Mizuho bolstered its anti-IHC argument with an additional argument based on reputational risks: "We believe that the Japanese banking industry generally, and we know that Mizuho specifically, will continue to support their respective local branches and subsidiaries around the world, as failure to do so would significantly impair the global entity. This has been demonstrated consistently over the past several decades."[127] This argument is an attempt to undermine the Fed's statement in the rulemaking that FBOs deserve discriminatory treatment because of the unique liquidity risks they create for U.S. financial stability. Recall that part of the motivation for the IHC requirement was the Fed's experience in providing emergency dollar funding to FBOs during the crisis period of 2008–2009.[128] Mizuho, speaking on behalf of itself and other Japanese banks, attempted to assuage the Fed's fears of moral hazard. If reputational factors provide an incentive for a parent to backstop its U.S. subsidiaries in times of financial stress, then the IHC requirement is rendered superfluous and the Fed's justification for deviating from national treatment is thereby weakened.

3. Nonpartisan Groups

Whereas the banks and foreign regulators were generally skeptical or outright critical of the Proposed FBO Rule, several nonpartisan groups provided a measure of resistance to the argument that the Fed's rule violated national treatment. For example, the group Americans for Financial Reform ("AFR") called the argument that FBOs are placed at a competitive disadvantage vis-à-vis their U.S. counterparts "deeply misleading."[129] Instead, they asserted that in the *absence* of rules like the IHC requirement, "foreign banking operations in the U.S. will receive an unfair subsidy due to the possibility of implicit backing by the U.S. safety net without accompanying prudential protections."[130] A comment letter from Better Markets also pursued this idea, claiming that "the Proposed Rule will reduce the competitive advantages that flow to FBOs from the current regulatory system."[131] This argument illustrates yet another way in which the national treatment debate can be conceptualized: since FBOs raise a unique moral hazard problem for U.S. markets, it is *not* a violation of national treatment to impose rules that operate to internalize that externality — even if, as AFR would concede, the rules are uniquely applicable to foreign banks. Discriminatory treatment works to level the

127. *Id.*
128. *See supra* Part I.
129. *See* Americans for Financial Reform, Comment Letter, *supra* note 76.
130. *Id.* at 3.
131. *See* Better Markets, Comment Letter, *supra* note 42, at 5.

playing field, which is no more or less than what national treatment demands.

The Systemic Risk Council, an organization chaired by former FDIC director Sheila Bair, offered further support for the view that ring-fencing capital in the United States is necessary to prevent FBOs from abusing the Fed's discount window in times of stress. The Council echoed Governor Tarullo's view that "the likelihood that some home-country governments of significant international firms will backstop their banks' foreign operations in a crisis has appeared to have diminished."[132] Furthermore, in a claim that runs counter to the optimistic statements of Mizuho and other FBOs, Better Markets warned: "The events of the crisis showed, however, that many foreign banking organizations were even more thinly capitalized than U.S. banks."[133] By putting pressure on FBOs to strengthen their U.S. capital and liquidity positions in contrast to their U.S. counterparts, the Proposed FBO Rule — and the IHC ring-fencing measure in particular — should be seen as *promoting* rather than frustrating the statutory goal of competitive equality between U.S. and foreign banks.

III. ANALYSIS

What are we to make of the two major lines of criticism — balkanization and national treatment — lodged against the Proposed FBO Rule? As a first pass, the structure of the public rulemaking process gives us a natural way of evaluating the cogency of the comments: to the extent that the Fed found some aspect of the comment letters forceful, it will have reflected any changes in the Final Rule accordingly.[134] As we know, however, the Fed did not fundamentally alter the most controversial and interesting aspect of the proposal — the IHC requirement. This Part will evaluate the desirability of the IHC requirement using a variety of tools: primary source statements from the Fed, general economic theory, and a valuable case study from recent regulatory history.

In Subparts A and B, I will outline considerations, drawn from the Fed's own public commentary as well as general principles of financial regulation, for pushing back on the anti-IHC arguments surveyed in Part II. The goal is to strip away purely self-interested comments from those which actually speak to the Fed's § 165 mandate of mitigating financial

132. *See* Systemic Risk Council, Comment Letter on Proposed Rule to Require Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Non-Bank Financial Companies 1 (Apr. 5, 2013), http://www.systemicriskcouncil.org/wp-content/uploads/2013/04/Final-SRC-Comment-Letter-to-FRB-re-FBO-EPS-4-5-13.pdf.

133. *See* Better Markets, Comment Letter, *supra* note 42, at 5.

134. *See supra* Part I.D (describing changes adopted in the Final Rule).

stability risk. Then, in Subparts C and D, I will formulate my own defense of the IHC requirement. In brief, I will argue that the IHC requirement serves as a legitimate check on the system of consolidated supervision of cross-border banks. According to the comment letters, the underlying economic justification for consolidated supervision is that larger, unregulated pools of capital and liquidity give banks greater flexibility during times of crisis. But insofar as this logic implies a preference for *larger* cross-border banks, it should be treated with as much skepticism as the pre-crisis regime that led to Too-Big-to-Fail.

A. Balkanization Revisited

Balkanization was on the mind of the Federal Reserve Board even before the Proposed FBO Rule opened to public comment. In December 2012, during the open meeting at which the proposal was first presented to the Fed's Board of Governors, Governor Jerome Powell expressed reservations regarding the Rule's potential balkanizing effects: "The proposal, it seems to me, moves us down the road toward a more fragmented banking system, toward a more fragmented regulatory system . . . . What do we think about the effect on . . . global economic growth?"[135] One of the staff members responsible for presenting the proposal to the Board responded to Governor Powell by simultaneously reaffirming the Fed's commitment to "harmonization of global regulatory standards" and explaining: "[W]e don't think our proposal is a movement towards a fully territorial model for the regulation of multinational banks. We think it's a targeted set of policies that addresses some material risks to U.S. financial stability."[136] She then pointed out that FBOs would not be hindered from operating branches in the United States and from sending money from U.S. operations to the foreign parent.[137] Nevertheless, the Proposed FBO Rule reflects a determination that international regimes like Basel are "not sufficient to protect the U.S. financial systems."[138]

Empirical studies of cross-border banking activity in both pre- and post-crisis time frames illustrate that financial regulation has powerful effects on the level of cross-border financial flows.[139] In that context, it is legitimate to worry that the Fed's stricter treatment of FBOs will

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135 . FED. RESERVE BD., Transcript of the Open Board Meeting (Dec. 14, 2012), http://www.federalreserve.gov/mediacenter/files/open-board-meeting-transcript-20121214.pdf.

136. *Id.*

137. *See id.*

138. *Id.*

139. *See, e.g.*, Franziska Bremus & Marcel Fratzscher, *Drivers of Structural Change in Cross-Border Banking Since the Global Financial Crisis* 5, DEUTSCHES INSTITUT FÜR WIRTSCHAFTSFORSCHUNG (2014), http://www.diw.de/documents/publikationen/73/diw_01.c.483458.de/dp1411.pdf.

contribute to the trend of retrenchment in cross-border banking activity that began after the crisis.[140] To the extent that the IHC requirement imposes particularly heavy burdens on non-U.S. global banks, the broad-based criticism of the Proposed FBO Rule as contributing to a fragmented financial system is worthy of attention, since the foreseeable consequence of a higher cost of capital for FBOs in the United States is a pull-back from U.S. markets.

Governor Daniel Tarullo, perhaps the United States' leading voice in the international finance community, undertook a vigorous defense of the adopted Final Rule in a March 2014 speech, roughly one month after its promulgation. Addressing the criticisms from the comment period head-on, Tarullo called the charge of balkanization "curious" and offered several reasons to resist it. Perhaps most damningly, Tarullo wondered whether the balkanization argument is not "premised on the notion that what we had in 2007 was a well-functioning, integrated global financial system with effective consolidated supervision of global banks."[141] In other words, the actual crisis experience in 2007–2009 seems to belie the Pollyannish attitude towards global banking reflected in the comments. If centralized management of globally active banks had been capable of providing a natural capital and liquidity buffer to their U.S. operations, then the Fed would not have been forced to inject hundreds of billions of dollars in loans to FBOs.[142] Given the transparent policy objective of preventing taxpayer bailouts of troubled banks, Tarullo's curt response to the commenters makes sense. The argument that balkanization via ring-fencing will hamper a global bank's ability to "prudently allocate capital and liquidity and thereby weather economic stress"[143] rings hollow in the face of the Fed's experience extending hundreds of billions of dollars to FBOs through the discount window, primary dealer credit facility, term securities lending facility, commercial paper funding facility, and many

140. *See id.* at 1.

141. Daniel K. Tarullo, Member, Bd. of Governors, Fed. Reserve Sys., Harvard Law School Symposium on Building the Financial System of the Twenty-First Century: Regulating Large Foreign Banking Organizations 2 (Mar. 27, 2014), http://www.federalreserve.gov/newsevents/speech/tarullo20140327a.pdf [hereinafter Tarullo 2014 Speech].

142. Bradley Keoun & Craig Torres, *Foreign Banks Used Fed. Secret Lifeline Most at Crisis Peak*, BLOOMBERG (Apr. 1, 2011), http://www.bloomberg.com/news/articles/2011-04-01/foreign-banks-tapped-fed-s-lifeline-most-as-bernanke-kept-borrowers-secret ("The biggest borrowers from the 97-year-old discount window as the program reached its crisis-era peak were foreign banks, accounting for at least 70 percent of the $110.7 billion borrowed during the week in October 2008 when use of the program surged to a record.").

143. *See* Credit Suisse, Comment Letter on Proposed Rule to Require Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Non-Bank Financial Companies 2 (Apr. 30, 2013), http://www.federalreserve.gov/SECRS/2013/May/20130521/R-1438/R-1438_043013_111119_561626954367_1.pdf.

other avenues of emergency funding.[144]

But Tarullo's March 2014 speech contained hints of a bolder rationale for rejecting the balkanization argument. Essentially, Tarullo was calling the balkanization critics' bluff: whereas the anti-balkanization argument presupposes that the threat of regulatory retaliation ought to militate against the Proposed FBO Rule, Tarullo signaled that the Fed would welcome such retaliatory measures with open arms. While acknowledging in the speech that the IHC requirement represents a "notable departure" from existing E.U. and U.K. practice,[145] Tarullo reiterated the Fed's conviction that it is "sound prudential practice — and consistent with various Basel Committee principles . . . — that large domestic operations of foreign banks meet capital standards on the basis of all exposures in the host jurisdiction."[146] Importantly, Tarullo framed this conviction as a generic principle of international financial policy, which is both harmonious with Basel and consistent as a justification for other foreign regulators to "retaliate" and impose ring-fencing measures of their own. As a show of sincerity, Tarullo gave a hat tip to the Fed's peer regulators in the United Kingdom, noting that "U.S. regulators count on the expertise and proximity of U.K. regulators in overseeing the London operations of large U.S. financial institutions to enhance the effective consolidated supervision and regulation for which we are responsible."[147] Embedded in this statement is the idea that consolidated supervision by the home-country supervisor *depends* on the vigilance of host-country regulators, especially in markets where foreign banks conduct systemically risky activity. Just as FBOs pose systemic risks in the United States through their heavy reliance on dollar funding, so too do global U.S. banks pose systemic risks in the United Kingdom. And since U.K. regulators are in the best position to monitor these U.S. banks (as well as local market conditions), they ought to be afforded discretion to impose locally tailored requirements — even if global banks must bear the cost. Finally, as if to dispel any doubt about the implications of his remarks, Tarullo concluded with a message to his colleagues on the Basel Committee: "The jurisdictions represented on the Basel Committee not only have the right to regulate their financial markets — including large FBOs participating in those markets — they have a responsibility to their home jurisdictions, and

144. *See* SCOTT & GELPERN, *supra* note 1, at 44–54.

145. *See* Tarullo 2014 Speech, *supra* note 141, at 15.

146. *See id.* at 15–16. For a sweeping defense of subconsolidated host-country regulation, see Romano, *supra* note 21, at 54–55 ("Basel grants host countries latitude to regulate foreign-owned local banking establishments because, even under a harmonized regime, there can be conflicts of interest between home and host countries when applying consolidated regulatory policies, such as the allocation of capital across a parent and subsidiary or branch.").

147. Tarullo 2014 Speech, *supra* note 141, at 17.

to the rest of the world, to do so."[148]

B. National Treatment and Home-Country Standards

In a sense, controversy over the Fed's infidelity to the principle of national treatment is the other side of the same balkanization coin. But instead of focusing on fragmentation of the global supply of capital and liquidity, commenters raised fears over the splintering of the global regulatory scheme. Boiled down to its essence, the divergence in regulatory ideology between the Fed (as represented by Daniel Tarullo) and its counterparts in other jurisdictions may be fairly described as a crisis of *trust*. It is no surprise that Mark Carney made trust the central theme of a speech on cross-border banking issues, made only a few months after the Fed released its initial proposal.[149] The comment letter from the Institute of International Finance summarized the situation succinctly:

> In many ways, the proposed rule sends a message that the US lacks confidence in the global financial regulatory framework and that it has chosen to pursue a separate course from the international regulatory program of the G20, the Financial Stability Board ("FSB"), the Basel Committee and other international bodies. Underlying the proposed rule is the clear assumption that cross-border cooperation cannot be relied upon during a period of stress.[150]

Notably, the Fed did not shy away from this conclusion in the Final Rule. It maintained its conviction that "localized stress on internationally active financial institutions may trigger divergent national interests . . . ."[151] One of the big takeaways from this case study is that the divide between the Fed and other regulatory bodies — including the international standard-setters BCBS and FSB — seems to go beyond parochial jostling for position in a competitive banking environment and to a deep disagreement about the desirability and plausibility of a more harmonized regulatory framework.

Historical context shows why the Fed's decision to follow through with the IHC requirement is so remarkable. In the decades prior to the crisis, cooperation between central bankers and bank supervisors in major financial jurisdictions, including the United States, set the conditions for

148. *Id.* at 19.
149. *See* Carney, *supra* note 3.
150. IIF Comment Letter, *supra* note 97, at 1.
151. Final FBO Rule, *supra* note 25, at 17268.

globalized finance to flourish.[152] The principles of national treatment and deference to home-country standards — whose importance was reaffirmed in the statutory language of § 165 — flow naturally from international finance's foundational commitment to "supervising international banking groups on a consolidated basis."[153] While this global regulatory norm was originally a principle of nonbinding soft law, it has nevertheless exerted significant "compliance pull" in virtue of its widespread acceptance by major financial jurisdictions.[154] Domestically, the United States has operationalized the principle of consolidated supervision through its "Strength of Support Assessments" program, which sets the parameters for Federal Reserve deference to home-country regulation.[155]

The basic tenets of the consolidated supervision approach are memorialized in the Basel Committee's "Minimum Standards for the Supervision of International Banking Groups and their Cross-Border Establishments." Principle 1 states that "[a]ll international banking groups and international banks should be supervised by a *home-country* authority that capably performs consolidated supervision."[156] However, Principle 4 maintains that "if a *host-country* authority determines that any one of the foregoing minimum standards is not met to its satisfaction," the host-country authority may permissibly impose restrictive measures on its own to assure consistency with the minimum standards.[157] Whereas the Fed saw the catastrophic experience of 2007–2009 as a clear justification for Principle 4, the comment letters lean heavily in the opposite direction, urging the United States to stay the course and maintain faith in a harmonized approach.

C. From Anti-Balkanization to Pro-Consolidation

Synthesizing the dominant lines of argument from the comment letters, the central criticism of the Proposed FBO Rule can be restated as

152. *See* Barr and Miller, *supra* note 11, at 20–23.

153. SCOTT & GELPERN, *supra* note 1, at 308, 556 (noting that the Basel Concordat was modified in 1983 to ensure "that every international bank would be subject to consolidated supervision by one regulator — that is, one supervisor would have an overview of all the bank's activities, anywhere in the world"). *But see* Tarullo 2014 Speech, *supra* note 141, at 3–5 (arguing that "the work of the Basel Committee over the years has not been directed at restraining host-country authorities from supervising and regulating foreign banking operations in their country"). For a detailed discussion of the inherent weaknesses of Basel's principle of consolidated supervision, see Romano, *supra* note 21, at 52–61.

154. *See* Romano, *supra* note 21, at 52–61; Barr & Miller, *supra* note 11, at 20.

155. *See* IIF Comment Letter, *supra* note 117 and accompanying text.

156. *Id.* at 306 (emphasis added).

157. *Id.* at 307 (emphasis added).

follows. First, the commenters assert that a rule imposing local prudential standards on cross-border banks aggravates rather than mitigates threats to financial stability. This is because local standards have the effect of ring-fencing capital and liquidity in localized pools, which ultimately hinders banks from efficiently managing capital and liquidity across their global operations during times of stress. Moreover, a rule like the Fed's IHC requirement has the foreseeable effect of inducing retaliatory measures by other foreign jurisdictions, which will multiply the financial stability risks associated with ring-fenced capital and liquidity described in the first restatement. Finally, the commenters invoke the principles of national treatment and deference to home-country standards to urge the Fed to adhere to the regulatory status quo, under which cross-border banks are largely supervised by home-country regulators on a consolidated basis.[158]

But the anti-balkanization argument, as presented in the comment letters, suffers a glaring omission. Implicit in the claim that balkanization is *bad* is the premise that consolidation — and with it, supervision only at the consolidated level — is *good*. This linkage becomes apparent in the criticism of the IHC requirement. Remember, banks strenuously protested the IHC requirement, calling it territorial ring-fencing that threatens to splinter the global supply of capital and liquidity. Again, the thought is that local capital and liquidity requirements imposed at the *sub*consolidated level impair a cross-border bank's ability to lend (reducing capital formation) and inhibit efficient intra-bank flows in times of stress (aggravating financial downturns). But the same reasoning also suggests an additional conclusion — namely, that larger pools of capital, unburdened by geographic ring-fencing measures, are *more* conducive to global safety and soundness. All things equal, a bank that has a larger pool of capital at the global level, and which is not constrained by locally imposed capital and liquidity requirements, should be safer because it has greater flexibility to shift capital across borders during times of stress, is less vulnerable to local economic downturns (adding countercyclical benefits), and faces a lower cost of capital due to fewer restrictions on the management of its balance sheet.

The allure of a seamless, globalized financial system can perhaps account for part of the anti-balkanization argument's persuasive force. But when stripped down to its essence, the argument that the IHC requirement is harmful to financial stability is really an argument for

158. Clearly, the distaste for balkanization expressed in the first two restatements goes hand-in-hand with the preference for consolidated global supervision implicit in the third restatement. Conversely, the Fed's distrust of home-country supervision of cross-border banks is consistent with its willingness to adopt ring-fencing measures that may contribute to a more balkanized financial system.

greater consolidation — i.e., for larger pools of capital subject to less structural ring-fencing. But adherence to this ideology entails a troubling conclusion: namely, that *any two unaffiliated banks ought to merge*. Why? If duplicative regulatory standards such as the IHC requirement are thought to threaten financial stability, then the same reasoning tells us that a single regulated entity (of size 2X) is safer than two separate regulated entities (each of size 1X). Aside from nullifying the Proposed FBO Rule completely, one obvious way for a bank to achieve desired consolidation is by merging with another cross-border bank. Hence, we come to the surprising conclusion that the commenters' aversion to balkanization entails a preference for financial institutions of increasing size and scope.

When framed in this light, the problems with the anti-balkanization line of reasoning become readily apparent. In short, the commenters' implicit preference for consolidation is in direct tension with the movement to break up the financial institutions deemed Too-Big-to-Fail ("TBTF").[159] A report from the St. Louis Fed puts it bluntly: "Are the nation's biggest banks too big? Many people think so."[160] The specific dangers posed by TBTF have been well documented.[161] Yet, while the campaign to end the government backstop for TBTF banks became a rallying cry for ordinary Americans in the wake of the crisis, the comment letters to the Proposed FBO Rule were careful to tiptoe around the issue altogether — focusing solely on the costs of balkanization without acknowledging that the flipside of balkanization is an affirmation of the TBTF status quo.[162] In a great irony, the St. Louis Fed study notes that

159. For a useful summary of the debate surrounding TBTF, see David C. Wheelock, *Too Big to Fail: The Pros and Cons of Breaking Up Big Banks*, REGIONAL ECONOMIST (Oct. 2012). In addition to the enhanced prudential standards discussed here, other Dodd-Frank rulemakings adopted by the Fed have tackled the problem of TBTF outright. Consider, e.g., the recently promulgated capital surcharge rule, described as the Fed's "plainest effort yet to encourage [the largest banks] to shrink." Ryan Tracy et al., *Fed Lifts Capital Requirements for Banks*, WALL ST. J. (Jul. 20, 2015), http://www.wsj.com/articles/fed-set-to-finalize-amount-of-capital-big-banks-must-maintain-1437410401.

160. Wheelock, *supra* note 159, at 10.

161. *See, e.g.*, Arthur E. Wilmarth, Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem*, 89 OR. L. REV. 952, 980–86 (2011) (describing how TBTF created a massive moral hazard, undermined market discipline, and resulted in disproportionate government assistance to the largest banks during the crisis).

162. Indeed, many of the same individuals and entities that submitted comment letters have elsewhere expressed affirmative support for the crusade against TBTF. In a 2014 speech, Michel Barnier openly declared that work must be done to end TBTF while, in nearly the same breath, reiterating the same ideological message that permeated his comment letter: "[O]ur objective must be deference to each other's rules. Not making foreign banks subject to double requirements." *See* Michel Barnier, Member, Eur. Comm'r for Internal Mkt. & Servs., Eur. Comm'n, Keynote Introductory Remarks at the Eurofi Financial Forum: The Challenge of Implementing Market Regulations Consistently at the Global Level (Sept. 12, 2014), http://europa.eu/rapid/press-release_SPEECH-14-593_en.htm. Mark Carney, another highly vocal critic of ring-fencing and any measures that might threaten or decelerate global financial integration, has also been credited for spearheading the G20's efforts to end TBTF. *See* Huw Jones, *G20 Finalizes Tools for Ending "Too Big to*

"[b]ankers often point to scale economies to justify bank acquisitions and mergers."[163] Of course, in a political environment where sympathy for the largest financial banks has run thin, no FBO would admit that its anti-balkanization argument could be repurposed to justify a merger of two financial giants — even though, as shown above, it is very easy to do.

I should clarify that my purpose is not to chastise banks for taking the position that balkanization and discriminatory treatment pose threats to global financial stability. Against a backdrop of enthusiasm[164] for regulatory harmonization at the highest levels of international policymaking, including the Basel Committee, it makes perfect sense that banks would channel the prevailing regulatory philosophy in lobbying the Fed for relief. On the other hand, the Fed *should* be applauded for resisting the temptation to take the balkanization bait. For adherents of the view that globalization *ceteris paribus* increases net wealth and reduces the cost of capital, it may be highly unintuitive to embrace a geographical ring-fencing measure like the IHC requirement. Indeed, for such adherents, Daniel Tarullo's suggestion that other jurisdictions are even obligated to retaliate[165] with ring-fencing measures of their own is sheer blasphemy. Nevertheless, if my analysis has merit, then it is not enough to discredit the IHC requirement by citing the virtues of unfettered pools of capital and liquidity as a backstop against financial stress. On that naïve account, if unrestricted consolidation across one bank's international affiliates is good, then the combination of two international banks is even better. But to the extent that this line of reasoning runs up against the problem of TBTF, then the Fed was prudent to reject it.

D. *Regulatory Lessons from the SEC: Consolidated Supervision of Investment Bank Holding Companies*

This Note will not attempt to prove, as a matter of economic theory, that the balkanizing effects of the IHC requirement are a net positive for financial stability. As an alternative method of proof, however, it is instructive to draw on examples from regulatory history that may have a bearing on the balkanization debate. In particular, the Consolidated Supervised Entity ("CSE") program instituted by the SEC in 2004 provides a clear example of how political economy motivations (as

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Fail" Banks, REUTERS (Nov. 9, 2015), http://www.reuters.com/article/us-g20-regulations-carney-idUSKCN0SY0PL20151109.

163. *See* Wheelock, *supra* note 159, at 11.

164. *See* Romano, *supra* note 21, at 5.

165. *See* Tarullo 2014 Speech, *supra* note 141. Of course, Tarullo does not use the word "retaliate" in this passage, but the effect is the same.

opposed to sound macroprudential logic) exert a strong push in favor of consolidated supervision of cross-border institutions — even if it comes at the expense of overall financial stability. Today, at a time when the Fed is under pressure to justify its "territorial turn" in the face of accusations of balkanization, the experience of the SEC and its European counterparts in regulating large investment banks prior to the crisis is a sobering reminder that consolidated global supervision is not a regulatory panacea.

The CSE program was the result of a negotiated effort by the SEC and European Union to divvy up responsibility for regulating the holding companies of the world's large investment banks.[166] The SEC's involvement in the regulatory scheme, however, was an eleventh-hour development. In 2002, the EU imposed a new framework to regulate the holding companies and affiliates of broker-dealers operating within Europe, the Financial Conglomerates Directive.[167] Pursuant to this Directive, the EU would become the umbrella regulator for any "unregulated holding companies of investment firms operating in the EU, unless they were already subject to 'equivalent' regulation by another country."[168] The carve-out for "equivalent" regulation by home-country regulators therefore left open the option for a home-country regulator to retain primary supervisory authority over its homegrown investment banks, even with respect to their European operations. In effect, the EU was presenting the U.S. securities industry with a choice: either submit to EU authority or find a suitable replacement. With Wall Street facing the uncomfortable prospect of a new regulatory overseer, it turned to the SEC, the traditional regulator of broker-dealers in the United States, for help. The CSE program was established soon thereafter, "with the explicit goal of helping U.S. firms avoid EU regulation," and the holding companies of the five largest Wall Street investment banks were placed under SEC supervision.[169]

The regulatory ideology underlying the EU's Financial Conglomerates Directive bears a striking resemblance to the ideas urged by anti-

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166. For a concise overview of the transatlantic regulatory developments that led to the SEC's adoption of the CSE program, see John C. Coffee, Jr., & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707, 737 (2009). For a more detailed account, published prior to the program's demise, see Jorge E. Vinuales, *The International Regulation of Financial Conglomerates: A Case-Atudy of Equivalence as an Approach to Financial Integration*, 37 CAL. W. INT'L L.J. 1, 40–41 (2006) (describing how the CSE program arose from a specific negotiating context between the U.S. and EU, and represented one of the "the main responses the United States [could] use to deal with the requirements imposed by the Financial Conglomerates Directive on third-country groups").

167. Council Directive 2002/87, 2003 O.J. (L. 35) 1 (EC) [hereinafter Financial Conglomerates Directive].

168. *Id.* art. 18(1); SCOTT & GELPERN, *supra* note 1, at 238–39.

169. SCOTT & GELPERN, *supra* note 1, at 239.

balkanization commenters in the FBO rulemaking. In the former case, the EU approached the task of regulating foreign cross-border institutions by openly deferring to home-country standards. Although it did give investment banks a choice between submitting to EU regulation or finding "equivalent" regulation by another country, the regime ensured in either case that the holding company would be assessed only *once* at the consolidated holding company level, and without geographical ring-fencing inside the EU.[170] From a structural perspective,[171] this is exactly the approach that commenters to the Proposed FBO Rule were advocating in response to the Fed's IHC requirement. If home-country supervision of an FBO is adequate, then there is no further need for the United States to intervene by adding on another layer of regulation — or so the comment letters from central banks and foreign regulators unanimously maintained.

But whereas critics of the Proposed FBO Rule can only speculate about the negative consequences of ring-fencing and balkanization, we know from recent history exactly how the consolidated approach worked for the EU and the SEC — that is, disaster. By 2008, all five banks subject to supervision as CSEs had either failed, been sold at fire-sale prices, or were voluntarily restructured to take advantage of Federal Reserve emergency funding.[172] The SEC disbanded the CSE program in September of that year.[173] While the post-crisis autopsy invited a handful of competing diagnoses,[174] some broad themes emerge from the testimony of SEC regulators charged with the creation, administration, and oversight of the short-lived CSE program.

170. *See id.*

171. This streamlined approach to allocating regulatory authority over cross-border financial groups has been defended in the academic literature. In a pre-crisis law review article published in 2007, two SEC officials outlined a proposal for a system of "substituted compliance" for foreign broker-dealers operating in the United States. Ethiopis Tafara & Robert J. Peterson, *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 HARV. INT'L L.J. 31, 31–32 (2007). The proposal would allow such foreign broker-dealers to opt out of SEC regulation so long as they complied with "substantively comparable foreign securities regulations and laws" and were supervised by a "foreign securities regulator with oversight powers and a regulatory and enforcement philosophy substantively similar to the SEC's." *Id.* at 32. The parallels to both the anti-IHC comment letters and the SEC's justification for the CSE program are readily apparent.

172. *See Testimony Concerning Lehman Brothers Examiner's Report: Hearing Before the H. Fin. Serv. Comm.*, 111th Cong. 3 (2010) (statement of Mary L. Schapiro, Chairman, Sec. & Exch. Comm'n), https://www.sec.gov/news/testimony/2010/ts042010mls.htm.

173. *Id.*

174. *See* Julie Satow, *Ex-SEC Official Blames Agency for Blow-Up of Broker-Dealers*, N.Y. SUN, Sept. 18, 2008, http://www.nysun.com/business/ex-sec-official-blames-agency-for-blow-up/86130/; Ben Protess, *'Flawed' SEC Program Failed to Rein in Investment Bank*, PROPUBLICA (Oct. 1, 2008), http://www.propublica.org/article/flawed-sec-program-failed-to-rein-in-investment-banks-101; Stephen Labaton, *S.E.C. Concedes Oversight Flaws Fueled Collapse*, N.Y. TIMES (Sept. 26, 2008), http://www.nytimes.com/2008/09/27/business/27sec.html; *see also* GELPERN & SCOTT, *supra* note 1, at 585 (explaining that the SEC's low capital requirements and forgiving leverage ratio for CSEs were a "recipe for disaster").

Ultimately, the failure of the CSE program illustrates the weaknesses of the "umbrella regulator" model for supervising cross-border financial institutions. Consider the testimony of SEC director Erik Sirri, speaking before a Senate subcommittee in March 2009. He specifically noted the "challenges any single regulator has in overseeing an entity — in the SEC's case, sizable broker-dealers — that reside within a complex institution with multiple material affiliates, regulated or not, in numerous countries."[175] Likewise, there is no obvious reason to think that a single consolidated supervisor charged with overseeing FBOs (as opposed to large broker-dealers) would fare any better than the SEC did prior to the crisis. Given that the largest and most systemically risky FBOs invariably contain massive broker-dealer affiliates with activities in multiple jurisdictions, there is considerable overlap in the types of entities that the Fed is responsible for regulating and those formerly subject to EU or SEC supervision as broker-dealers. If the SEC admitted its inability to effectively supervise a complex cross-border institution entirely on its own, then the Fed would be foolish to assume the same approach will work the second time around.[176]

Thus, we can view the Fed's decision to impose ring-fencing measures in the Proposed FBO Rule as an acknowledgment of the limitations of the consolidated supervision model. Indeed, from a naïve standpoint, the Fed's approach seems perfectly reasonable: if safety and soundness is the goal, then having two regulators is better than one. The argument is only strengthened to the extent that the FBO affiliate in Host-Country A incurs liquidity or maturity mismatch risks, since the principal fear underlying the cross-border banking model is that events in Home-Country B (e.g., unexpected regulatory action, local market conditions, domestic creditor preference) will obstruct the timely flow of capital and liquidity to Host-Country A during times of stress. So instead of giving Home-Country B regulators the ultimate discretion to ensure that the global bank balances the interests of both Host-Country A and Home-Country B, surely it would be more prudent to allow *both* Host-Country A and Home-Country B regulators to craft rules aimed at mitigating stress within their respective

175. *Testimony Concerning Lessons Learned in Risk Management Oversight at Federal Financial Regulators: Hearing Before the Subcommittee on Securities, Insurance and Investment Committee on Banking, Housing and Urban Affairs*, 111th Cong. (2009) (statement of Erik Sirri, Director, Div. of Trading & Mkts., Sec. & Exch. Comm'n), https://www.sec.gov/news/testimony/2009/ts031809es.htm.

176. Of course, I recognize that each host-country regulator still plays an active role in supervising the host-country branches, subsidiaries, and agencies of an FBO to enforce compliance with host-country Basel III standards. However, if the host country declines to impose additional ring-fencing measures on FBO operations and openly defers to home-country regulators to assess the stability of the global entity, then it is fair to draw a parallel to the "umbrella regulator" model implemented under the CSE program.

domains. By rejecting the chorus of pleas to remove the IHC ring-fencing requirement, the Fed affirmed its belief that two autonomous regulators is better for financial safety and soundness than an umbrella home-country regulator acting alone.

Again, the great advantage of drawing on the CSE precedent is that we can rely on more than theoretical speculation to evaluate the fears of the anti-balkanization commenters. From Erik Sirri's testimony, no piece of evidence is more compelling than the historic bankruptcy of Lehman Brothers.[177] Lehman, which was one of the five entities subject to CSE supervision, serves as a chilling admonition to national regulators who place too much faith in the cross-border resolution process. Sirri drilled this point home, noting that:

> [The SEC's] experience with the bankruptcy filing of a foreign affiliate of Lehman Brothers has demonstrated the innate difficulties of any multijurisdictional approach to regulation. While cross border coordination and dialogue is important, jurisdictions nonetheless have unique bankruptcy and financial regulatory regimes — and creditors wherever they are located shall always act in their own interest during a crisis. Thus, a U.S. liquidity provider might be faced with the difficult choice of guaranteeing the assets of the holding company globally, or else risk creditors exercising their rights against foreign affiliates or foreign supervisors acting to protect the regulated subsidiaries in their jurisdictions, either of which could trigger bankruptcy of the holding company.[178]

The difficulties inherent in cross-border resolution are both well-documented and highly salient in the case of cross-border banking.[179] Here too, one dominant school of thought maintains the workability (and superiority) of an internationally harmonized approach, which would discourage measures like the Fed's IHC requirement that use ring-fencing to prioritize host country operations during times of stress. The anti-balkanization commenters to the Proposed FBO Rule, unsurprisingly, strongly advocated for the harmonized approach, urging the Fed not to interfere with the ongoing progress at the FSB and BCBS levels.[180] But in

177. *See* Shell, *supra* note 2 (quoting a fund manager: "Lehman's bankruptcy will forever be synonymous with the financial crisis and (resulting) wealth destruction . . .").

178. Sirri, *supra* note 175.

179. Recall the substantial overlap between the former CSE entities, which fell under SEC supervision, and the large banking organizations that are now under the purview of the Fed and equivalent regulators in other jurisdictions. This suggests that the SEC's experience with the Lehman bankruptcy is highly relevant for the Fed.

180. *See, e.g.*, IIB Comment Letter, *supra* note 65, at 38–40; IIF Comment Letter, *supra* note 97, at 5–8.

contrast to this nearly unanimous position that ring-fencing will frustrate attempts to coordinate the orderly resolution of cross-border banks, Sirri's comments suggest instead that ring-fencing may be absolutely *necessary* — or at least a necessary evil — to prevent threats to U.S. financial stability.

Of course, it is important not to put too much pressure on the analogy between CSE oversight of investment bank holding companies and traditional supervision of large banking organizations by the Fed and its peers in other jurisdictions. Although the regulated entities are similar, the substantive content of the regulation may diverge significantly — e.g., the SEC's familiarity with broker-dealer regulation may incline it toward looser leverage limits than a bank regulator would prefer. Thus, it would be a mistake to reflexively assume that consolidated supervision by the Fed is the same "recipe for disaster" as the CSE program.[181] But what can we take away from the SEC's ill-fated experiment? At the very least, it is useful as a plausibility check against some of the more aggressive claims of the anti-balkanization contingent. Most importantly, we should be skeptical of the ability of a single "umbrella regulator" (or a structurally similar arrangement) to effectively manage a complex, cross-border financial institution that has exposure to risks in a number of jurisdictions. Building upon the previous Subpart, which cast theoretical doubt on the wisdom of greater consolidation in assuring financial stability, the CSE example serves as a case-in-point — a cautionary tale against placing too much responsibility in the hands of a single regulator.

CONCLUSION

The Fed's new prudential standards for FBOs have attracted considerable attention in international banking and regulatory circles. The rules not only represent a substantial departure from the Basel III capital framework that was established in the wake of the financial crisis, but, to the extent they restrict an FBO's freedom to structure its U.S. operations, they also mark a change from the Fed's traditional "light touch"[182] approach to foreign banks. Unsurprisingly, reaction to the Proposed and Final Rules has been overwhelmingly negative. Observers predict that the IHC requirement, in particular, will promote the unhealthy fragmentation of global finance and instigate retaliatory measures by other regulators around the world. Further, they insist that the IHC requirement is misguided because it discriminates against FBOs in violation of established

181. *See* SCOTT & GELPERN, *supra* note 1, at 585.

182. *See, e.g.*, Mitchell Berman, *New Rules for Foreign Banks: What's at Stake?*, BUS. REV., First Quarter 2015, at 5, https://www.philadelphiafed.org/research-and-data/publications/business-review.

principles of international finance: national treatment and respect for home-country standards. At the core of these two criticisms is the assumption that balkanization is a trend that the Fed ought not to encourage — both in discharging its statutory obligations under § 165 and as the representative of a key player in global finance.

The central aim of this Note has been to push back on the premise that balkanization poses a threat to the safety of the global financial system. As against the near-consensus in the comment letters that balkanization is a cause for concern, the Note points out that the anti-balkanization line of reasoning suffers a major oversight. It ignores the fact that considerations militating against *balkanization* also happen to support greater *consolidation* (both of pools of capital and in the allocation of regulatory authority). But that preference for consolidation is in tension with the broadly accepted movement to end or downsize institutions deemed TBTF, giving rise to an ideological conflict that few commenters would be keen to acknowledge. In this context, then, the Fed's decision to push forward and adopt the IHC requirement deserves recognition for its boldness. It is too early to tell whether bearish predictions of retaliatory ring-fencing and rapid FBO pull-out of U.S. banking markets will materialize. But even if they do, financial stability *can* tolerate private costs to the world's largest and most profitable banks. What it cannot afford is a taxpayer-funded repeat of the SEC's doomed experiment in consolidated supervision. Perhaps the final takeaway from this study of cross-border banking regulation is the affirmation of the simple maxim that two regulators are better than one.

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