The New Foreign-Bank Paradigm:

Capturing First-Mover Advantage in the Face of Regulatory Headwinds

Karen Shaw Petrou
Managing Partner
Federal Financial Analytics, Inc.

Remarks Prepared for the

Institute of International Bankers
Washington, D. C.

March 4, 2013

It's a pleasure to speak again to so distinguished a group of bank executives, folks with the fortitude to run the U.S. operations for banks around the globe. This has never been easy, but now is a particularly challenging time for each of you. As the program Sally and her team have put together makes clear, policy developments are now the most critical driver of bank profitability. This is saying something given low interest rates and struggling economies around the world, but each of these factors is a macro driver across the spectrum of financial-services firms. What makes the difference between lackluster performance in key markets and above-the-pack success is, I believe, now largely determined by the extent to which management successfully navigates this extremely challenging regulatory environment.

How to do so here and now is the topic on which Sally has asked me to speak today. I'll lay out key challenges, of course including the Federal Reserve's new plans for you and your profits. Then, I'll outline critical decision points for individual banks to support your strategic planning at this critical time. For some of you, the new rules present so bleak a picture that it's a do-or-die moment; for others, there are glimmers of comparative advantage that may well warrant M&A, expansion or other take-charge decisions. This isn't a one-size-fits-all framework – the new regulatory standards are complex and their business impact for each of you depends on an array of factors, not least your parent bank's expectations for the U.S. and the rules that govern the firm back home. But, there is one strategic conclusion I think common across your sector: the rules are so substantive that victory will go to the bank with the courage to adopt a first-mover strategy. The challenge is, I think, so great and the opportunities so significant that banks content to comfort themselves with the "rapid-adaptor" approach will find themselves left by the roadside in the U.S. – a financial system that, for all its policy obstacles, remains one of the most vital to each of your banks for an array of lending, funding and capital-markets considerations.

The Lay of the Land

I'll turn shortly to a few decision points regarding a first-mover strategy. However, it's important first to put the bottom-line decision points into the broader policy context that affects each of you here today. The lay of the land requires GPS to navigate, but there's one landmark I know all of you fear blocks the road to continued competitiveness here: the Federal Reserve's proposed new standards for foreign banking organizations (FBOs).

You know the FBO proposal well – indeed, probably now by heart. And, I know IIB is working hard to craft a final rule that resolves the serious concerns this proposal sparked not just with all of you, but also with your home-country regulators. Of most concern, I know, is the new capital framework the FRB plans for FBOs forced to convert into intermediate holding companies and the *de facto* hikes in capital and liquidity for branch-

and-agency operations. The cost is breath-taking – for example, Goldman Sachs late last week calculated that Deutsche Bank would need to move $13 billion from Frankfurt to New York to meet the Fed's standards.

But, a word in the Fed's defense and, perhaps, also a strategic consideration for all of you here: the U.S. has a long history with foreign-bank branches that, backed by lax home-country capital standards, distort critical lending markets. Systemic risk may or may not ensue, but these unduly-advantaged competitors take the place of more prudent ones, posing serious challenges to all of you here from robust home-country regulatory regimes. We saw this in the early 1980s, when Japanese banks dominated the U.S. commercial real-estate market because their capital standards were too low. They lived very much to regret this, and Basel I was the price the industry around the world paid for their sins. Now, foreign state-owned banks are repeating history, igniting a run-up in New York and U.S. CRE in part due to their significant capital advantage. The Fed's rule is aimed at past history, but new worries could spark prudential and competitive problems not just for the FRB, but also for many of you. Thus, I think it important not only to push back against problematic FRB proposals, but also to work with the FRB and other regulators to craft a robust framework to prevent boom-bust cycles in sectors or, still worse the broader financial market. Been there, done that.

I know you are working to make the FBO rule as sensible as possible. In doing so, you will be advancing not just a balanced U.S. supervisory policy for FBOs, but also making a contribution to a free, fair and open cross-border market for banking and other financial services. Last week, I submitted testimony to the U. S. Trade Representative outlining my fears about resurgent protectionism in this area.[1] The Fed isn't the only offender here – other U.S. rules like pending extraterritorial standards and Volcker are also extremely problematic in this regard. But, the U.S. isn't the only major market developing new standards with the often-unintended effect of excluding offshore institutions no matter how safe and sound. The pending EU financial-transaction tax is a case in point, as are numerous other barriers to entry highlighted in another recent paper by my firm.[2]

As you worry about the FBO rule, worry too about this growing protectionism here in the U.S. and back home. First-mover advantage pertains only when an adroit bank can operate efficiently in selected national markets. If the door is blocked for reasons outside your control, first movers have nowhere to go. Your bank will have to go home, leaving the U.S. and global financial market very much the worse.

---

[1] Karen Shaw Petrou, International Services Agreement: Ensuring that Trade-in-Financial-Services Agreements Address Emerging Safety-and-Soundness Risk (Feb. 26, 2013), available at http://www.fedfin.com/images/stories/press_center/speeches/USTR%20International%20Services%20Agreement%20Testimony_Speech.pdf

[2] Federal Financial Analytics, Banking by Border: Preventing Prudence from Turning into Protection in the New Financial Regulatory and Trade Framework (Feb. 19, 2013), available at http://www.fedfin.com/images/stories/client_reports/Petrou_Banking_by_Border.pdf

Targets of Opportunity

I am optimistic that IIB's hard work on the FBO rule and other troubling initiatives will head off any resurgence of protectionism here and that cooler minds elsewhere will also rethink potential barriers to entry. This doesn't, though, mean the regulatory landscape will remain as is. Far from it. So, in the time remaining, I'd like to forecast the outcome on other strategic drivers in the policy arena, suggesting some decision points to consider.

- **M&A**: As you think through first-mover options, some of you will wish to sell operations in the U.S. and others here may look upon them with favor or even decide to fatten up their U.S. presence. After all, if you're forced into a holding company here, why not make the best of it? In doing so, I suggest you carefully consider the rapidly-changing framework governing bank M&A, especially for the largest firms. Even if your U.S. footprint is small, the FRB will take a hard, skeptical look at acquisitions here if your parent is a G-SIB or it has doubts about the robustness of your home-country regime. Little-bitty deals for worrisome parents might continue to avoid allegations that the U.S. is even more protectionist than most already allege, but substantive deals will require careful policy and political planning.

- **Securities Finance**: One way or the other, most of your banks are active in the tri-party repo market. Global regulators have been debating a series of fixes here, but the U.S. has here – as in so many other areas – decided to go out on its own. Those of you actively supporting REITs and other capital-markets operations should, I think, carefully consider how new restrictions will affect this growing business.

- **Risk Retention**: When you do, traditional lending might look like a better bet than it has in years, especially given the improvement in U.S. market conditions (I hope). Because of capital pressures at your parent and those to come from the FRB's FBO rule, you may contemplate lending in both the retail and corporate sector for subsequent packaging in asset-backed securities or structures like CLOs. When considering this option, think carefully through how U.S. risk-retention rules affect capital planning – a host of activities you might think immune from risk-retention actually come under the pending inter-agency rule. Loan transfers through branches might seem like the way out, but my guess is that the FRB will work hard to make risk retention comparable across the U.S. market, preventing exceptions some would argue provide undue competitive advantage to foreign banks and securities firms. Thus, U.S. operations need to be rethought in terms of portfolio capacity here or at home, as well as in light of other product opportunities.

You'll notice in this list I haven't mentioned the whoppers in the FBO rule or those contemplated by the Federal Reserve's systemic standards and the FDIC's emerging framework for the no-bailout orderly liquidation authority. These are vital defining factors too, but I suggest you think them through in concert with the issues noted above –

often less noticed – to construct a strategic plan with first-mover advantage based not only on these top-tier issues, but also the products and services you now offer or could quickly mobilize to build out a complete forward-looking plan, not just a regulatory risk management one. Of course, as you do so, governance is a vital consideration – in my view, U.S. rules will not skirt final standards on independent boards, qualified chief risk officers and full compliance with U.S. law and rule. Indeed, on the latter point, I would suggest the critical importance of rapid build-out of internal compliance and risk-management capability that looks ahead to a host of new rules. Although FBOs have so far been spared the worse in a spate of recently costly enforcement actions, you all know how hot the pressure is on U.S. regulators and the Department of Justice to make an example of someone soon.

Conclusion

But, process isn't the problem. All too often, industry fears about changing regulatory requirements focus on seeking certainty – which day must we file what? How much will building out a new MIS cost? Must we fill out lots more forms? And so forth.

These questions are substantive with regard to cost and burden – no longer negligible, as you know all too well. But, they're not strategic. Considering the new framework in context with your bank's comparative advantages here and back home, your top-tier strategic plan, the way U.S. growth can compensate for home-country weakness – these are the real drivers of decisions that can, I think, reveal significant opportunity for foreign banks doing business in the U.S., perhaps reducing the significant challenges sure to come in the new framework.

A foreign bank officer I know believes the future framework in the U.S. is a "new paradigm." She's right – and, with this revolution in banking here comes not just danger, but also real opportunity. The business model isn't the same here, but it isn't the same back home either because, for all the delay, uncertainty and confusion in the new regulatory paradigm, it's a sure bet. The only remaining question in my mind is if the new paradigm crosses borders to craft a free, fair and prudent banking market for cross-border banks like yours or if, as seems all too possible, we hide behind borders to protect short-term interests despite the long-term cost protectionism surely imposes.

Thank you. I look forward to discussing this further with you now and to answering your questions.