ENTRY INTO US CREDIT MARKETS BY SOVEREIGN WEALTH FUNDS AND ENTERPRISES CONTROLLED BY SOVEREIGN WEALTH FUNDS

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Recent developments have brought the structure of commercial lending platforms into sharp focus. The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act")[1] imposes new restrictions and requirements on foreign banking organizations that are bank holding companies or are treated as bank holding companies under US law. Meanwhile, collateralized loan obligation funds, as well as mutual funds that invest in commercial loans and loan participations, signal an active commercial credit market, with intense investor interest in exposures to quality commercial loans. At once a US commercial lending platform is highly desirable yet carries significant barriers to entry, particularly for non-US lenders. These factors may push the prevalent structure used by non-US entities for a commercial lending platform from US branches or bank subsidiaries to non-bank commercial finance firms.

Banking Platform

Bank charters have historically been the charter of choice for commercial lenders, as they offered low-cost deposit funding, access to the Federal Reserve discount window, and the ability to maximize a lending relationship by requiring deposit accounts to be held with the lender. Prior to the enactment of the Federal Deposit Insurance Corporation Improvement Act in 1991, foreign banks could apply for FDIC deposit insurance coverage for US-branches. Since that time, foreign banks wishing to fund loans with FDIC-insured deposits have been required to establish banks chartered by the US or a state.[2] Branch, agency and representative offices have also been a popular choice for non-US banking organizations to engage in commercial lending. This may be about to change.

The Dodd–Frank Act, and regulations being promulgated thereunder, are imposing increasing burdens on foreign banks that operate branches, agency offices and certain commercial lending companies in the US.[3] Some of these requirements can impact global operations, notwithstanding a limited scope of banking activities in the US.

For example, the requirement to submit a resolution plan (or living will) to US regulators is being applied to foreign banking organizations based upon global assets at the top-tier holding company level. A global organization with $50 billion or more in assets worldwide would subject itself to these living will requirements in the US with even a minimal branch or agency

[1] Pub. Law 111–203 (July 21, 2010).

[2] US branches of foreign banks are, however, authorized to offer wholesale deposits (i.e., deposits in excess of the standard maximum deposit insurance amount) that are not insured by the FDIC. 12 U.S.C. § 3104(b).

[3] The Federal Reserve Board's Regulation K makes a regulatorily important distinction between a "foreign bank" and a "foreign banking organization." A foreign bank is 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." A foreign banking organization includes, among other types of entities, a foreign bank that operates a branch, agency or commercial lending company subsidiary in the United States or controls a bank in the United States.

office presence in the US. The Volcker Rule, which restricts the ability of "banking entities" to engage in proprietary trading and certain private equity fund/hedge fund-related sponsorship and ownership activities, has as a regulatory trigger a US branch, agency or commercial lending company subsidiary of any foreign banking organization. In addition, federal regulators have recently proposed enhanced prudential standards for foreign banking organizations based on global assets which may include a requirement to establish an intermediate holding company for foreign banking organizations with more than $10 billion in assets in the US exclusive of branch and agency offices. Such intermediate holding companies would be subject to a number of regulatory requirements, including US regulatory capital requirements.

Securitization activities by US banks, including subsidiaries of foreign banking organizations, have also been impacted by the Dodd-Frank Act and other regulatory reform. While much-publicized risk retention rules will apply to all securitizations, regardless of sponsor, there are unique issues that impact banks and banking organizations specifically. For example, anticipated capital rules promise to impose new burdens in the securitization process for organizations subject to them.

Application of the Bank Holding Company Act to Foreign Banking Organizations

While some of the burdens of the Dodd-Frank Act and US bank regulation can be avoided by not operating an FDIC-insured depository institution in the US, significant burdens will nevertheless be imposed upon foreign banking organizations – i.e., foreign banks that operate branch offices, agency offices or commercial lending companies in the US.[4] Under the International Banking Act of 1978 (the "IBA"),[5] activities of affiliates of a foreign bank that operates a branch or agency office in the US or that controls or is under common control with a "commercial lending company" are subject to the restrictions of the Bank Holding Company Act of 1956 (the "BHC Act").[6]

Fortunately, not all commercial lenders are "commercial lending companies" under the IBA. The IBA defines a "commercial lending company" as a company "organized under the laws of any State of the United States, or the District of Columbia which [1] maintains credit balances incidental to or arising out of the exercise of banking powers *and* [2] engages in the business of making commercial loans."[7] Thus, a commercial lending company must engage in at least two activities: maintaining certain credit balances and making commercial loans.

Regulation K indicates that the kind of credit balances included within the definition of commercial lending company must be: "(1) incidental to, or arise out of the exercise of, other lawful banking powers; (2) to serve a specific purpose; (3) not solicited from the general public; (4) not used to pay routine operating expenses in the United States such as salaries, rent, or taxes; (5) withdrawn within a reasonable period of time after the specific purpose for which they were

[4] 12 U.S.C. § 3106(a).

[5] 12 U.S.C. § 3101 *et seq.*

[6] 12 U.S.C. § 1841 *et seq.* In addition to the new burdens described above, the BHC Act limits the activities of a bank holding company and its affiliates to those that are either closely related to banking or financial in nature.

[7] 12 U.S.C. § 3101(9).

placed has been accomplished; and (6) drawn upon in a manner reasonable in relation to the size and nature of the account."[8] These criteria indicate that a commercial lending company must be a vehicle for the exercise of other authorized banking powers, such as a company established under Article XII of the New York Banking Law.

Merely operating a commercial finance firm that does not offer deposits or maintain credit balances, however, would not be sufficient to subject a foreign bank to the BHC Act.[9] Deposits and credit balances are not common for commercial finance firms in the US. Thus, sovereign wealth funds and foreign banks that do not operate branch or agency offices in the US could engage in lending activities through the operation of a commercial finance firm and avoid becoming subject to the BHC Act.

Commercial Finance Firms

Commercial finance firms generally operate outside the scope of federal banking regulation because they do not offer federally insured deposits or otherwise rely upon deposit funding. Put another way, commercial finance firms do not enjoy the "deposit insurance subsidy" and therefore are not subjected to the burdens purportedly justified by such "subsidy."[10] While the limited scope of regulation is generally perceived as a positive to commercial finance firms, it comes at the cost of a significant source of low-cost funding.

As a result, commercial finance firms generally operate in a manner similar to residential mortgage lenders: using credit facilities with institutional lenders to fund loan originations, and repaying borrowings under such facilities with the proceeds of loan sales or securitizations. This translates into higher funding costs than banks, and greater exposure to counterparty risks through the reliance on lenders under credit facilities. These barriers to entry may make acquiring an existing commercial finance firm preferable to establishing a new one for many entrants into US credit markets.

Given the higher cost of the funds coupled with regulatory flexibility, commercial finance firms typically engage in more specialized, higher margin lending activities that cannot efficiently be conducted in a regulated banking environment. This is often the same niche served by foreign banks with lending activities in the US. Any foreign bank not operating in the US, however, would need to structure any commercial finance firm subsidiary carefully, in order to avoid issues of the commercial finance firm acting as an agency or representative office of the foreign bank.

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[8] 12 C.F.R. §§ 211.21(b), 211.21(g).

[9] *See* N.Y. Banking Dept. memorandum dated December 20, 2007 (http://www.dfs.ny.gov/legal/interpret_opinion/banking/lo071220.htm). Note, however, that a commercial finance firm that acts as a representative of a foreign banking organization could be deemed a representative office of the foreign banking organization. N.Y. Banking Dept. memorandum dated December 16, 2002 (http://www.dfs.ny.gov/legal/interpret_opinion/banking/lo021216.htm).

[10] It is, of course, possible that a commercial finance firm could be deemed a "covered financial company" under Section 201 of the Dodd-Frank Act (12 U.S.C. § 5381) pursuant to Section 203 of the Dodd-Frank Act (12 U.S.C. § 5383).

The Paradox of Regulation and "Shadow Banking"

The difference in regulation of commercial finance companies operated by foreign banking organizations versus branches, agencies and US banks operated by foreign banking organizations highlights the paradox of regulation: too much regulation can lead to a less regulated environment as industries move from heavily regulated activities to less regulated substitutes. Dodd-Frank Act provisions intended to address systemic risk may actually push many foreign banks outside of the US banking industry as they are applied to smaller institutions that could just as easily conduct their lending operations through a commercial finance firm. The value of any "subsidy" implied in the operation of a bank or banking office could easily be outweighed by the costs of compliance with new prudential standards – particularly for smaller operations in the US. While commercial finance firms do not present the same risks to taxpayers or economies as banking organizations, regulated banks may have to compete with them in certain markets.