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HIGHLIGHTS

Page

LEGISLATIVE

Both the House and Senate passed versions of banking legislation which included the Foreign Bank Supervision Enhancement Act; the Senate version of the legislation raised national treatment issues for international banks in the interstate banking context....2

The Institute testified before New York State's Advisory Committee on Transnational Banking concerning the regulation of international banks and maintained that U.S. and international banks should be permitted to continue to operate around the world through direct branches and agencies....4

REGULATORY

The SEC adopted the approach advocated by the Institute in final Rule 3a-6 which exempts international banks from the definition of "investment company" for all purposes under the Investment Company Act of 1940....5

The New York State Attorney General issued a ruling under the Martin Act that branches and agencies of international banks qualify for the bank exemption from registration as broker-dealers; the Institute worked with the New York State Banking Department to secure the ruling....6

TAX

The Institute is preparing comments on important IRS proposals concerning foreign reporting and record maintenance rules and tax treatment of bad debts....7

Mergers, Acquisitions and Expansions....8

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CONGRESS MOVES TO COMPLETE BANKING LEGISLATION

Executive Summary

Under pressure to recapitalize the Bank Insurance Fund (BIF) before Congress recesses for the remainder of the year, the House and Senate concluded debate on financial modernization legislation and passed different versions of banking legislation. After twice voting down broader bills earlier in the month, on November 21st the House adopted a bill (H.R. 3768) which includes the Foreign Bank Supervision Enhancement Act. On the same day, the Senate adopted by voice vote the Senate Banking Committee bill (S.543) with important amendments. A Manager's Amendment eliminated the Glass-Steagall changes that would have permitted affiliations between banks and full service securities firms. The Senate also adopted an amendment offered by Senator Wendell Ford (D-KY) which permits interstate branching by domestic banks but also raises severe national treatment issues for international banks because the amendment would permit international banks to utilize the new interstate branching powers only through a domestic bank subsidiary.

Efforts in Congress to adopt comprehensive financial modernization legislation this year have been defeated. The House passed H.R. 3768, a bill which contained no provisions permitting new affiliations or powers for banks and no liberalization of interstate banking provisions. The principal elements of the legislation included the BIF recapitalization, deposit insurance changes including prompt regulatory intervention for failing depository institutions and the Foreign Bank Supervision Enhancement Act, legislation supported by the Federal Reserve which would strengthen the regulation and supervision of branches and agencies of international banks.

The first legislation to reach the House floor earlier in the month contained the Gonzalez/Dingell compromise which permitted affiliations between banking and securities firms subject to strict firewalls and limited existing insurance activities of bank holding companies and also contained interstate branching authority. While the Gonzalez/Dingell compromise and the interstate proposal were separately adopted by the House, the complete package was rejected by the House by a large margin after the Treasury and large U.S. banks withdrew their support from the bill, arguing that the bill did not constitute progressive reform of the financial services industry. Shortly after the defeat of H.R. 6, the House Banking Committee reported out another bill, H.R. 2094, which retained only the Banking Committee's original proposals on the BIF recapitalization and

prompt regulatory intervention. The House adopted a controversial amendment offered by Rep. Chalmers Wylie (R-OH) which included interstate branching authority and restrictions on existing insurance and real estate activities. The package as a whole was also defeated on the floor.

Even as broad legislation was being defeated in the House, the Senate began debate on S. 543, the comprehensive modernization legislation approved by the Senate Banking Committee. In light of the decisive defeat in the House of Glass-Steagall reform, Senators Riegle and Garn agreed with the Treasury Department to sponsor a Managers Amendment deleting these provisions from the Senate bill. As part of that amendment related provisions affecting international banks such as termination of grandfathered securities arrangements when securities activities are authorized for U.S. banks and extraterritorial application of the firewalls were deleted. The amended Senate bill retained, however, the sections requiring Treasury in consultation with others to conduct a twelve month study on whether international banks should generally be required to operate in the U.S. through subsidiaries rather than branches, requiring the Federal Reserve and Treasury to develop guidelines for evaluating an international bank's capital and requiring that the Federal Reserve consult with Treasury on capital equivalency in connection with international bank activities.

In addition, the Senate passed an amendment sponsored by Senator Wendell Ford (D-KY) which permits national and state banks to establish interstate branches if a host state passes "opt in" legislation permitting such branching. However, the Ford Amendment raised national treatment issues for international banks because it does not remove the Federal law prohibition on branching outside a home state. International banks would be able to take advantage of the new interstate branching powers to branch outside of their home state only through a U.S. bank subsidiary.

The Senate adopted a number of other amendments, including the proposal by Senator Alfonse D'Amato (R-N.Y.) to impose a cap on credit card interest rates, a compromise amendment limiting the insurance powers of banks and two amendments by Senator Jesse Helms (R.-N.C.) prohibiting foreign persons including international banks from doing business in the United States if they finance directly or indirectly the acquisition by other countries of biological or chemical weapons or the production of goods by "forced labor" in the People's Republic of China.

INSTITUTE TESTIFIES AT ADVISORY COMMITTEE HEARING

Executive Summary

The Institute was the lead witness at a public hearing of New York Superintendent Cephas' Advisory Committee on Transnational Banking Institutions. The Institute testified that the examination and supervision of branches and agencies of international banks was equivalent to that of U.S. banks and that there was no need for major changes in the regulatory system. The Institute also emphasized the importance of consolidated supervision by home country regulators of international banks but maintained that international banks should be permitted to operate transnationally through branches and agencies.

The Advisory Committee on Transnational Banking Institutions established by New York State held a public hearing on November 19th to hear testimony on its four major areas of study concerning international banks operating in New York: standards for entry, forms of organization, examination and supervision and finally exit and liquidation. The Institute and other parties from the private sector testified at the hearing.

The Institute stated that the U.S. system had generally worked well and major changes were not necessary. Chairman de Weck recalled that the New York State Banking Department pioneered the regulation and supervision of branches and agencies of international banks and that Congress in the International Banking Act of 1978 and other state legislatures had built on New York's experience in developing their frameworks for regulation. Noting that the Federal Reserve Bank of New York had increased the frequency of its examination of branches and agencies, the Institute cited the close coordination between the Federal Reserve and the State Banking Department as a model for nationwide coordination between federal and state banking authorities.

Referring to the reports of worldwide fraud and deliberate deception of regulators by the Bank of Credit and Commerce International (BCCI), the Institute stated that the lesson to be drawn from the scandal was the importance of consolidated supervision of transnational banking organizations by their home country regulators. Most bank regulators in major banking centers around the world carefully regulate and supervise their banks on a worldwide basis, and while no regulatory system can ensure that efforts to mislead regulators will not occur, consolidated home country supervision could help decrease the opportunity for fraud.

In their questions, the members of the Committee explored the concept of consolidated supervision and how it would apply to banks and their holding companies. Committee Chairman John Heimann raised the ques-

tion of whether New York should adopt minimum standards of consolidated supervision as a condition of entry. Mr. de Weck recommended that international standards be developed in cooperation with other countries through an international forum such as the Supervisory Committee of the Bank for International Settlements.

The Institute also testified that neither the BCCI affair nor other recent developments justify any changes to the ways in which international or American banks operate around the world. Banks operate wholesale banking business around the world through branches so that the capital of the global bank stands behind the transactions. The Institute also noted that there would be no tangible supervisory benefit to requiring banks to operate through subsidiaries rather than branches, and the fragmentation of the capital of international banks would diminish their ability to provide financing to U.S. customers and could cause capital dependent activities to gravitate to other financial centers.

SEC ISSUES FINAL RULE EXEMPTING INTERNATIONAL BANKS FROM INVESTMENT COMPANY ACT

Executive Summary

The Securities and Exchange Commission (SEC) adopted final Rule 3a-6 under the Investment Company Act of 1940 which excepts international banks, foreign insurance companies and their holding companies from the definition of "investment company" for all purposes under the Act. As a result, international banks will be able to sell their debt and equity securities in the United States without first seeking an exemption from registration under the Act. In the final rule, the SEC adopted the comprehensive approach advocated by the Institute and others which treats international banks as the equivalent of domestic banks.

In order to sell their securities in the United States, international banks have in the past been required first to obtain exemptive orders from the registration requirements of the Investment Company Act of 1940 (the "Act") because the SEC treated international banks as investment companies. Since 1979, the SEC has granted individual international banks exemptive orders under section 6(c) of the Act to permit them to sell their securities. More recently, the SEC codified the exemption in connection with the issuance of debt securities in Rule 6c-9 and in 1990 proposed to extend the scope of the rule to equity securities of international banks.

The approach advocated by the Institute and others, and adopted by the SEC, was to exclude from the definition of investment company, for all

purposes under the Act, an international bank which is organized under the laws of a country other than the United States, is regulated by that country and is "engaged substantially" in commercial banking activity. Rule 3a-6 defines "engaged substantially" as regularly engaged in, and deriving a substantial portion of its business from, extending commercial and other types of credit and accepting demand and other types of deposits as customary for commercial banks from that country.

The SEC also adopted a companion amendment to Rule 3a-5 which exempts finance subsidiaries of international banks from the Act provided they meet the conditions of the rule designed to ensure that the finance subsidiary functions primarily as a conduit for financing purposes of the international bank. Together with Rule 3a-6, an international bank, its parent holding company or a finance subsidiary can now sell its debt or equity securities in the United States without the cost and delay of seeking an exemption from the SEC under the Act.

As sought by the Institute, the SEC also pared back the paperwork burdens associated with relying on the exemption under old Rule 6c-9. Rather than having to file Form N-6C9 and obtaining signatures of the international bank's Board of Directors in order to rely on the exemption, the new rule only requires a filing if the sale of securities is being registered under the Securities Act of 1933, and in any event members of the Board of Directors will not be required to sign the new form.

NEW YORK ATTORNEY GENERAL ISSUES NO-ACTION LETTER UNDER THE MARTIN ACT

Executive Summary

As requested by the Institute to the New York State Banking Department, the New York Attorney General has issued a "no-action" letter that New York State-licensed branches and agencies of international banks do not have to register as broker/dealers with New York State. This ruling would treat branches and agencies of international banks in the same manner as domestic banks which enjoy a statutory exemption from registration under the Martin Act.

New York's Martin Act establishes registration requirements for securities brokers and dealers operating in New York but exempts banks chartered by New York State and national banks operating in New York from these registration requirements. A large number of branches and agencies of international banks conduct securities brokerage activities in reliance on the informal position of the New York Attorney General's office that they were covered by the bank exemption. Recently, however,

the New York Attorney General's office had raised some questions about this interpretation, leading to uncertainties among international banks and their counsel as to whether they were in compliance with the statute or whether they would need to register as broker-dealers.

The Institute wrote the New York State Banking Department about this issue and secured assistance in explaining to the Attorney General's office the scope and nature of the Banking Department's regulation of branches and agencies of international banks. While the State Banking Department and the Institute believed the regulation was comparable to that of domestic banks, the State Banking Department agreed to ask in its first day letter for certain additional material concerning the international bank's securities operations and to review that information as part of its routine examination or visitation of a branch or agency. Based on that undertaking, the Attorney General's Office issued the "no-action" ruling.

INSTITUTE READIES COMMENTS ON SECTION 6038C, BAD DEBT REGULATIONS

Executive Summary

The Institute will submit comments to the IRS in the near future on two ongoing tax issues that will have a significant impact on the international banking community: the foreign reporting and record maintenance rules applicable to international banks under section 6038C and the proposed rules that generally conform the regulatory and tax treatment of bad debt. The Institute's comments on section 6038C will generally seek to minimize unnecessary burdens on branches and agencies. The Institute supports the objectives of the proposed rules on bad debts, but is seeking modifications to ensure that the rules take account of the special circumstances of international banks.

Following up on its meeting with IRS staff, the Institute is finalizing a comment to the IRS addressing the forthcoming regulations under section 6038C, which authorizes the IRS to impose specific reporting and record maintenance requirements on U.S. branches and agencies of international banks. The IRS is expected to issue these regulations in draft form sometime next year.

The Institute comment will urge the IRS to make the annual reporting requirements as streamlined as possible. Extensive reporting requirements would be extremely burdensome and, in the Institute's view, would not be needed to enable the IRS to perform its proper functions. The Institute comment will also make recommendations as to the type of record maintenance requirements with which international banks could