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The Institute's mission is to solve the many special legislative, regulatory and tax issues confronting **internationally headquartered** financial institutions that engage in banking, securities and/or insurance activities in the United States.

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INSTITUTE SUBMITS COMMENT LETTER SUPPORTING NEW YORK'S PROPOSED REVISIONS TO ITS ASSET PLEDGE REQUIREMENT AND SUGGESTING OTHER CONSTRUCTIVE CHANGES

The Institute submitted a comment letter expressing strong support for the New York State Banking Department's proposed revisions to its asset pledge requirement, which would greatly reduce the approximately \$35 billion of collateral currently pledged by New York-licensed branches and agencies of international banks. The proposed revisions, which are consistent with the policy recommendations made by the Institute during the last two years, were publicly released by the Banking Department on June 3rd and comments were due by August 2nd. (The comment letter is available on the Institute's web site at www.iib.org/8-2AssetPledge-CL.pdf and the proposal itself is available on the Banking Department's web site at www.banking.state.ny.us/propregu.htm.)

At the same time, the Institute is continuing its efforts in support of the Comptroller of the Currency's amendment, included in regulatory relief legislation pending in Congress, that would eliminate the mandatory 5% capital equivalency deposit (CED) requirement applicable to federal branches and agencies of international banks.

While the Institute strongly supports the New York Banking Department's initiative on asset pledge reform, there are certain aspects of the proposal that raise concerns, such as the prohibition against pledging same-country assets and the eligibility criteria to qualify for more advantageous treatment. The Institute's comment letter suggests several substantive changes to address these and other issues, as further discussed below.

The draft proposal would amend New York's asset pledge requirement by, among other things, lowering the basic requirement from 5% of total third-party liabilities (excluding liabilities booked at a branch or agency's International Banking Facility) to 1% of all third-party liabilities on the branch's or agency's balance sheet. In addition, well-managed and well-capitalized institutions would be allowed to use an expanded list of eligible assets to cover up to one half of the

required pledge which would be capped for such institutions at \$400 million.

In its comment letter the Institute offered the following suggestions regarding the various aspects of the proposal:

Capping the Amount of the Asset Pledge

The Institute believes the proposed cap of \$400 million is unnecessarily high and suggested that an appropriate amount would be \$50 million (and, in any event, no more than \$100 million), a level consistent with changes adopted or under consideration by other regulators.

Eligibility Standards for More Advantageous Treatment

In lieu of the proposed "well capitalized and well managed" standard, the Institute suggested the application of a "well rated" standard that would be based on (i) a composite ROCA (Risk Management, Operational Controls, Compliance and Asset Quality) rating for the New York office(s) of "1" or "2" and (ii) there being no formal supervisory, regulatory or enforcement action outstanding against the New York office(s). The Institute pointed out that a composite ROCA rating of "1" or "2" indicates the overall condition of the branch or agency is sound and provides more than adequate assurance that there would be no adverse result in making such branch or agency eligible for more advantageous treatment.

Were the determination made that the eligibility criteria also should in some fashion explicitly take into account a bank's overall condition, the Institute suggested that reference be made to the "Strength of Support Assessment" ("SOSA") rating and that a bank would be eligible if it has a SOSA rating of "1" or "2". In any event, the Institute said it is not necessary to apply a specific minimum capital requirement such as the proposed "well capitalized" standard.

Calculation of the Asset Pledge Requirement

The Institute expressed support for the approach adopted in the proposal that would permit institutions to calculate their asset pledge requirement using a backward-looking average, based on the daily average of total third-party liabilities for the previous calendar month. The Institute suggested, however, the use of the average liabilities on each Wednesday during the previous month rather than a daily average and further suggested that the required pledge amount should be due on the fifth business day (instead of the second) immediately following the end of the period for which the calculation is made. In addition, the Institute suggested that well rated institutions that pledge the maximum amount under the cap should be exempt from the normal reporting requirement.

Additional Assets Eligible for Deposit

The Institute supported the expansion of the list of eligible pledged assets but suggested that the ability to utilize other types of assets should not be conditioned on whether an international bank qualifies for the asset pledge cap. Instead, the Institute said the proposal should be revised to permit all branches and agencies to pledge assets not otherwise listed in Section 322.2 of the asset pledge regulation that are eligible, or subsequently become eligible, as collateral at the Federal Reserve Discount Window, subject to several restrictions (for example, that they would be dollar-denominated).

Restrictions on Same-Country Assets

The proposal would prohibit a branch or agency from pledging securities or obligations of an entity located or domiciled in, or any governmental entity of, the home country of the parent bank (with respect to certificates of deposits issued by entities domiciled in a bank's home country, this ban would take effect one year after the adoption of the proposal). The Institute suggested that the proposal be revised to permit the pledge of same country assets subject to a cap (50% of total pledged assets was suggested as reasonable), with retention of a one-year transition period for any certificates of deposit that become ineligible.

Exclusion of Additional Liabilities from the Calculation of the Amount of Assets Required to be Pledged

In addition to the existing exclusion applying to securities repurchase agreements (repos), the Institute suggested that the proposal be revised to also exclude liabilities arising from any other type of qualified financial contract covered under Section 618-a.2(d) of the Banking Law – including, for example, short sales and swaps – from the calculation of the asset pledge requirement. The Institute further suggested that deposit liabilities that are collateralized in accordance with applicable federal, state or local law should also be excluded from the calculation of the asset pledge.

TREASURY PROVIDES INTERIM GUIDANCE ON COMPLIANCE WITH ENHANCED DUE DILIGENCE PROCEDURES FOR CORRESPONDENT AND PRIVATE BANKING ACCOUNTS UNDER SECTION 312 OF THE USA PATRIOT ACT

The Treasury Department and its Financial Crimes Enforcement Network (“FinCEN”) published on July 19th interim guidance regarding compliance with Section 312 of the USA PATRIOT Act (the Interim Guidance is available on the Treasury’s web site at www.ustreas.gov/press/releases/docs/interim.pdf).

Section 312, which became effective on July 23rd, requires many U.S. financial institutions (including U.S. banks and broker-dealers and U.S. branches and agencies of international banks) to establish due diligence and enhanced due diligence procedures for correspondent and private banking accounts provided to certain non-U.S. customers.

Treasury and FinCEN published the Interim Guidance because FinCEN will not publish final regulations implementing Section 312 until well after the July 23rd statutory effective date of Section 312. In addition, industry comment letters regarding the proposed regulations published by FinCEN in May raised numerous significant issues. On July 1, 2002, the Institute joined ten other trade organizations in a cross-industry comment letter regarding the Section 312 regulations and submitted its own comment letter addressing issues of particular importance to international banks. (The Institute's comment letter is available on our web site at www.iib.org/Section-312_Comment_Letter.pdf.)

The principal focus of the Institute's comment letter relates to the appropriate scope of an exception from the enhanced due diligence requirements of Section 312 for correspondent accounts maintained by non-U.S. banking organizations that are subject to comprehensive consolidated supervision (CCS). The Institute's comment letter also addresses the proposed definition of "beneficial ownership interest" for purposes of private banking due diligence.

Representatives of the Institute subsequently held meetings on July 10th with the Treasury Department, Federal Reserve Board and Office of the Comptroller of the Currency, during which we discussed the issues raised in the Institute's comment letter.

The Institute's comment letter suggested several ways in which the proposed CCS exception should be expanded, consistent with the policies underlying the proposed exception. For example, the Institute argued that the CCS exception should apply to bank subsidiaries (and international banks themselves) that may operate under an offshore license. The Institute also argued that the CCS exception should apply not only to offshore operations but to operations in countries designated by the Financial Action Task Force ("FATF") as non-cooperative with anti-money laundering efforts (as for example, a European bank's branch in Moscow), provided the international bank meets the relevant criteria for the CCS exception.

Another important point that the Institute raised in its July 1st comment letter, and discussed in its meetings on July 10th, is the fact that the list of countries that the Federal Reserve Board has determined to be subject to CCS (and thus the list of countries that would qualify for the enhanced due diligence exception in FinCEN's proposed regulations) is arbitrarily defined by the list of countries in which international banks happen to have applied for Federal Reserve Board approval under the International Banking Act since 1991. As FinCEN noted in its proposal, these countries are Argentina, Australia, Austria, Belgium, Brazil, Canada, Chile, France, Germany, Greece, Hong Kong Special Administrative Region, Israel, Italy, Ireland, Japan, Korea, Mexico, the Netherlands, Portugal, Spain, Switzerland, Taiwan, Turkey, and the United Kingdom.

This list of countries would not include all FATF-member countries; it would exclude Denmark, Finland, Iceland, Luxembourg, New Zealand, Norway, Singapore and Sweden. Thus, for example, the Cayman Islands booking location of a Swedish bank would be subject to enhanced due diligence by U.S. banks, while the Cayman Islands booking location of an Australian, Belgian, etc. bank would not. In this regard, the Institute's comment letter had suggested that FinCEN's regulations under Section 312 create a mechanism whereby Treasury could make a determination to add to the list of countries that would qualify for the exception.

In a July 12th follow-up letter to Treasury, the Institute proposed that all members of FATF should automatically qualify for the enhanced due diligence exception (i.e., regardless of whether the Federal Reserve Board may have approved an application under the International Banking Act for a bank headquartered in a particular FATF-member country).

Meanwhile, the basic approach of the Treasury's Interim Guidance appears designed to defer, to the extent possible, to

existing industry best practices relating to due diligence for correspondent accounts and private banking accounts pending release of a final rule under Section 312.

The Interim Guidance does not address whether FinCEN intends to adopt the Institute's suggested changes to its proposed regulations under Section 312. However, the Interim Guidance does contemplate that the application of enhanced due diligence may take into account the U.S. correspondent's overall risk assessment regarding an institution that falls within the categories of institutions identified as high-risk in Section 312. This appears to suggest that U.S. correspondents should have the flexibility to make risk assessments that would be consistent with the exceptions proposed by the Institute in its submissions to Treasury and FinCEN.

In this regard, FinCEN's proposed regulations specifically exempted offshore branches of banks from jurisdictions that the Federal Reserve has determined provide comprehensive consolidated supervision. Although the Interim Guidance does not address the scope of this exception, it also does not indicate that Treasury or FinCEN views the exception as inappropriate from a risk-assessment standpoint. In addition, the

New York Clearing House Association's guidelines (which are cited in the Interim Guidance as a source of best practices), contain a "regulated affiliate" exception from the scope of the recommended enhanced due diligence procedures for offshore banks.

The Interim Guidance provides important advice regarding how U.S. correspondents may implement the statutory requirements of Section 312 pending release of final regulations by FinCEN. However, the Interim Guidance is only temporary and does not necessarily indicate how Treasury will interpret Section 312 for purposes of FinCEN's final regulations. The issues relating to the scope of Section 312's enhanced due diligence requirements raised by the Institute in its submissions to Treasury will still need to be addressed in those final regulations.

The Institute therefore continues to encourage national and regional banking associations to urge their banking regulators and other governmental authorities to contact Treasury, as well as the Federal Reserve Board and the Comptroller of the Currency, to emphasize the importance of the points raised in the Institute's submissions.

INSTITUTE MEETS WITH SENIOR TREASURY OFFICIALS REGARDING INTEREST EXPENSE AND EARNINGS STRIPPING ISSUES

On July 25th, the Institute met with U.S. Treasury Assistant Secretary (International Affairs) Randy Quarles, as well as with Acting Assistant Secretary (Tax Policy) Pamela Olson and International Tax Counsel Barbara Angus, to discuss two tax issues of concern to international banks and their impact on capital investment flows into the United States – (i) the continuing problems that international banks face in determining their deductible interest expense under Treasury regulation section 1.882-5 and (ii) the proposed changes to the "earnings stripping" rules under Internal Revenue Code section 163(j) which, if enacted into law, may restrict the interest expense deductions of U.S. subsidiaries and branches of

international banks and other non-U.S. multinational groups.

The Institute's assessment is that continued persistent lobbying efforts will be necessary in order to prevail on both of these important issues. The tax officials at the Treasury Department appear to have institutionally formed reservations regarding the feasibility of devising a solution to the problems under Treasury regulation section 1.882-5. The earnings stripping proposal, which has already been harshly criticized by a broad spectrum of non-U.S. based multinationals, is closely bound up with the highly charged political issue of how to address the issues presented by "corporate inversions" (where

U.S. based multinationals move their tax domicile to a tax haven such as Bermuda).

Deductible Interest Expense Under Treasury Regulation Section 1.882-5

The Institute argued before the Treasury officials that the existing tax rules for determining an international bank's interest expense create anti-competitive disincentives for such banks to expand their lending and other business operations in the United States. As a result, at least some major banks have concluded that at the margin it is more profitable to expand their non-U.S. operations, and have diverted capital resources away from the United States. This argument was punctuated by the testimony of senior bankers from several member banks regarding the impact of these rules on the business decisions of their banks.

The Institute contended that the 93% fixed ratio of worldwide liabilities to assets imputes too much capital (7% capital to the U.S. branch) for many banks. While actual capitalization levels of international banks vary, for many banks, this high level of imputed capital exceeds – often by a significant amount – the actual ratio of their worldwide liabilities to worldwide assets. When the fixed ratio was reduced from 95% to 93% in 1996 – resulting in a 40% increase of imputed capital, from 5% to 7% – Treasury and the IRS explained that the intention was to encourage international banks to use the economically more accurate actual ratio, and to view the fixed ratio as a “safe harbor” for those banks that were unwilling to elect the actual ratio. However, because of the uncertainties and exposures described below under the actual ratio, many banks have felt compelled to elect the fixed ratio.

Each percentage point disparity between the fixed ratio and a bank's actual ratio can cost the bank millions of dollars in taxes. For example, a U.S. branch with \$20 billion of assets and an actual ratio of 95% that is forced to elect the 93% fixed ratio at a time when its cost of funds is 4% will suffer an increased tax cost of \$5.6 million each year (as a result of losing \$16 million of interest expense, at a 35% tax rate, on a \$400 million reduction in liabilities).

Accordingly, the Institute argued that if the Treasury Department and the IRS are unwilling to increase the fixed ratio, this unintended burden of the regulation needs to be redressed by clarifying and refining the actual ratio to make it more workable and accessible to more banks.

In particular, the Institute pointed out the compliance and audit problems that arise because the actual ratio must be determined in accordance with U.S. tax principles. However, U.S. tax principles differ in significant respects from the accounting methods and financial reporting systems utilized by many international banks, including with respect to basic items such as (i) loan loss reserves, loan restructuring and interest accruals, (ii) asset valuations, (iii) the treatment of securities repo transactions, swaps, foreign exchange transactions and derivatives, (iv) the use of mark-to-market rules and (v) retirement allowances.

Applied literally, this tax regulation requires a bank to make specific adjustments to virtually each of the foregoing items appearing on its global financial statements in order to restate those items in accordance with U.S. tax principles. Thus, in the absence of practical guidance by the IRS, it would be prohibitively costly and unworkable for a bank to have to overhaul its financial reporting systems around the world to gather and report information with respect to its *non-U.S.* businesses in conformity with U.S. tax principles. Moreover, banks that elect the actual ratio risk exposure to potentially significant audit adjustments because of the impracticality of making all the necessary conversions to U.S. tax principles. Finally, there is a sense that this tax regulation violates basic principles of international comity. *Certainly U.S. banks would be unable and unwilling to make similar adjustments to their worldwide financial statements if a European country were to adopt rules similar to regulation section 1.882-5.*

The Institute urged the Treasury Department to provide a more practical basis for applying regulation section 1.882-5, by accepting the audited worldwide financial statements prepared in accordance with home country GAAP as the starting point for computing the actual ratio, with discrete adjustments (i) to restate material liabilities in accordance with U.S. tax principles (for example, in

the case of perpetual debt that is issued for regulatory capital reasons) and (ii) to permit taxpayers to appropriately net integrated financial positions, including securities repos, securities loans and certain offsetting derivatives positions. The Institute suggested that this approach is in line with the most current thinking on a tax policy level at the Treasury Department, as reflected in the OECD's recent discussion draft on the taxation of bank branches.

Proposed Changes to the Earnings Stripping Rules Under Code Section 163(j)

Proposed tax legislation being considered by the Ways & Means Committee of the U.S. House of Representatives may, if enacted into law, restrict the interest expense deductions of U.S. subsidiaries and branches of international banks and other non-U.S. multinational groups. The proposal would significantly tighten the "earnings stripping" rules of Internal Revenue Code section 163(j). This proposal is generally supported by the Bush Administration as part of a broad approach to address the problems of "corporate inversions" as well as a more general perception that U.S.-based multinationals are at a competitive disadvantage to foreign-based multinationals operating in the United States.

The proposal is most likely to affect international banks and other non-U.S. multinationals that have capitalized their U.S. subsidiaries with affiliated company loans (in addition to equity) or that guarantee third-party borrowings by their U.S. subsidiaries. However, the proposal may also affect the funding decisions of U.S. branches.

Among other changes tightening section 163(j), the proposal would disallow a deduction for interest paid by a U.S. subsidiary or branch to non-

U.S. affiliates (or in respect of debt that is guaranteed by a non-U.S. affiliate) to the extent the U.S. subsidiary group is more highly leveraged than the multinational's worldwide affiliated group (*regardless* of whether the U.S. subsidiary group has net interest expense). This computation would be based on a comparison of the debt-to-total-assets ratio of the U.S. subsidiary group to the debt-to-total-assets ratio of the worldwide affiliated group. All members of the group would be treated as part of a single corporation, except that separate computations would be made for sub-groups consisting of U.S. and non-U.S. financial institutions (including banks, finance companies, securities firms and insurance companies) in recognition of their higher leverage. Worldwide assets would be valued using their basis under U.S. tax principles.

The Institute argued to the Treasury officials that, in addition to the general objections being raised by non-U.S. based multinationals, this proposal has a particularly harsh impact on financial institutions because it ignores the different leverage ratios under which various types of financial institutions operate. For example, it would force a disallowance of "excess" interest on affiliate loans of a U.S. securities dealer subsidiary that is leveraged at 99-to-1, in conformity with industry standards, as a result of a significant portfolio of repoed Treasury securities, merely because the worldwide banking group has a lower leverage ratio consistent with banking industry standards.

The Institute also objected to this proposal on the ground that it imposes on virtually every non-U.S. multinational the impractical and extremely burdensome requirement of computing an actual ratio of worldwide liabilities to assets on a group-wide basis in accordance with U.S. tax principles, and goes even further than the actual ratio computation under regulation section 1.882-5.