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HIGHLIGHTS

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	<u>Page</u>
Institute Meets with European Commission Officials on Proposed Exemption for International Banks from Section 402 of the Sarbanes-Oxley Act.....	2
Institute Writes Treasury Secretary O'Neill on Due Diligence Requirements Under Section 312 of the USA Patriot Act.....	3
Institute Submits Comment Letter on New York State Banking Department's Asset Pledge Proposal.....	4
Federal Reserve Approves Partial Application of Regulation W to Uninsured Branches of International Banks.....	5
Institute Submits Comment Letter on Federal Reserve's Proposed Changes to Annual Report on Form FR Y-7.....	6
Institute Tax Submission to Treasury, Congressional Staff Outlines Concerns Over Proposed Changes in "Earnings Stripping" Rules.....	7
Institute Submits Comment Letter on IRS Revised Proposed Regulations on Reporting of Bank Deposit Interest to Nonresident Alien Individuals.....	8

TAX

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.

299 Park Avenue, 17th Floor, New York, N.Y. 10171

Telephone: (212) 421-1611 Facsimile: (212) 421-1119

E-Mail: IIB@IIB.ORG <http://www.iib.org>

Robert B. Mills, Chairman Lawrence R. Uhlick, Executive Director

INSTITUTE MEETS WITH EUROPEAN COMMISSION OFFICIALS ON PROPOSED EXEMPTION FOR INTERNATIONAL BANKS FROM SECTION 402 OF THE SARBANES-OXLEY ACT

Executive Summary

In recent meetings with European Commission officials, the Institute discussed its proposed exemption for international banks from Section 402 of the Sarbanes-Oxley Act, which prohibits public companies from making personal loans to their directors and executive officers. EC officials share our concern in solving this matter promptly. The Institute's proposed exemption for international banks is comparable to the exemption already granted under the Act to FDIC-insured U.S. banks. SEC Corporate Finance Director Alan L. Beller was quoted last month in the *Financial Times* as saying the SEC is "mindful" of the unequal treatment of international banks vis-à-vis domestic banks, and the Institute is continuing discussions on this issue with the SEC as well as with the Treasury and the Federal Reserve.

As previously reported, the Institute urged the SEC in its August 16th submission to adopt a two-part exemption from Section 402 for international banks, in deference to international bank supervisory standards and to ensure national treatment for international banks. The Institute also sent letters to Federal Reserve Chairman Greenspan and Treasury Secretary O'Neill urging their support for the Institute's proposed exemption. (the submission and letters are available on the Institute's web site at www.iib.org/member/Sarbanes-Oxley/). In response, Treasury has communicated its view to the SEC that the Institute's concerns regarding the treatment of international banks under Section 402 merit prompt attention.

The Section 402 prohibition on loans to directors and executive officers applies to all issuers, including non-U.S. issuers, that have securities registered under the Securities Exchange Act of 1934 or that are required to file reports with the SEC under the Exchange Act. Thus, international banks or their parent companies that have ADRs listed on a U.S. exchange are subject to Section 402.

The prohibition is subject to certain limited exceptions that apply to both U.S. and non-U.S.

issuers. However, an important exception for banking institutions applies only to U.S. banks and does not apply to internationally headquartered banks. Specifically, loans made by FDIC-insured U.S. depository institutions are not subject to the prohibition if they are subject to U.S. insider lending restrictions (such as the Federal Reserve Board's Regulation O) which generally do not apply to non-U.S. banks.

Under the Institute's proposed exemption, international banks from jurisdictions that the Federal Reserve Board has determined provide comprehensive consolidated supervision would be exempt from Section 402. International banks from other jurisdictions would be permitted to make loans without regard to the prohibitions in Section 402 if the loans comply with the core principles of U.S. bank insider lending regulations.

Concerns have also been expressed about other provisions in the Sarbanes-Oxley Act of importance to international banks, such as the independent audit committee requirement of Section 301.

INSTITUTE WRITES TREASURY SECRETARY O'NEILL ON DUE DILIGENCE REQUIREMENTS UNDER SECTION 312 OF THE USA PATRIOT ACT

Executive Summary

The Institute wrote Treasury Secretary O'Neill on November 22nd regarding Section 312 of the USA Patriot Act, which requires Treasury to adopt regulations defining the due diligence and enhanced due diligence procedures U.S. banks and broker-dealers must apply to non-U.S. banks that maintain U.S. correspondent accounts. Among other things, Section 312 requires certain enhanced due diligence procedures if the correspondent account is for a non-U.S. bank that operates under an offshore banking license. An exception was made under Treasury's proposed regulations (which had been recommended by the Institute) for offshore branches of international banks that are from countries that the Federal Reserve Board has determined provide comprehensive consolidated supervision ("CCS"). The Institute's November 22nd letter also urged Treasury to expand the scope of the exception to apply to offshore booking locations of international banks from countries that are members of the Financial Action Task Force ("FATF"). The Institute has also suggested that the exception should apply if the offshore licensed entity is a subsidiary of the international bank or is the international bank itself, and urged that Treasury should have express discretion to grant exemptions for specific countries that may not be members of FATF.

The Institute's November 22nd letter to Secretary O'Neill emphasizes the issues raised in the Institute's July 1st submission and follow-up letter dated July 12th on Section 312, which became effective on July 23rd. The Treasury Department and its Financial Crimes Enforcement Network ("FinCEN") published interim guidance regarding compliance with Section 312 on July 19th. (The Interim Guidance is available on the Treasury's web site at www.ustreas.gov/press/releases/docs/interim.pdf and the Institute's letters are available at www.iib.org/member/Anti-Money/).

The Institute's suggested changes to Treasury's proposed regulations would avoid what could be an unintended arbitrary effect of the proposed CCS exception. The list of countries that would be covered by the proposed CCS exception is largely a function of historical accident. This is because the Federal Reserve Board makes CCS determinations only when an international bank applies to expand its U.S. banking operations or to become a financial holding company under the Gramm-Leach-Bliley Act. The list of countries currently includes: Argentina, Australia, Austria,

Belgium, Brazil, Canada, Chile, Finland, 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.

As a result, many leading foreign banking organizations are based in countries as to which the Federal Reserve Board has not yet had reason to make a CCS determination. These countries include the following FATF members: Denmark, Iceland, New Zealand, Norway, Singapore and Sweden.

In its submissions, the Institute argued that the offshore operations of banks located in these FATF member countries should be exempted from enhanced due diligence procedures in the same way as the offshore operations of banks from countries for which the Federal Reserve Board has made a CCS determination. The Institute noted that by definition, FATF-member countries are ones that the United States and the other members of FATF view as having strong anti-money laundering controls.

The Institute also argued that Treasury should have discretion to grant additional exemptions on a case-by-case basis for the several countries that may not yet be members of FATF but that have well-recognized anti-money laundering laws and regulations. Such a discretionary procedure is vital to avoiding undue interference with international financial transactions that do not pose significant money laundering or terrorist financing risks, the Institute said in its letter to Secretary O'Neill.

The Institute expressed its concern that without expansion of the CCS exemption to cover banks in other countries that are meeting their responsibilities to prevent money laundering, particularly those that are FATF members, serious harm could be done to their world wide competitive position by being unnecessarily placed in the

pejorative category of banks that require enhanced due diligence before they may be considered to be eligible counterparties.

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 final regulations. The Institute is in ongoing discussions with Treasury and its USA Patriot Act Task Force that has been formed under Deputy Secretary Dam. The Institute also 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 SUBMITS COMMENT LETTER ON NEW YORK STATE BANKING DEPARTMENT'S ASSET PLEDGE PROPOSAL

Executive Summary

The Institute submitted a comment letter on November 1st to the New York State Banking Department on the Department's proposed amendments to the asset pledge requirement. As previously reported, the amendments incorporate the general approach taken by the Department in the preliminary asset pledge proposal it released this past June and are expected to reduce by approximately 80% the \$35 billion of collateral currently pledged by member institutions and streamline administration of the asset pledge requirement.

Reflecting the Institute's discussions with the Banking Department and input from member institutions, including at the "Town Hall" meeting in mid-July, the final submission expresses the Institute's strong support for the proposal generally but recommends that it be modified to (i) eliminate the prohibition against pledging "same-country issuer" obligations in favor of a more flexible approach permitting a bank to pledge such obligations provided that they account for not more than 50% of its total pledged assets; (ii) reduce the maximum amount of assets required to be pledged by "well rated" banks from \$400 million to \$50 million (and, in any event, not more than \$100

million); and (iii) simplify the criteria and procedures for determining whether an institution is "well rated" and thus eligible for further relief from the asset pledge requirements.

In addition, the final comment letter recommends that the proposed expansion of the rating requirement for pledged assets be limited to additional eligible assets provided for under the proposed revisions. The current rating requirement applies only to commercial paper but would be expanded to apply to all pledged assets under the proposal.

Speaking on the second day of the Institute's annual regulatory examination and compliance seminar (November 20-21), Michael J. Lesser, the Banking Department's Deputy Superintendent in the Foreign Financial Services Division, said the Department is making some changes to its proposal based on the comments it received and hopes to

issue the final revisions soon.

The proposed amendments are available on the Banking Department's web site at www.banking.state.ny.us/amd322.htm. The Institute's comment letter is available on our web site at www.iib.org/11-1-02AssetPledge-CL.pdf.

FEDERAL RESERVE APPROVES PARTIAL APPLICATION OF REGULATION W TO UNINSURED BRANCHES OF INTERNATIONAL BANKS

Executive Summary

On October 31st, the Federal Reserve Board adopted a final version of Regulation W that comprehensively implements the limitations under Section 23A and 23B of the Federal Reserve Act to transactions between insured depository institutions and their affiliates. Such limitations include, for example, quantitative restrictions and collateral requirements for loans and other exposures to affiliates and arms-length requirements for transactions with affiliates. Of special significance to Institute members, the Board finalized its earlier proposal to apply Regulation W to uninsured U.S. branches and agencies of international banks with regard to transactions with any affiliate that is engaged in new activities under the Gramm-Leach-Bliley Act. These activities include securities underwriting and dealing, insurance underwriting and merchant banking investment activities. The effective date of the final Regulation W is April 1, 2003.

In response to extensive discussions by the Institute and others with the Federal Reserve, the new regulation does not apply Regulation W to transactions between an uninsured branch/agency and U.S. affiliates engaged in activities that were permissible before the passage of the Gramm-Leach-Bliley Act.

The Institute had also filed comments with the Board opposing the proposed application of Regulation W to affiliates of international banks engaged in new activities (see Institute comment letter on our web site at <http://www.iib.org/8-15CommentLetter.pdf>). However, the Board's staff continues to take the view that application to uninsured branches and agencies was necessary to

maintain a level playing field with domestically headquartered banking/financial groups. The Board's staff also emphasized that these limitations had always applied in the case of transactions by uninsured branches and agencies with their Section 20 securities affiliates and with affiliates engaged in securities and merchant banking activities under the authority of Gramm-Leach-Bliley.

The new Regulation W applies to branches and agencies licensed in the United States and not to "offshore branches". There is a strong consensus among the Institute's member banks to oppose any application of these limitations to non-U.S. branches, including those that are managed out of the U.S.

INSTITUTE SUBMITS COMMENT LETTER ON FEDERAL RESERVE'S PROPOSED CHANGES TO ANNUAL REPORT ON FORM FR Y-7

Executive Summary

The Institute submitted a comment letter on October 18th regarding the Federal Reserve Board's proposed changes to the Annual Report of Foreign Banking Organizations on Form FR Y-7 (see www.iib.org/10-18-02CL-ijohnson.pdf). In its comment letter, the Institute strongly supported those aspects of the Board's proposal that are designed to alleviate reporting burdens applicable to international banks. However, the Institute also said certain aspects of the Board's proposed changes to reporting of capital adequacy data and financial information for U.S. nonbank subsidiaries would add significant new burdens for many of the Institute's members. The Institute has held informal follow-up discussions with Federal Reserve staff and is awaiting further action.

As previously reported, the proposed changes relate principally to certain of the financial data required to be included in the current Form FR Y-7. Specifically, capital adequacy information and U.S. nonbank subsidiary financial reports would be removed from the FR Y-7 and moved to new reporting forms – the FR Y-7Q (for capital adequacy data) and the FR Y-7N and FR Y-NS (for U.S. nonbank subsidiary financial reports). In general, the deadlines for these reports would be shortened from the current deadline for the FR Y-7, which is 120 days after the end of the reporting bank's fiscal year.

Under the Federal Reserve Board's proposal, those portions of the FR Y-7 other than capital adequacy data and U.S. nonbank subsidiary financial reports would remain part of the FR Y-7, and the deadline for the FR Y-7 would remain unchanged. Thus, the reporting bank's annual financial statements and annual report, organizational chart, "qualifying foreign banking organization" calculations, etc. would continue to be provided within 120 days after its fiscal year-end. In addition, the Federal Reserve Board's proposal would eliminate the requirement that reporting banks provide financial statements for material non-U.S. unconsolidated subsidiaries (Items 6 and 7 of the current FR Y-7).

The Institute's comment letter reflects information solicited from its members regarding the feasibility of reporting the required capital

adequacy information and U.S. nonbank subsidiary financial reports within the new and shortened time periods and whether the Federal Reserve Board's proposal will result in a net increase or decrease in the burden associated with preparing the FR Y-7 and new forms. The Board estimates that the net effect of its changes will be an approximately 25% decrease in the regulatory burden (measured in aggregate hours for all filers) associated with preparing the FR Y-7 and new forms.

Following are the Institute's principal comments and recommendations regarding the Board's proposal:

- The Board should retain the existing 120-day deadline for reporting capital adequacy data. Alternatively, the Board should link the deadline for (and frequency of) the FR Y-7Q to the date on which the reporting bank submits the required data to its home country supervisor.
- Federal Reserve System staff should retain discretion to grant extensions to file the FR Y-7Q under appropriate circumstances.
- The Board should adhere to its existing practice of not requiring top-tier foreign banking organizations to submit capital adequacy data if the top-tier entity does not

calculate and report capital adequacy data under home country requirements.

- Financial statements for U.S. nonbank subsidiaries should continue to be required on an annual basis 120 days after the end of the reporting bank’s fiscal year, without a quarterly requirement for “significant” subsidiaries or an accelerated deadline.
- The Board should retain (or raise) the current \$150 million maximum total assets limit for streamlined financial reporting by U.S. nonbank subsidiaries.
- The Board should retain the option under the current NFIS to consolidate U.S. nonbank subsidiaries that engage in similar lines of business.
- The Board should increase the maximum total assets limit for the proposed exemption from financial reporting for U.S. nonbank subsidiaries from \$20 million to \$100 million.
- U.S. nonbank subsidiaries should continue to be able to prepare the financial statements required by the Board on the basis of their parent’s fiscal year, without being required to prepare financial statements on a calendar year basis solely for purposes of the FR Y-7N/NS.
- The Federal Reserve System should accord appropriate confidential treatment under the Freedom of Information Act (“FOIA”) for financial data reported on the FR Y-7Q and FR Y-7N/NS.
- Any eventual changes to the FR Y-7 (including implementation of the FR Y-7Q and FR Y-7N/NS) that are adopted by the Board should become effective not for the current reporting period (*i.e.*, as of December 31, 2002) but rather for the next annual reporting period (*i.e.*, as of December 31, 2003).

INSTITUTE TAX SUBMISSION TO TREASURY, CONGRESSIONAL STAFF OUTLINES CONCERNS OVER PROPOSED CHANGES IN “EARNINGS STRIPPING” RULES

Executive Summary

The Institute submitted a detailed tax memorandum on October 30th to the Treasury Department and key staff members of the Congressional tax-writing committees outlining the serious problems raised for international banks by the proposed changes to the “earnings stripping” rules included in legislation introduced in July by Chairman Thomas of the House Ways & Means Committee. No action was taken on the Thomas bill this year, but the earnings stripping proposals – which have been estimated to raise more than \$5 billion of additional tax revenues over a 10-year period – may be part of the Administration’s budget proposals next year. The Institute plans follow-up discussions with Treasury, Congressional staff and other Washington policy makers on this important issue.

The submission followed meetings of representatives of the Institute and its member banks with Treasury officials and Congressional staff and details concerns over the disproportionate U.S. leverage rule contained in section 201 of H.R. 5095

(the Thomas bill) and recommends certain changes to address those concerns (the submission is available on the Institute’s web site at www.iib.org/10-30submission.pdf). The proposed disproportionate U.S. leverage rule would disallow

the gross interest expense of the U.S. operations of an international bank if those operations are deemed to be “disproportionately leveraged” under section 201.

Section 201 would amend section 163(j) of the Internal Revenue Code to disallow interest paid to, or on debt guaranteed by, a related foreign person (“disqualified interest”) to the extent that the U.S. operations of a non-U.S. parent are more highly leveraged than the overall worldwide corporate group. The calculation of disproportionate leverage would require the entire worldwide group to attempt to restate its balance sheet in accordance with U.S. tax principles.

In its submission, the Institute made three key points. First, the disproportionate U.S. leverage test will frequently result in a determination that the leverage of an international bank’s U.S. operations is “disproportionate” to its worldwide leverage. This is because of the differences between the U.S. and non-U.S. operations of international banks – in particular, the greater importance of their securities businesses in the United States and the greater leverage characteristic of securities businesses.

Second, international banks fund their U.S. non-bank subsidiaries to a significant degree by loans from, or guaranteed by, the parent bank. This means that a substantial portion of the interest expense of such U.S. subsidiaries will be “disqualified interest” for purposes of section 201. International banks’ funding decisions are made

from a global perspective and are based on business objectives and strategies, among the most important of which are seeking the lowest cost of funds and the ability to monitor more closely the activities and risks of the businesses that are funded.

Third, the disallowance of gross, rather than net, interest expense fails to take into account the pivotal importance of interest expense to banking and other financial services. Interest expense is incurred to generate interest income or its equivalent – it is an essential and integral operating expense that is comparable to the cost of goods sold for a manufacturing business. Disallowing gross interest expense has the potential to convert the current tax on net income into a tax on gross revenue.

The Institute argued that the three considerations above, taken together with the practical difficulties in making the required determinations, justify the exclusion of financial corporations (as defined in section 201) from the disproportionate U.S. leverage test. As an alternative, the Institute proposed three critical changes to the disproportionate U.S. leverage test: first, the disallowance should apply to net, rather than gross, interest expense; second, section 201 should be changed to provide a carryover of disallowed interest and of excess limitation; and third, interest expense (i) on bank deposits and (ii) on liabilities that fund securities positions of a securities dealer should be excluded from “disqualified interest.”

INSTITUTE SUBMITS COMMENT LETTER ON IRS REVISED PROPOSED REGULATIONS ON REPORTING OF BANK DEPOSIT INTEREST TO NONRESIDENT ALIEN INDIVIDUALS

The Institute submitted a comment letter on November 14th to the Internal Revenue Service on the revised proposed regulations on reporting of bank deposit interest to nonresident alien individuals.

This summer the IRS withdrew proposed regulations, issued in January 2001, that would have required banks to report to the IRS bank deposit interest paid to all nonresident alien individuals, and issued new proposed regulations that would require

reporting on a more limited basis, only with respect to residents of specified countries with which the United States has an income tax treaty. (The Institute’s comment letter is available at www.iib.org/11-14-02CommentLetter.pdf and the new proposed regulations are available on the IRS web site at www.irs.gov/pub/irs-regs/13325402.pdf.)

The Institute’s comment letter welcomes the exemption of deposits from South American, Asian

and other countries from the revised proposal, but expresses concern that the revised proposal does not solve the basic problems of the original proposal, as

set forth in our prior comments. The Institute also will be testifying at a public hearing on the revised proposal, scheduled for December 5th.

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