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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 HOLDS TALKS WITH SEC, TREASURY AND FEDERAL RESERVE ON PROPOSED EXEMPTION FOR INTERNATIONAL BANKS FROM SECTION 402 OF THE SARBANES-OXLEY ACT

The Institute is engaged in ongoing discussions with the Securities and Exchange Commission, the Treasury Department and the Federal Reserve regarding the Institute's proposed exemption for international banks from Section 402 of the Sarbanes-Oxley Act.

In a submission to the SEC dated August 16th, the Institute urged the SEC 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). 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.

Section 402 of the Act prohibits public companies from making personal loans to their directors and executive officers. The prohibition 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 Insider Loan 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 Insider Loan 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.

The Act generally, as well as the Insider Loan Prohibition, have drawn significant criticism from the European Commission and other non-U.S. governmental authorities, including bank supervisors in countries that subject their banks to comprehensive consolidated supervision. The regulation of insider loans by banks falls squarely within the domain of bank safety and soundness supervision—an area for which home country supervisors are responsible under international standards of bank supervision. In addition, the Insider Loan Prohibition as worded in the Act is inconsistent with current SEC policies that generally accommodate home country practices and regulation. Questions are also being raised as to whether the extraterritorial scope of the Insider Loan Prohibition and certain other requirements of the Act run counter to well established principles of international comity and could trigger retaliatory actions by other countries to subject U.S. issuers in foreign markets to non-U.S. principles of corporate practice and governance.

The Institute expects to raise separate concerns with the SEC regarding other provisions in the Sarbanes-Oxley Act of importance to international banks, such as the independent audit committee requirement of Section 301. There are several provisions of the Sarbanes-Oxley Act that represent unprecedented intrusions into international banks' home country corporate practices and governance, and the Institute is in the process of collecting suggestions for its next initiatives in this area.

TREASURY ISSUES FINAL RULES IMPLEMENTING SECTIONS 313 AND 319(b) OF THE USA PATRIOT ACT

On September 18th, the Financial Crimes Enforcement Network (“FinCEN”) of the U.S. Treasury Department issued final rules implementing Sections 313 and 319(b) of the USA Patriot Act. The final rules implement the prohibition in Section 313 that prevents U.S. “covered financial institutions” (including U.S. banks and broker-dealers and U.S. branches and agencies of international banks) from maintaining correspondent accounts for so-called “shell banks” (non-U.S. banks that do not have a physical presence in any country and are not subject to regulatory oversight by any jurisdiction). The final rules also implement the recordkeeping requirements of Section 319(b), which requires that covered financial institutions maintain certain information regarding their non-U.S. respondent banks (including information regarding the respondent’s ownership and U.S. agent for service of process).

FinCEN’s final rule includes a favorable clarification that the Institute requested limiting the reach of the shell bank prohibition in Section 313 as regards “indirect” correspondent relationships (see below). The final rule also adopts several other specific suggestions made by the Institute in its comment letter on the proposed rule.

Under Section 313, a U.S. covered financial institution is required to take reasonable steps to ensure that a correspondent account for a non-U.S. respondent bank will not be used by the respondent bank “indirectly” to provide banking services to a shell bank. Under the proposed rule, a covered financial institution could rely on a certification procedure to satisfy this requirement (and, at the

same time, to obtain necessary information for its record-keeping requirements under Section 319). Because of a change in the wording in the certification that accompanied FinCEN’s proposed rules from the certification included as part of Treasury’s earlier interim guidance, a question arose regarding the scope of this latter certification. In its comment letter on the proposed rule (available at www.IIB.org), the Institute requested clarification that the certification would reach only to a non-U.S. respondent bank’s dealings with its *direct* customers and does not require investigation into the potentially long and complex chain of correspondent relationships that may underlie such dealing.

The preamble to FinCEN’s final rules states that Treasury interprets the ban on indirect service to shell banks to mean that:

the foreign bank is not using the correspondent account to provide banking services to a foreign shell bank that is the foreign bank’s **direct customer**. Thus, a foreign bank could certify that it is not using a correspondent account with a covered financial institution to provide banking services to any foreign shell bank, without in turn asking each of its foreign bank customers to provide it with a similar certification. To interpret this requirement otherwise would lead to an endless chain of certification.

FinCEN’s final rule reflects several other changes and clarifications to the proposed rule (most of them favorable from the Institute’s perspective).

NEW YORK STATE BANKING DEPARTMENT PUBLISHES FORMAL REGULATORY PROPOSAL TO REVISE ITS ASSET PLEDGE REQUIREMENT

The New York State Banking Department on September 18th published for public comment proposed amendments to the asset pledge requirements for New York branches and agencies of international banks (Part 322 of the Superintendent’s Regulations). The amended

regulation is expected to become effective in mid-November following a 45-day comment period.

The proposed amendments incorporate the general approach taken in the preliminary asset pledge proposal released by the Banking

Department this past June and will greatly reduce the approximately \$35 billion of collateral currently pledged by New York-licensed branches and agencies.

Among other things, the proposal would (i) reduce the amount of the asset pledge from 5% to 1% of third-party liabilities; (ii) cap at \$400 million the amount required by “well rated” banks that meet certain “well capitalized” and “well managed” standards; (iii) provide for the pledge of additional types of assets not currently enumerated in Part 322 in an amount not to exceed 50% of a bank’s total asset pledge requirement; and (iv) simplify administration of the asset pledge by basing the calculation of the pledge on a backward-looking average of liabilities for the previous month. On the other hand, the proposed amendments retain the prohibition on pledge of “same-country issuer” assets that was included in the preliminary proposal (subject to a one-year transition period for negotiable certificates of deposit).

The proposed amendments reflect a number of the suggestions made by the Institute in its August 2nd comment letter on the preliminary proposal (the comment letter is available on the Institute’s web site). Among the included suggestions, the following are of particular significance:

- Whereas the preliminary proposal would have permitted only “well capitalized”/“well managed” banks to pledge additional types of assets, the proposed amendments include the Institute’s suggestion that a ratings criteria be used to determine eligibility to pledge additional types of assets, thereby expanding the banks eligible for such treatment beyond those that are “well rated”. The proposed amendments would permit “well rated” banks to pledge these types of assets provided the assets have an investment grade rating, while banks that are not “well rated” could pledge such assets provided the assets have the highest investment grade rating (in either case, subject to the 50% cap discussed above).

- The proposal would expand the current exclusion of liabilities arising from repurchase agreements from the calculation of the pledge to exclude as well liabilities arising from any other type of “qualified financial contract” to the extent such liabilities are secured as provided in the Banking Law. (However, it appears that collateralized public deposits would remain subject to the asset pledge.)
- The proposal would base the amount of the asset pledge on the average of third-party liabilities as of the close of business on each Wednesday during the previous month rather than on an average daily basis.

As indicated above, the proposed amendments retain the \$400 million cap suggested in the preliminary proposal (in its August 2nd comment letter, the Institute urged that the cap be reduced to somewhere in the range of \$50 million to \$100 million). In addition, eligibility for the cap would continue to be based on whether a bank is “well capitalized”/“well managed”. In contrast to the preliminary proposal, which would have established objective criteria for determining whether these standards are met, the proposed amendments would make the determination subject to the Superintendent’s discretion. In this connection, the proposed amendments describe certain factors, among others, which the Superintendent “will consider” in making such determinations. The listed factors include (i) a bank’s tier 1 and total risk-based capital ratios (minimum 6% and 10% respectively, as calculated in accordance with the Basel Accord), (ii) its Strength-of-Support Assessment (SOSA) rating (in contrast to the preliminary proposal, no minimum rating is prescribed) and (iii) the composite ROCA rating of the bank’s New York office(s), which “should be no lower than a ‘2’.”

The proposed amendments would significantly reform current asset pledge requirements and for most banks should result in a substantial reduction in the amount of assets they are required to pledge. Accordingly, the Institute plans

to support the proposed amendments in general, although we continue to believe that (i) the amount of the cap should be reduced; (ii) eligibility for the cap should not be based on a bank's capital; and (iii) the "same-country issuer" prohibition is

unnecessarily restrictive. A draft of the Institute's comment letter on the proposed amendments will be circulated to the Institute's membership prior to submission.

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

The Institute is in the process of preparing a comment letter regarding the changes recently proposed by the Federal Reserve Board to the Annual Report of Foreign Banking Organizations on Form FR Y-7. The comment letter is due on October 18th.

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-7NS (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).

As part of the preparation of its comment letter, the Institute is soliciting information 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.

REPRESENTATIVES OF THE INSTITUTE AND ITS MEMBER BANKS MEET WITH KEY CAPITOL HILL, TREASURY POLICY MAKERS ON PROPOSED CHANGES TO "EARNINGS STRIPPING" RULES

On October 2nd, representatives of the Institute and five of its member banks met with the Chief of Staff of the Joint Committee on Taxation Lindy Paull, and separately with Assistant Secretary of Treasury (Tax Policy) Pamela Olson and their staffs to discuss the proposed changes to the "earnings stripping" rules under Internal Revenue Code section 163(j). These changes, if enacted into law, may significantly restrict the interest expense deductions of U.S. subsidiaries and branches of

international banks and other non-U.S. multinational groups. These meetings were part of the Institute's continuing education and lobbying effort regarding the proposed legislation.

The proposal, which was introduced in July by the Chairman of the House Ways & Means Committee, generally is 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 Institute previously met with the Ways and Means majority and minority staffs and the Senate Finance Committee staff on this issue.

The proposal would, among other changes, add to section 163(j) a rule disallowing 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 that 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).

Representatives of the Institute and its member banks argued to the Joint Committee on Taxation and the Treasury Department that this proposal has a particularly harsh impact on financial institutions for three reasons. First, there are wide variations in the leverage ratios of different financial businesses and because securities businesses generally have a much higher leverage ratio than other financial businesses and because most international banking/financial groups have the bulk of their securities operations in the U.S., the proposal's "disproportionate leverage" test will almost always result in a determination that there is excessive U.S. leverage. Second, for valid business

reasons, including obtaining the lowest cost of funds, international banks tend to centralize all their external borrowings in the parent bank (putting "one face to the market"), with the parent then on-lending to its affiliates. Accordingly, a large portion of the debt of the U.S. operations will be related-party debt and thus subject to disallowance under the proposal. Third, because the proposal would disallow gross interest expense, rather than net interest expense, the proposal ignores the role that leverage and interest expense play in a financial institution. The Institute explained that in a financial business interest expense is an operating expense, not a cost of capital, and is comparable to cost of goods sold for a manufacturing business. A disallowance of interest expense would, in effect, for financial institutions convert the U.S. tax system from a tax on net income to a tax on gross income.

The Institute suggested that the proposed legislation be modified to provide that the disproportionate leverage rule, if applicable, would disallow net interest expense, rather than gross interest expense.

The Institute's assessment is that continued persistent lobbying efforts will be necessary in order to prevail on this important issue. The meetings with the key Capitol Hill and Treasury policy makers are the first steps in this effort.

IRS RELEASES FINAL EXTERNAL AUDIT GUIDELINES FOR QUALIFIED INTERMEDIARIES (QIs)

The Internal Revenue Service has released its final external audit guidelines for Qualified Intermediaries (QIs). The final Guidelines are quite responsive to the concerns expressed by the Institute and other representatives of financial intermediaries – and indeed adopt some of our suggestions for simplifying the external audit process – and will thus substantially reduce the cost and burdens of external audits. Nonetheless, compliance costs will still be very high for large institutions, and additional efforts may be necessary, once member banks and their affiliates and advisers have had an

opportunity to evaluate the Guidelines in a practical setting, in order to persuade the IRS to further streamline the Guidelines.

Key aspects of the revised Guidelines, including i) expanded waivers, ii) streamlined scope of audit procedures, iii) sampling, iv) projections of underwithholding, and v) external auditors' reliance on internal auditors are discussed in the Institute's memorandum dated August 21st (available on the Institute's web site at www.iib.org/member/8-21QIMemo.pdf).

