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TAX

The Institute’s mission is to help resolve 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 COMMENT LETTER ON BASEL II FOCUSES ON CROSS-BORDER IMPLEMENTATION ISSUES

Executive Summary

The Institute submitted a comment letter on July 31st to the Basel Supervisory Committee on the third Consultative Paper (CP 3) regarding Basel II. The Institute's submission (available on our web site at www.iib.org/7-31-03/CommentLetter.pdf) urges the Basel Committee to articulate clear international standards for cross-border implementation of Basel II to ensure the primacy of the home country supervisor's role in supervising the capital adequacy of internationally active banking institutions under the new accord. The letter builds on the points the Institute made in its May 31, 2001 submission on the second Consultative Paper (www.iib.org/member/5-31CommentLetter.pdf) and reflects input from member institutions during the discussions at the Institute's roundtable meeting/conference call on July 15th.

In its July 31st submission, the Institute argued that host country standards requiring capital in excess of Basel II minimum requirements – such as U.S. capital standards under the Gramm-Leach-Bliley Act – present an especially compelling case for cross-border coordination and deference to home country supervisors.

The Institute's comment letter also addressed Pillar 3 disclosure requirements under Basel II as well as the Committee's proposed implementation schedule. With regard to Pillar 3, the Institute encouraged the Basel Committee to reconsider in particular the detailed credit risk disclosure requirements set forth in CP3. The Institute's letter also expressed the view of many member institutions that the Committee's implementation

schedule for Basel II is overly ambitious, particularly in connection with the operational risk capital charge calculation and the need to develop and adequately test operational risk management systems.

The Basel Committee issued CP3 on April 29th with the goal of completing the new accord by the fourth quarter of 2003 and having it implemented by member countries by the end of 2006. In the United States, an Advanced Notice of Proposed Rulemaking was issued on July 11th. U.S. supervisory authorities intend to use only the most sophisticated approaches of Basel II, which will be required for only about the 10 largest U.S. banks (another 10 U.S. banks are expected to adopt them on a voluntary basis).

INSTITUTE CONTINUES TO URGE THE SEC TO TAKE PROMPT ACTION ON THE INSTITUTE'S PROPOSED EXEMPTION FOR INTERNATIONAL BANKS FROM SECTION 402 OF THE SARBANES-OXLEY ACT

Executive Summary

The Institute met with Alan Beller, Director of the SEC's Division of Corporation Finance, on June 26th to discuss the Institute's proposed exemption for international banks from Section 402 of the Sarbanes-Oxley Act. The meeting followed recent Institute letters to SEC Chairman Donaldson and Commissioner Campos. At the meeting, Mr. Beller indicated that the staff is in the advanced stages of considering the Institute's proposal, as one of the first discretionary items the SEC is considering after the mandatory rulemaking

procedures under the Act. In another development, the Institute sent a letter to the Treasury Department on July 21st in response to a submission by the Bankers' Association for Finance and Trade (BAFT) questioning the national treatment issues previously identified by the Institute in connection with Section 402. (See related documents on the Institute's web site at www.iib.org/member/Sarbanes-Oxley.)

As previously reported, Section 402 regulates loans by U.S.-listed international banks to their executive officers and directors (*i.e.*, including head office loans to head office executive officers and directors). Among its other practical implications, Section 402 potentially interferes with the ability of international banks to make available to executive officers and directors discounts that they may offer to bank employees for mortgage and other loans.

One issue that the SEC staff is continuing to consider is the extent to which certain "core principles" of U.S. regulatory standards for loans to executive officers (codified in the Federal Reserve Board's Regulation O) should apply to international

banks under an eventual exemption from Section 402. (Loans by U.S. domestic banks subject to Regulation O are exempt from Section 402.) The Institute has argued that international banks from jurisdictions that provide comprehensive consolidated supervision should be exempt from Section 402 and should not be subject to detailed U.S. standards regarding insider lending.

The Institute continues to encourage member institutions, national and regional banking associations and home country governmental authorities, who have not done so, to send letters to the SEC, the Treasury Department and the Federal Reserve to communicate their concerns regarding Section 402.

INSTITUTE LETTER TO SENATE BANKING COMMITTEE CHAIRMAN RICHARD SHELBY URGES REMOVAL OF "STATE FLOOR" LIMITATION ON COMPTROLLER'S AUTHORITY IN REGULATORY RELIEF BILL DEALING WITH REFORM OF ASSET PLEDGE/CED REQUIREMENT

Executive Summary

In anticipation of possible Senate consideration of regulatory relief legislation currently pending in the House of Representatives, the Institute sent a letter on July 17th to Sen. Richard Shelby, Chairman of the Senate Banking Committee, regarding Section 107 of the House bill (H.R. 1375), which grants the Comptroller of the Currency discretion in applying the asset pledge/capital equivalency deposit (CED) requirement to OCC-licensed branches and agencies of international banks. The letter states strong support for reform of the mandatory 5% CED requirement, but expresses concerns about the "state floor" provision in Section 107 that would limit the Comptroller's discretionary authority.

As previously reported, the House Financial Services Committee approved regulatory relief legislation on May 20th. The state floor provision of Section 107 of the bill would bar the Comptroller from setting the CED in any given state at a level below that state's comparable asset pledge requirement. In its letter to Senator Shelby, the

Institute said such a state floor on the Comptroller's powers would result in the potentially anomalous situation of an international bank with federal branches in multiple states meeting different CED requirements based on the individual state requirements. The Institute also pointed out that the "state floor" is inconsistent with the principle of

national treatment established by the International Banking Act of 1978 and accorded to international banks doing business in the United States.

In its letter to Chairman Shelby, the Institute recommended that if the Banking Committee considers H.R. 1375 or develops its own regulatory relief legislation, the discretionary authority language of section 107 should be included without the state floor limitation on the Comptroller's discretion. This would provide the Comptroller with

the same type of discretionary power that many states have provided to their banking commissioners and superintendents.

As previously reported, the Institute successfully completed its multi-year initiative on asset pledge reform in New York and Connecticut and has continued to pursue the necessary statutory changes to obtain similar relief for member institutions with federally-licensed branches and agencies.

INSTITUTE SUBMITS COMMENT LETTER ON FEDERAL RESERVE'S PROPOSED AMENDMENT TO REGULATION K

The Institute submitted a comment letter on June 30th regarding a proposal by the Federal Reserve Board to amend Regulation K to specify that U.S. branches, agencies and representative offices of international banks are required to maintain anti-money laundering (AML) programs under the Bank Secrecy Act (the "BSA"). The principal focus of the Institute's comment letter is language in the proposal that would require the AML program to be "approved by the board of directors, and noted in the minutes." The Institute's comment letter argues that the language, which is unclear in the context of U.S. banking offices regulated under the BSA, should be modified to permit the senior management of the relevant U.S. banking office to approve the AML program. The

comment letter is available on the Institute's web site at www.iib.org/6-30-03CL_Johnson.pdf.

Under existing Regulation K, U.S. banking offices are subject to suspicious activity reporting requirements of the BSA. In addition, although the Board has not previously specified in Regulation K that U.S. banking offices are required to have AML programs, the Board has required that U.S. banking offices have AML programs as a supervisory matter. In this regard, the Board's proposed amendment to Regulation K would clarify the obligations of U.S. banking offices under Section 352 of the USA Patriot Act, which amended the BSA to require all financial institutions to implement and maintain an AML program.

INSTITUTE COMMENTS FAVORABLY ON OCC PROPOSAL TO SIMPLIFY APPROVAL PROCESS FOR FEDERAL BRANCHES AND AGENCIES

The Institute commented favorably in a June 23rd submission on a proposal by the Office of the Comptroller of the Currency relating to federal branches and agencies of international banks. As previously reported, the proposal would, among other things, streamline certain procedures relating to federal branches and agencies and make additional

improvements to the OCC's Capital Equivalency Deposit regulations. The Federal Register notice is available on the Institute's web site at www.iib.org/member/FederalRegister.pdf and the Institute's comment letter is available at www.iib.org/6-23-03CL_OCC.pdf.

LATEST “EARNINGS STRIPPING” PROPOSALS ARE RESPONSIVE TO THE INSTITUTE’S CONCERNS REGARDING PREVIOUS PROPOSALS TO DISALLOW DEDUCTIONS FOR INTEREST PAID TO AFFILIATES

Executive Summary

As Congress approaches its summer recess, the prospects appear to be quite favorable that Congress will not enact previously proposed changes to the “earnings stripping” interest disallowance rule that, if adopted, would have a severe adverse impact on U.S. branches and subsidiaries of many international banks, including their securities affiliates.

On July 25th, House Ways & Means Committee Chairman Thomas introduced a new tax bill that focuses on international provisions, and on July 28th, Senator Hatch introduced a similar bill in the Senate Finance Committee. Neither bill includes the earlier, troublesome proposal – which had been favored by Chairman Thomas and the Treasury Department – to add a new “worldwide limitation” to the existing “earnings stripping” rule. Furthermore, the alternative international tax bills that have been, or will be, introduced by Representatives Crane and Rangel and by Senators Grassley and Baucus do not, and are not expected to, contain the troublesome proposal. Accordingly, while we understand that the Treasury Department continues to support a “worldwide limitation” with safe harbors, it appears unlikely that the 108th Congress would enact such a provision.

As previously reported, the Institute has been actively lobbying against the earlier proposal to add a new “worldwide limitation” to the existing “earnings stripping” rule. This proposed change would compare the leverage ratio of the U.S. operations of a foreign-owned multinational group to the leverage ratio of the worldwide group, and would disallow the *gross* amount of interest paid by the U.S. operations to, or guaranteed by, the parent or its non-U.S. affiliates to the extent attributable to the “excess” leverage of the U.S. operations over the leverage of the worldwide group.

In response to concerns raised by the Institute and others, the Treasury Department in February modified the original proposal so as to add a safe harbor setting forth specific debt-to-asset ratios for different categories of assets. However, the Treasury’s proposed safe harbor debt ratios are much lower than prevailing debt ratios in the financial industry (both in the U.S. and abroad, the financial industry is much more highly leveraged than the proposed ratios). As a result, major

financial institutions are unlikely to be helped by the Treasury’s proposed safe harbor.

While the other international tax bills that have been, or are expected to be, introduced in Congress (by Senators, Hatch, Grassley and Baucus and by Representatives Crane and Rangel) generally would not seek to tighten the “earnings stripping” rule, Chairman Thomas’ new bill proposes the following with respect to the rule:

1. There would be no worldwide limitation requiring that the leverage of the U.S. operations conform to that of the worldwide group.
2. The existing law’s “adjusted taxable income limitation” (which, in general, limits the deduction for interest paid to, or guaranteed by, foreign affiliates if and to the extent the U.S. group’s net interest expense exceeds 50% of tax EBITDA) would

be revised in the following respects:

- (a) The limitation would be reduced from 50% to 35% next year and to 25% thereafter. However, the 50% limitation would continue to apply to the extent that third-party borrowings are guaranteed by foreign affiliates. Also, the limitation would continue to apply only if and to the extent that the U.S. group has net interest expense.
- (b) The 1.5:1 debt-to-equity safe harbor would be eliminated, and would not be replaced with alternative safe harbor ratios (such as those proposed by Treasury).
- (c) Disallowed interest expense could be carried forward for 10 years.
- (d) There would be no “excess limitation” carryforward.

Chairman Thomas’ revised “earnings stripping” proposal reflects the position that he expressed when we met with him and his staff in May, and this proposal has already elicited the Institute’s support. As previously reported, at that

meeting Chairman Thomas and his staff indicated that in formulating this revised proposal, they accept our fundamental contention that financial institutions operate on a different business model than industrial companies and that neither the worldwide limitation nor Treasury’s proposed safe harbors were appropriate for financial firms.

Senator Hatch’s bill actually proposes to relax the application of the “earnings stripping” rule to borrowings from third parties that are guaranteed by foreign affiliates, by excluding interest paid on such loans from the “earnings stripping” rule if the taxpayer establishes that it could have borrowed the same amount of debt from an unrelated lender on substantially similar terms without a guarantee. The Grassley-Baucus bill is expected to contain a harsher “earnings stripping” rule that would be applicable only to “inverted” companies (*i.e.*, certain U.S. companies that migrate the group’s holding company to a non-U.S. jurisdiction).

Obviously, the Institute is very gratified by these recent developments. However, we believe that Treasury Department tax policy officials still favor, at least as a conceptual matter, a worldwide limitation with safe harbor ratios. In addition, there could be pressure to include “revenue raiser” provisions in future tax legislation to narrow projected deficits, which could induce Congress to entertain further changes to the “earnings stripping” rule. This will require continued vigilance on our part as the legislative process evolves as well as in coming years.

INSTITUTE MEETS NEW IRS INTERNATIONAL OFFICIAL AND PROPOSES A NEW GUIDANCE PROGRAM FOR ISSUES ARISING IN THE APPLICATION OF REGULATION SECTION 1.882-5 FOR DETERMINING AN INTERNATIONAL BANK’S DEDUCTIBLE INTEREST EXPENSE

Executive Summary

The Institute hosted the new IRS Associate Chief Counsel (International), Harry J. (Hal) Hicks, at the July 24th Tax Committee meeting. The Institute used that occasion to review a broad range of issues of concern to international banks, including most prominently the absence of a mechanism for obtaining guidance from the IRS on the

application of the “actual ratio,” as well as other issues, under Treasury regulation section 1.882-5 in connection with the determination of an international bank’s deductible interest expense.

Essentially, the Institute is recommending that the IRS create a program, patterned after recent initiatives by the IRS, whereby a bank could present to the IRS a proposed, detailed method for computing the “actual ratio” of its worldwide liabilities to worldwide assets and obtain prior agreement from the IRS regarding that method and the records that it must retain to substantiate its application of the method. This program should also enable a bank to obtain agreement with the IRS regarding other practical issues arising under regulation section 1.882-5, including the calculation of the applicable interest rate on “excess U.S.-connected liabilities” under regulation section 1.882-5(d)(5)(ii) and the interest expense attributable to each separate currency pool under regulation section 1.882-5(e)(2).

The Institute explained that because of the uncertainties and exposures in the application of the actual ratio, many banks felt compelled to elect the 93% fixed ratio, and thereby incur a much higher tax burden because the 7% equity capital that is imputed under that ratio is significantly higher than their actual equity capital (i.e., their leverage ratio, which is not determined on a risk-weighted basis). In addition, while some banks that have elected the actual ratio have had satisfactory audit experiences in recent years, others have not.

The Institute expects to send a detailed proposal to Mr. Hicks and to follow up with him in September. Member banks should consider whether they would avail themselves of such a guidance program if it were instituted.

NEW YORK STATE RECOGNIZES THAT IT MUST CURTAIL LEGISLATION THAT COULD ELIMINATE INTEREST DEDUCTIONS ON MANY ORDINARY COURSE BORROWINGS BY U.S. SECURITIES FIRMS AND OTHER SUBSIDIARIES FROM THEIR NON-N.Y. AFFILIATES

As reported in the May issue of *Focus*, the New York State budget legislation that was passed in May contains a provision that could eliminate interest deductions on many ordinary course borrowings by U.S. securities firms and other subsidiaries from their non-New York affiliates. This legislation, which was intended to address perceived abuses relating to intra-group licenses of intangibles, seems to have been drafted without an adequate appreciation of the business operations of financial institutions, and therefore could have an unintended but severe adverse impact on U.S. securities subsidiaries of international banks. In the absence of clarification, the legislation could result in the disallowance of interest deductions on borrowings from affiliates that are not New York taxpayers including, significantly, (i) interest that is deemed to be paid on securities repo transactions

and (ii) other funding received from affiliates that are not New York taxpayers.

The Institute and certain member banks, as well as other organizations, effectively communicated this significant problem to the tax-writing committees of the State Senate and Assembly as well as the Tax Department, who were persuaded that they had erred. Remarkably, on the last day of the legislative session, the Senate and Assembly each passed corrective technical legislation that would cure the problem. However, there were differences between the two bills (relating to other provisions), and the session ended before the bills could be reconciled and enacted. The Institute expects that the corrective technical legislation will be enacted into law during the next legislative session, beginning in the Fall.