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LEGISLATIVE
&
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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’S PROPOSED EXEMPTION FOR INTERNATIONAL BANKS UNDER SECTION 402 OF THE SARBANES-OXLEY ACT IS “FRONT AND CENTER ISSUE,” ACCORDING TO SEC OFFICIAL

Executive Summary

The Institute’s proposed exemption for international banks from the insider lending prohibitions under Section 402 of the Sarbanes-Oxley Act is a “front and center issue” for the staff of the Securities and Exchange Commission, a senior SEC official told attendees at the Institute’s Annual Washington Conference on March 3rd. Alan L. Beller, Director of the Division of Corporation Finance and Senior Counselor to the Commission, also acknowledged that the Institute had been “diligent” in seeking an exemption to place international banks on an equal footing with U.S. banks. FDIC-insured U.S. banks were granted an exemption under the Act from the Section 402 prohibition on loans by public companies to their directors and executive officers, but a comparable exemption was not provided for non-U.S. banks. In his remarks at the Institute’s annual conference, Mr. Beller said that international banks “are treated worse than their similarly situated U.S. counterparts” under Section 402.

In a February 21st letter to Mr. Beller, the Institute reiterated its request that the SEC issue for public comment an exemption for international banks under Section 402. The Institute stated that such an exemption is required to address the acute issues of national treatment that Section 402 presents.

In its earlier submission dated August 16, 2002, the Institute noted that the lending prohibitions of Section 402 affect the ability of the head offices of international banks to make loans to their non-U.S. directors and executive officers. In this regard, Section 402 represents an unprecedented extension of the U.S. securities laws into an area that falls squarely within the supervisory jurisdiction of international banks’ home country bank supervisors, the Institute said. 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 (www.iib.org)). In response, Treasury communicated its view to the SEC that the Institute’s concerns regarding the treatment of international banks under Section 402 merit prompt attention.

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.

INSTITUTE EXPRESSES CONCERN ABOUT “STATE FLOOR” LIMITATION ON COMPTROLLER’S AUTHORITY IN REGULATORY RELIEF BILL DEALING WITH REFORM OF CED REQUIREMENT

Executive Summary

New regulatory relief legislation under consideration in Congress includes a provision that provides the Comptroller of the Currency discretion in applying capital equivalency deposit (CED) requirements to federal branches and agencies of international banks. The provision, however, also bars the Comptroller from setting the CED in any given state at a level below that state’s comparable asset pledge requirement. In a February 21st letter to Rep. Michael G. Oxley, Chairman of the House Committee on Financial Services, the Institute restated its strong support for reform of the mandatory 5% CED requirement, but expressed concern about inclusion of any “state floor” limitation on the Comptroller’s discretionary authority. The first hearing on the bill, H.R. 1375, The Financial Services Regulatory Relief Act of 2003, was held on March 27th by the House Subcommittee on Financial Institutions. Similar legislation cleared the full Financial Services Committee last year but did not reach the House floor.

In its February 21st letter to Chairman Oxley, the Institute noted that most states provide their bank regulators with discretionary authority to set CED-equivalent asset pledge requirements for state licensed branches and agencies without any floor or other limitation based on a federal standard. The Institute said 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 with different CED requirements based on the individual state requirements. The federal bank regulatory system

of providing consistent national standards would be contradicted by a state floor system of CEDs, the Institute further stated in its letter to Chairman Oxley.

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.

SEC ISSUES FINAL RULE IMPLEMENTING DEALER “PUSH-OUT” PROVISIONS OF THE GRAMM-LEACH-BLILEY ACT

Executive Summary

The Securities and Exchange Commission issued a final rule on February 14th implementing the dealer “push-out” provisions of the Gramm-Leach-Bliley Act – the functional exceptions for banks from the dealer registration requirements of the Securities Exchange Act of 1934. The SEC also issued a separate order extending the temporary exemption granted to banks from dealer registration through September 30, 2003. Meanwhile, the Institute continues to await further indications from the SEC staff

regarding the Institute's proposed exemption from the push-out provisions of the GLB Act for certain transactions in securities that have been offered and sold under Regulation S.

In general, the SEC's final rule regarding the functional exceptions for banks from the dealer push-out provisions of the GLB Act responded favorably to the issues raised in the Institute's December 5, 2002 comment letter on the SEC's proposed rule. (See the Institute's February 19th memorandum at www.iib.org/member/2-19-03Push-Out.pdf; the Institute's comment letter is available at www.iib.org/12-5-02Katz-CL.pdf.)

Separately, the Institute met with senior members of the staff of the Division of Market Regulation on January 21st regarding the Institute's proposed exemption for certain Regulation S activities of banks. The meeting followed on the Institute's submission of the proposal to the SEC staff in September 2002 (available at www.iib.org/member/9-10DiscussionDraft.pdf).

Under the push-out provisions of the GLB Act, certain securities brokerage and dealing

activities are required to be moved out of a bank (including a U.S. branch or agency of an international bank) into a separately organized broker-dealer that is registered with the SEC. The Institute's proposal would exempt from this requirement certain transactions in securities that have been offered and sold under Regulation S, if the bank acts as agent or riskless principal for non-U.S. customers. The proposal is designed to allow member institutions to continue to conduct transactions in Regulation S securities, including as part of their private banking activities, through their U.S. branches and agencies.

As previously reported, the Institute described for the SEC staff the business considerations in support of the proposal, including among other factors the special circumstances of U.S. branches and agencies seeking to offer non-U.S. customers access to offshore markets.

INSTITUTE HOLDS ROUNDTABLE DISCUSSION ON FEDERAL RESERVE'S RECENT INTERPRETATIONS OF REG K CONCERNING UNDERWRITING BY INTERNATIONAL BANKS OF SECURITIES DISTRIBUTED IN THE U.S.

The Institute held an informal roundtable discussion on March 11th among interested member banks and professional advisors regarding the Federal Reserve Board's recent interpretation under Regulation K regarding the ability of international banks to underwrite securities to be distributed in the United States.

The Board's interpretation applies to international banks that are subject to the Bank Holding Company Act because they operate a U.S. branch or agency or control a U.S. bank or commercial lending company subsidiary. In short, the interpretation provides that, unless such an international bank is a financial holding company under the Gramm-Leach-Bliley Act, or operates a Section 20 subsidiary, the international bank would not be permitted to become a member of an

underwriting syndicate in a registered offering of securities intended to be distributed in the United States.

The interpretation states that "the underwriting of securities to be distributed in the United States is an activity conducted in the United States, regardless of the location at which the underwriting is assumed and the underwriting fees are booked." For international banks that operate a Section 20 subsidiary, the interpretation also notes that revenues generated from underwriting bank-ineligible securities in such transactions should be attributed to the Section 20 subsidiary for purposes of the Section 20 ineligible revenues limit. A copy of the interpretation is available at <http://www.federalreserve.gov/boarddocs/press/bcreg/2003/20030207/default.htm>.

INSTITUTE CONTINUES INTENSIVE LOBBYING EFFORT REGARDING PROPOSED “EARNINGS STRIPPING” LEGISLATION

Executive Summary

As the Treasury Department and the House of Representatives Ways & Means Committee consider ways to tighten the “earnings stripping” rules under Internal Revenue Code section 163(j), the Institute has been continuing its intensive lobbying efforts to counter the potentially severe anti-competitive impact that the proposed legislation would have on foreign-owned securities firms and U.S. branches of many international banks. During the past two months, the Institute has had meetings with senior tax and non-tax officials at the Treasury Department as well as staff members of the congressional tax-writing committees, and has also discussed its concerns with Federal Reserve Board officials. The Institute anticipates that it will need to devote a considerable amount of time and resources in the coming months on this lobbying effort. In addition, given the importance of this issue, member banks and banking associations should consider expressing their concerns directly to the Treasury Department and others in Washington and to encourage their government authorities to do likewise.

The “earnings stripping” proposal that is under consideration would introduce a “worldwide limitation,” which 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.

If enacted, the proposed legislation would adversely impact the ability of foreign-owned securities firms, as well as U.S. branches of international banks, to compete in the U.S. markets. The negative consequences could be quite serious in the case of U.S. securities subsidiaries that are primary dealers in U.S. Government bonds or that have substantial positions in securities which are financed on a secured basis through sale-repurchase (repo) agreements and securities loans. This proposal would also reduce the availability of collateralized (*e.g.*, repo) funding from international banks to finance the corporate debt and equity securities portfolios of the major U.S. securities firms.

The Administration’s budget proposal, released February 3rd, contains a new safe harbor setting forth acceptable debt-to-asset ratios for different categories of assets. The worldwide limitation would apply only if and to the extent that the leverage of the U.S. operations exceeds the safe harbor amount. According to the Treasury Department, the safe harbor is intended to ensure that the worldwide limitation disallowance “would apply only to companies with unusually high levels of indebtedness when compared with other companies that have a similar mix of assets.” Thus, the Treasury Department evidently has accepted the fundamental point advanced by the Institute that different activities within the financial industry call for different leverage levels, and that the U.S. operations may be more highly leveraged than the worldwide group as a result of differences in the nature of their respective businesses and assets.

However, the debt-to-asset ratios set forth in the Administration’s new proposal are not consistent with prevailing ratios in the financial industry, and as a result most financial institutions are unlikely to be helped by the Administration’s new proposed safe harbor.

The proposed safe harbor ratios are as follows:

<u>Asset Class</u>	<u>Debt-to-Asset Ratio</u>
Cash, Cash Equivalents, Government Securities	.98
Municipal Bonds, Publicly Traded Debt Securities, Receivables	.95
Publicly Traded Equities, Mortgages and Other Real Estate Loans, Other Corporate Debt and 3rd Party Loans	.90
Trade Receivables and Other Current Assets	.85
Inventory	.80
Land, Depreciable Assets, Other Investments, Loans to Shareholders	.70
Intangible Assets	.50

In its lobbying efforts, the Institute has argued that the proposal does not adequately take account of the fact that (i) the amount of leverage within the financial services industry varies widely depending on the type of financial institution, the nature of its business and regulatory and business considerations (*e.g.*, banks, securities firms and insurance companies all have different capital structures), (ii) securities firms, whether or not foreign-owned, need to obtain unsecured debt financing through their parent, for commercial reasons, to fund various activities, and (iii) because interest expense is analogous to a manufacturing company’s cost of goods sold, the disallowance of gross interest expense is tantamount to a punitive tax on gross receipts. The Institute has also submitted data to support its contention that the proposed safe

harbor leverage ratios understate the leverage of financial institutions.

The Institute and senior executives of several member banks have emphasized to the Treasury Department, the Federal Reserve Board and congressional staff members their concern that the “earnings stripping” proposal, if enacted, would have serious adverse repercussions for the U.S. Government bond market and the liquidity of the securities markets if internationally owned financial institutions are compelled to scale back their operations as a result of the anti-competitive impact of the proposal.

The Institute will continue to express its concerns to the Administration and Congress regarding the adverse impact that the “earnings stripping” proposal will have on internationally headquartered financial institutions and on the U.S. Government bond market. While organizations representing groups of internationally headquartered industrial corporations have also actively opposed the proposed legislation, a parallel, focused lobbying effort on behalf of internationally headquartered financial institutions is crucial because the proposal unfairly impacts these institutions in ways that differ from its effect on industrial companies and which call for specially tailored solutions.

Furthermore, we understand that the Treasury Department and Congress are being urged by some U.S.-based multinationals to tighten the “earnings stripping” rules as a means of curtailing competitive advantages allegedly enjoyed by foreign-based multinationals. It is very important to counter these erroneous arguments and the anti-foreign message that is being advanced by some of these groups.

**OECD RELEASES REVISED DISCUSSION DRAFT ON
ATTRIBUTION OF PROFITS TO PERMANENT
ESTABLISHMENTS**

Executive Summary

On March 4th, the OECD released a revised version of Part II of the Discussion Draft on the attribution of profits to permanent establishments (PEs), which focuses on bank branches, and also released a draft of Part III, which discusses global trading of financial

instruments by financial institutions. These documents are available on the OECD's website, www.oecd.org/daf/ctpa. The OECD has invited interested parties to submit comments by May 31, 2003.

The basic approach of the revised Discussion Draft has not changed materially from the earlier version, which raised practical, business and administrability concerns. The Institute will hold a Roundtable Discussion of the revised Discussion Draft on April 10th and plans to submit comments to the OECD prior to the May 31st deadline.

The OECD had originally issued Part I of the Discussion Draft (describing in general its Working Hypothesis ("WH") for attributing profits to PEs) and Part II (applying the WH to bank branches) in February 2001. The OECD received comments from approximately 25 interested parties, including the Institute, and held a public consultation in Paris in April 2002, at which the Institute and other organizations expressed their concerns. The revised version of Part II reflects the OECD's response to those concerns. In addition, Part III updates the OECD's 1998 paper on the taxation of global trading activities of financial institutions and applies the WH to cross-border dealer-related activities involving securities, derivatives and foreign currencies.

As previously described, the Discussion Draft proposes as a Working Hypothesis ("WH") a new, comprehensive framework for determining under income tax treaties the amount of profits that should be attributed to the various foreign branches (and head office) of a multinational bank. Significantly, the document proposes to allocate equity capital to each branch (for purposes of determining its deductible interest expense) based on the risk-weighted assets (and off-balance sheet exposures) of the branch, which in turn would be determined based on a functional analysis that focuses on where the "people functions" relating to the creation and management of those assets and risks take place. The original version of the Discussion Draft had proposed using, as a proxy for allocating equity capital, the risk-weighted capital standards under the Basel Accord for bank regulatory standards. The Discussion Draft could have a major impact on the manner in which a multinational bank is taxed in each country in which it conducts business.

The revised Discussion Draft deserves to be carefully examined, and its implications for banks and their securities and derivatives dealer affiliates need to be discussed. The following very general preliminary observations can be made at this time:

1. As a result of industry input, the revised Discussion Draft reflects a deeper and more accurate understanding of the banking and global trading businesses of financial institutions. Many of the more glaring misunderstandings have been remedied, which has improved the approach of the Discussion Draft in some respects. However, most of the basic positions of the WH have not been changed, which is a disappointment.

2. Perhaps the most significant change is that the revised Discussion Draft acknowledges that it will not be possible to develop a single internationally accepted approach – or even a hierarchy of approaches – for attributing equity capital. Rather the revised Discussion Draft merely articulates the general principles for attributing capital, and emphasizes that they need to be applied in a flexible and pragmatic manner and that there is likely to be a range of acceptable results and methods. The Discussion Draft essentially gives equal weight to methods that would allocate capital based on (i) the Basel bank regulatory standards for risk-weighting assets and off-balance sheet exposures (while acknowledging the possible need for adjustments to account for temporary surpluses and "war chests" and for "solo-consolidated" situations), (ii) a bank's internal risk measurement models; (iii) measurements of economic capital; (iv) a quasi-thin capitalization approach, in which each PE is assigned at least the minimum amount of regulatory equity capital that an independent bank would be required to maintain; and (v) a thin capitalization approach, in which each PE is

assigned the amount of capital that it would have if it were an independent bank.

3. Nonetheless, the Discussion Draft continues to maintain that capital is to be attributed to each PE in a manner that appropriately supports the assets, off-balance sheet exposures and other risks that are attributed to that PE under a functional analysis which assumes that in general the creditworthiness of each PE is the same as that of the enterprise as a whole. The Discussion Draft rejects the proposition that one part of a single legal enterprise can be paid a guarantee fee for providing capital or credit support to another part.

4. The Discussion Draft emphasizes that the aim of the WH is not to achieve equality of results between a branch and a subsidiary, but rather to apply the same principles to dealings between parts of an enterprise as apply to inter-company transactions between associated enterprises.

5. The Discussion Draft continues to follow an “ownership” model in fragmenting and allocating assets based on where the “people functions” relating to the creation and management of those assets takes place. In doing so, it did not accept the Institute’s suggestion that the same substantive results could be achieved at significantly lower compliance costs by allocating assets to where they are booked and applying arm’s length allocations only to the income statements under a “service fee” model.

6. The Discussion Draft has an elaborate discussion of the circumstances in which dealings between branches would not be respected due to tax avoidance concerns.

7. Part III of the Discussion Draft applies the same principles developed in Parts I and II to global trading of financial instruments by securities, derivatives and currency dealers. The Discussion Draft discusses how a functional analysis would be applied to those activities in the context of three business models for global trading – integrated trading, centralized product management and separate enterprise.

8. The Discussion Draft reiterates the OECD’s position that where global trading activities involve a “dependent agent” acting on behalf of a principal (such as an affiliate that exercises discretionary authority to conclude contracts on behalf of the enterprise in whose name the transactions are booked), there are two taxpayers in the jurisdiction of the dependent agent – the affiliate entity that acts as dependent agent and the PE of the principal that is deemed to be created as a result of such activity. The Discussion Draft proposes to apply the WH without any adjustments to the deemed PE so as to attribute to it assets, risks and capital (as well as the associated profit or loss) under a functional analysis.