



# INTERNATIONAL BANKING FOCUS

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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 SUBMITS COMMENT LETTER ON SEC PROPOSED RULE TO EXEMPT INTERNATIONAL BANKS FROM THE PROHIBITION ON LOANS TO DIRECTORS AND EXECUTIVE OFFICERS UNDER SECTION 402 OF THE SARBANES-OXLEY ACT

### Executive Summary

The Institute submitted a comment letter to the Securities and Exchange Commission on October 17<sup>th</sup> regarding the SEC's proposed rule to exempt qualifying international banks from Section 402 of the Sarbanes-Oxley Act of 2002. Section 402 prohibits loans by U.S.-listed international banks to their directors and executive officers (including head office loans to head office directors and executive officers). The Institute's comment letter generally commends the SEC's decision to issue a proposed exemption for international banks to address the national treatment issues created by Section 402, as the Institute has advocated since shortly after passage of the Act. The SEC's proposal follows extensive discussions with and submissions to the SEC staff by the Institute, and the SEC's proposed rule adopts the general framework suggested by the Institute. At the same time, the Institute's comment letter suggests that the proposal be revised and clarified in a number of respects. The Institute's comment letter is available on our web site at [http://www.iib.org/member/10-17-03CL\\_402.pdf](http://www.iib.org/member/10-17-03CL_402.pdf) and the release accompanying the SEC's proposed exemption can be found on the Commission's web site at <http://www.sec.gov/rules/proposed/34-4841.htm>.

As previously reported, the SEC release accompanying the proposed rule acknowledges that Section 402's exemption for loans by FDIC-insured U.S. banks had created disparate treatment for international banks, and the proposal reflects a clear intention by the SEC to defer to home country bank supervisory standards where appropriate. With limited exceptions, the Act applies to all "issuers," including non-U.S. issuers, that have securities registered under, or that are required to file reports pursuant to, the U.S. Securities Exchange Act of 1934.

In its comment letter, the Institute's first main suggestion relates to the "comprehensive consolidated supervision" condition for the SEC's proposed exemption. The Institute's comment letter argues that an international bank headquartered in a jurisdiction where one or more international banks have obtained a CCS determination should be eligible for the exemption, even if that particular international bank has not had occasion to obtain a

CCS determination. In the Institute's view, the SEC's proposal, which would require that the international bank itself have obtained a CCS determination, would unfairly disqualify certain international banks from the benefits of the exemption.

The Institute's second major suggestion relates to the "home country insider lending restrictions" condition. As summarized in our September 16<sup>th</sup> memorandum (available on the Institute's web site at <http://www.iib.org/member/9-16-03Sarbanes-Oxley.pdf>), the SEC's release appears to suggest that an international bank would need to be subject to certain insider lending restrictions (which are modeled on the Federal Reserve Board's Regulation O) under the bank's home country laws or regulations (or, alternatively, would need to be subject to home country regulatory approval procedures) in order to qualify for the exemption. The Institute's comment letter points out that if an insider loan complies with the

specified insider lending restrictions as a matter of fact, it should be irrelevant whether the international bank's home country has adopted such restrictions in the form of laws or regulations. The Institute believes this is a fundamental issue, as jurisdictions may elect to implement insider lending restrictions using a wide variety of appropriate means.

The Institute's comment letter also suggests that the SEC reconsider including a specific board of directors approval requirement for large insider loans. To the extent such a requirement is retained, however, the Institute's letter suggests that the threshold for requiring board approval be raised from \$500,000 to at least \$2 million and suggests that the rule permit approval by a committee of the board under delegated authority.

The Institute's comment letter also makes a number of important points regarding the scope of the SEC's proposal, including suggestions (1) that the proposed exemption be broadened to apply to a wider range of international banks, (2) that loans by subsidiaries of international banks be covered by the exemption, and (3) that loans by international banks to insiders of any affiliated issuers be covered by the exemption. The Institute's letter also suggests that the SEC define the terms "director" and "executive officer" for non-U.S. issuers, specifically by using the narrower definitions adopted by the SEC for such terms in connection with the SEC's new Regulation BTR. Among other things, this would mean that the term "director" would exclude directors who are not also management employees. The Institute believes that such a limitation would be appropriate in the context of the SEC's proposed exemption for international banks.

## INSTITUTE SUBMISSION ON U.S. IMPLEMENTATION OF BASEL II FOCUSES ON HOME- HOST COUNTRY COORDINATION

### Executive Summary

**On November 3, 2003, the Institute submitted a comment letter to the U.S. federal banking agencies in connection with the advance notice of proposed rulemaking (ANPR) relating to their planned implementation of Basel II. The Institute's submission builds on the letter we submitted to the Basel Committee in July, urging the 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 Institute's submissions on Basel II are available on our web site at <http://www.iib.org/member/Basel-Capital>.**

The Institute's November 3<sup>rd</sup> comment letter argues that the U.S. banking agencies should permit U.S. bank and thrift subsidiaries of international banks to calculate and manage their capital ratios in accordance with the approach adopted by their parent bank under home country Basel II standards.

For example, a mid-size U.S. bank that is a subsidiary of an international bank that uses the foundation internal ratings-based approach to credit risk under Basel II should be permitted to use the same F-IRB approach rather than use Basel I-based standards (as the ANPR would require).

The comment letter also argues that the U.S. banking agencies should defer to home country capital supervision in connection with making determinations of whether an international bank's capital meets applicable requirements in excess of Basel minimum standards. For example, in evaluating an international bank's compliance with financial holding company ("FHC") eligibility criteria under the Gramm-Leach-Bliley Act, the Federal Reserve Board should, as Vice Chairman Ferguson indicated in his June speech to the Institute, permit an international bank to calculate its capital ratios using whichever of the Basel II

approaches the international bank has adopted under home country standards.

International banks have expressed concerns regarding statements by certain Federal Reserve

staff suggesting that the Federal Reserve may independently evaluate whether international banks qualify to use advanced Basel II approaches before accepting their home country capital ratio calculations for FHC purposes.

## **INSTITUTE SUGGESTS MODIFICATIONS TO FEDERAL RESERVE'S PROPOSED INTERPRETATION AND SUPERVISORY GUIDANCE ON ANTI-TYING RESTRICTIONS**

### **Executive Summary**

**In a comment letter dated October 3, 2003, the Institute made a number of suggestions for ways in which the Federal Reserve Board's proposed interpretation and guidance relating to the anti-tying prohibitions of Section 106 of the Bank Holding Company Act Amendments of 1970 should be modified to minimize adverse effects on international banks' U.S. banking operations. The Institute's comment letter is available at <http://www.iib.org/member/Anti-Tying>.**

The Institute's comment letter points out that international banks, which compete largely in wholesale markets in the United States, frequently offer a narrower range of banking products than their major U.S. competitors. Thus, while the Institute expressed support for the Board's clear recognition of the validity of "relationship banking" under Section 106, including the use of internal hurdle rates, the Institute notes in its letter that international banks operating in the U.S. generally will not be able to look to such traditional bank products as cash management and custody operations as a source of profitability sufficient to meet customers' hurdle rates. In its letter, the Institute urged the Board to consider the competitive position of international banks and smaller U.S. banks in crafting its approach to mixed-product arrangements.

As previously reported, The Federal Reserve's proposal is designed to provide a comprehensive guide to anti-tying compliance for affected institutions, including U.S. branches and agencies of international banks. The release is

available at <http://www.federalreserve.gov/boarddocs/press/bcreg/2003/20030825/default.htm>.

The Institute will hold a training program on Tuesday, December 9<sup>th</sup> to assist member institutions in developing and updating their policies, procedures and training to comply with the anti-tying prohibitions of Section 106. The training program will be held at the Banco Santander Central Hispano Auditorium (45 East 53<sup>rd</sup> Street) from 8:45 a.m. to 12:15 p.m. There is a clear indication that bank examinations will increasingly focus on an assessment of policies, procedures and training in this area. Accordingly, all member institutions are encouraged to send one or more representatives to the training program (further details, including a preliminary program and registration form, are available on the Institute's web site at <http://www.iib.org/11-21-03Anti-Tying.pdf>).

Section 106 of the Bank Holding Company Act Amendments of 1970 generally prohibits a bank from conditioning the availability or price of one product on a requirement that the customer also obtain another product from the bank or an affiliate.

## CONGRESS EXPECTED TO RECESS WITHOUT ENACTING ANY ADVERSE CHANGES TO “EARNINGS STRIPPING” RULES

### Executive Summary

**Congress is expected to defer until its next session, beginning in January, consideration of major tax legislation that includes international tax reform. As previously reported, the Senate’s version of this legislation – the Jumpstart Our Business Strength (JOBS) Act (S. 1637) – does not contain any changes to the “earnings stripping” interest disallowance rule that would adversely affect U.S. branches or subsidiaries of international banks. Moreover, the latest version of the legislation that was introduced by House Ways and Means Committee Chairman Thomas is responsive to the Institute’s concerns regarding the previous version, and drops the controversial proposal to add a new “worldwide limitation” to the existing “earnings stripping” rule. Accordingly, while we understand that the Treasury Department continues to support a “worldwide limitation” with safe harbors, it appears unlikely that the 108<sup>th</sup> Congress will 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 section 163(j) "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.

Chairman Thomas' new bill, introduced on July 25<sup>th</sup>, proposes the following modifications to section 163(j):

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 accepted 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.

The Senate Finance bill contains an "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). In addition, the Finance bill would extend the current-law earnings stripping rules to partnerships and S corporations.

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 SUCCESSFULLY LOBBIES FOR FLEXIBILITY IN APPLICATION OF PROPOSED "CEO SIGNATURE" REQUIREMENT TO INTERNATIONAL BANKS**

The Senate Finance Committee report on the JOBS Act contains language developed by the Institute that will give the Internal Revenue Service flexibility in applying the proposed "CEO signature" requirement to internationally headquartered financial institutions with any licensed U.S. branches or "deemed" branches for U.S. tax purposes.

The CEO signature provision that is contained in the Senate's version of pending tax legislation requires the chief executive of a corporation to sign a declaration certifying the accuracy of the corporation's U.S. federal income tax return. As suggested by the Institute, the language contained in the Committee report would give the IRS flexibility to issue guidance with respect to the designation of another officer of the corporation to sign the declaration "when the corporation is a foreign corporation and the CEO is not a U.S. resident."

As previously reported, we hope the proposed CEO signature requirement is not enacted

into law. Nevertheless, we believe this language will in any event eliminate the burden and costs that the provision would otherwise present to head office CEOs of internationally headquartered financial institutions operating in the United States.

While the JOBS Act still must be considered by the full Senate and a CEO signature requirement is not included in companion legislation on the House side, it was critically important to ensure that the appropriate modifications were included in the Finance Committee bill at this crucial stage in the legislative process. It is likely that Congress will consider the proposed tax legislation in its next session, beginning in January.

This successful effort reflects legal/policy submissions and lobbying in Washington by the Institute, our advisors and the many member institutions and governmental authorities outside the U.S. that communicated with Washington on this issue.

## **INSTITUTE HOLDS FURTHER DISCUSSIONS WITH IRS ON PROPOSAL TO ESTABLISH AN IRS GUIDANCE PROGRAM FOR ISSUES ARISING IN THE APPLICATION OF SECTION 1.882-5 FOR DETERMINING AN INTERNATIONAL BANK'S DEDUCTIBLE INTEREST EXPENSE**

### **Executive Summary**

**The Institute met with Internal Revenue Service officials in Washington on October 14<sup>th</sup> to further discuss the Institute's proposal to the IRS to establish a guidance program to resolve practical issues arising under the application of Treasury Regulation Section 1.882-5 for determining an international bank's deductible interest expense. The Institute submitted a formal proposal to the IRS on August 11th, following a meeting held at the Institute on July 24th with Harry ("Hal") J. Hicks III, the recently appointed Associate Chief Counsel (International) of the IRS, and held a meeting with Mr. Hicks and his staff on September 15<sup>th</sup>. The proposal is available on the Institute's web site at <http://www.iib.org/member/882-5Proposal.pdf>.**

As previously reported, 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).

In its proposal, 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, some banks that have elected the actual ratio have had unsatisfactory audit experiences in recent years.

At the October 14<sup>th</sup> meeting, the Institute and the IRS explored the possibility that the IRS might provide more general guidance on specific adjustments that would, and would not, need to be made to an international bank's financial statements, that are maintained in accordance with its home country standards, in order to compute its "actual ratio." In response to the IRS' request for additional information, the Institute, with the assistance of three member banks, is preparing materials regarding the impact of certain of the proposed adjustments to the financial statements.

## **INSTITUTE MEETS WITH IRS TO DISCUSS GUIDANCE PROJECT ON COMPUTING LOSS CARRYOVER LIMITATION AFTER AN OWNERSHIP CHANGE OF AN INTERNATIONAL BANK**

As part of its Industry Issue Resolution (IIR) Program, the IRS has agreed to issue guidance regarding the application to U.S. branches of international banks of the limitation on utilization of net operation losses (NOLs) and other tax attributes following an acquisition of the bank. At the request of several member banks, the Institute had requested the IRS to provide guidance on this matter (as well as on various other matters of general concern) under the IIR Program. This question has received greater attention in recent years as a result of the phenomenon of bank consolidations.

On November 13<sup>th</sup>, the Institute met with the IRS team that is responsible for issuing the guidance in order to scope out the project and to explore various approaches for addressing the issues raised by the NOL limitation rules. The Institute is preparing a submission discussing points raised at the meeting. The IRS hopes to finalize its guidance within the next 10 months.

Section 382 provides, in general, that the utilization of pre-ownership change NOLs will be subject to a limitation equal to the fair market value of the loss corporation multiplied by the long-term tax-exempt rate. The value of the loss corporation is generally defined as the fair market value of its stock immediately before the ownership change. However, where the loss corporation is a foreign corporation, only items treated as connected with the conduct of a trade or business in the United States are to be taken into account. The guidance project is intended to provide guidance on suitable methodologies to value the U.S. branch operations of international banks for purposes of Section 382, including (1) how to identify and value the goodwill of the U.S. operations and (2) how to determine whether and to what extent any goodwill premium paid for the shares of the bank is attributable to the U.S. operations.

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