



INTERNATIONAL BANKING FOCUS

A Bimonthly Publication of the
INSTITUTE OF INTERNATIONAL BANKERS

Volume XXV, Number 5
October 2, 2003

HIGHLIGHTS

LEGISLATIVE & REGULATORY

SEC Issues Proposed Rule to Exempt International Banks from the Prohibition on Loans to Directors and Executive Officers Under Section 402 of the Sarbanes-Oxley Act2

Institute to Submit Comment Letter on Federal Reserve’s Proposed Interpretive and Supervisory Guidance on Anti-Tying Restrictions.....3

TAX

Senate Finance Committee Approves Major International Tax Bill Without Worldwide Limitation to Existing “Earnings Stripping” Rule.....3

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.....5

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.

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

SEC ISSUES 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

On September 11th, the Securities and Exchange Commission issued a proposed rule that would exempt certain qualifying international banks from Section 402 of the Sarbanes-Oxley Act of 2002. The SEC's proposed rule adopts the general framework suggested by the Institute in its August 2002 submission and discussed in numerous follow-up meetings and communications to SEC officials and others in Washington. The proposed exemption would provide qualifying international banks with significantly greater flexibility to make loans to directors and executive officers in accordance with home country regulations. For example, in the absence of such an exemption, international banks have been constrained in their ability to make loans to directors and executive officers at preferred rates that are available to all employees but not to the general public. U.S. domestic banks, in contrast, have not been similarly constrained, and the proposed exemption is designed to alleviate this disparity. The Institute is preparing a comment letter on the SEC's proposed rule, which will be submitted by the October 17th deadline date for comments. A copy of the release accompanying the proposed exemption can be found on the SEC's web site: <http://www.sec.gov/rules/proposed/34-4841.htm>.

As previously reported, Section 402 regulates loans by U.S.-listed international banks to their directors and executive officers (i.e., including head office loans to head office directors and executive officers). 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.

For U.S. banks, the Act provides an exemption for loans made by FDIC-insured U.S. depository institutions if the loan is subject to U.S. "insider lending restrictions" in the Federal Reserve Act (such as those set out in the Federal Reserve Board's Regulation O). By its terms, this exemption is not available to international banks or their uninsured U.S. branches and agencies.

The SEC staff recognized on several occasions since passage of the Act that the statutory exemption in Section 402 for U.S. banks put international banks at a disadvantage. The SEC's proposal is designed to remedy this disparity of treatment of international banks under Section 402, while at the same time preserving the original objectives of the Act.

As noted above, the SEC's proposal reflects the general framework for an international bank exemption from Section 402 that the Institute has advocated for over a year. In its August 2002 submission to the SEC staff, the Institute suggested an exemption for international banks from countries whose supervisors the Federal Reserve Board had determined exercise comprehensive consolidated supervision (CCS), with an alternative standard for international banks that did not qualify under that test. (The Institute's August 2002 submission and related documents are available on our web site at <http://www.iib.org/member/Sarbanes-Oxley>.)

The SEC's proposed rule would provide an exemption from the prohibitions in Section 402 for

loans by an international bank to its directors and executive officers (and to the directors and executive officers of its parent company) if three conditions are met. The first two conditions—the home country deposit insurance or CCS condition and the home country insider lending restrictions

condition—apply to all loans. The third condition—a board of directors approval requirement—applies only to loans that result in aggregate indebtedness by the director or executive officer that exceeds the equivalent of U.S. \$500,000.

INSTITUTE TO SUBMIT COMMENT LETTER ON FEDERAL RESERVE'S PROPOSED INTERPRETIVE AND SUPERVISORY GUIDANCE ON ANTI-TYING RESTRICTIONS

As *International Banking Focus* was going to press, the Institute was preparing a comment letter on a proposal by the Federal Reserve Board to issue interpretive and supervisory guidance relating to the anti-tying restrictions of Section 106 of the Bank Holding Company Act Amendments of 1970. The comment letter will reflect input received from member institutions, including at the Institute's September 16th roundtable discussion regarding the proposal.

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 on the Federal Reserve's web site at <http://www.federalreserve.gov/boarddocs/press/bcreg/2003/20030825/default.htm>. The Institute plans to hold a workshop in early November to help member institutions develop policies and procedures to comply with the proposed supervisory guidance.

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.

SENATE FINANCE COMMITTEE APPROVES MAJOR INTERNATIONAL TAX BILL WITHOUT WORLDWIDE LIMITATION TO EXISTING “EARNINGS STRIPPING” RULE

Executive Summary

The Senate Finance Committee on October 1st approved a major international tax bill, the “Jumpstart Our Business Strength (JOBS) Act of 2003 (S.1637)”. As expected, the bill did not contain a proposal – which had been included by Chairman Thomas of the House Ways & Means Committee in legislation introduced during the previous Congress and favored by the Treasury Department – to add a new “worldwide limitation” to the existing “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, Chairman Thomas introduced a new tax bill that was responsive to the Institute's concerns regarding the previous “earnings stripping” proposal. Accordingly, while we understand that the Treasury continues to support a “worldwide limitation” with safe harbors, it appears unlikely that the 108th Congress will enact such a provision.

The Senate Finance bill is intended in part to head off \$4 billion in trade sanctions from Europe, following a ruling by the World Trade Organization that the Foreign Sales Corporation/Extraterritorial Income Tax regime is an impermissible export subsidy.

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 25th 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 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 September 15th 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. 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.