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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.

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>

Everett Schenk, Chairman Lawrence R. Uhlick, Executive Director

INSTITUTE URGES THAT CONCERNS WITH SEC'S ALTERNATIVE NET CAPITAL RULE SHOULD BE ADDRESSED IN EU-U.S. FINANCIAL MARKETS REGULATORY DIALOGUE

On July 20th, the Institute sent letters to EC Commissioner Charlie McCreevy and European and other international banking regulators providing an updated analysis of the two fundamental concerns we have raised with the treatment of international banks under the Securities and Exchange Commission's alternative net capital rule and urging that these issues should be addressed at the September meeting of the EU-U.S. Financial Markets Regulatory Dialogue. These concerns relate to the imposition of SEC consolidated supervision over international banks and the \$5 billion gross (non-risk adjusted) minimum capital requirement as conditions to being able to utilize the favorable alternative net capital rule. The Institute also encourages all interested member institutions to contact their home country governmental authorities and strongly recommend that these concerns be addressed. (Institute submissions and related documents are available on the Institute's web site at <http://www.iib.org/member/Other-Regs/>.)

FEDERAL RESERVE ADOPTS INSTITUTE RECOMMENDATIONS REGARDING PROPOSED CHANGES TO FORM FR Y-7

The Federal Reserve Board has adopted the key recommendations advocated by the Institute regarding the Federal Reserve Board's October 2004 proposed changes to the "Annual Report of Foreign Banking Organizations" on Form FR Y-7. The final versions of the Form FR Y-7 are available on the Federal Reserve Board's website at <http://www.federalreserve.gov/boarddocs/reportforms/ReportDetail.cfm>. The Institute's January 28, 2005 submission is available on the Institute's web site at <http://www.iib.org/member/FRY-7>.

Most importantly, the Federal Reserve Board eliminated its proposed change to the Form FR Y-7 that would have required only top-tier foreign banking organizations to file a consolidated Form FR Y-7 for all foreign banking organizations that are "controlled" (for Bank Holding Company Act purposes) by the top-tier foreign banking organization. The Federal Reserve Board also eliminated its proposed change to the signature requirement that would have required the signer of the form to be a director and officer (i.e., a member of the filer's managing board). Regarding the implementation date, the Federal Reserve Board adopted the Institute's suggestion and made the new Form FR Y-7 effective beginning with fiscal years ending December 31, 2005.

INSTITUTE MEETS WITH FEDERAL RESERVE BANK OF NEW YORK ON THE COMPETITIVE DISADVANTAGES TO INTERNATIONAL BANKS FROM THE DAYLIGHT OVERDRAFT STANDARD

Following a March meeting with the staff of the Federal Reserve in Washington, the Institute met on July 19th with the Federal Reserve Bank of New York to discuss our ongoing concerns regarding intra-day overdraft limits and the differential in the deductible for domestic versus international banks. At the meeting, the Institute provided a chart illustrating the \$2 million of annual cost disadvantage that an international bank with \$30 billion in capital would experience in comparison to a comparably-sized domestic bank, assuming both institutions made full use of their deductibles. The cost disadvantage arises because an international bank's deductible is 65% lower than that of a U.S. domestic bank because the Fed recognizes only 35% of the capital for international banks compared with 100% for domestic banks. (See Institute submissions to the Fed dated March 11, 2005, February 4, 2005 and October 26, 2004 at <http://www.iib.org/member/Other-Regs/>.)

An initiative is under way to show the serious delays in payments that result from efforts to limit overdraft charges and further meetings are planned on this important issue.

INSTITUTE CONSIDERS 'WHITE PAPER' ON ISSUES RAISED BY FEDERAL RESERVE TREATMENT OF MINORITY SHAREHOLDINGS BETWEEN INTERNATIONAL BANKS

The Institute held a conference call in late July with interested member institutions and professional firms to discuss the Federal Reserve Board's treatment of minority investments by international banks that are (or seek to be) financial holding companies (FHCs) in other international banks with U.S. banking operations. The discussion confirmed the growing importance of this issue in view of cross-border merger and acquisition trends in Europe and elsewhere. As a follow-up to the conference call, the Institute is now assessing the level of support among our members for possible Institute efforts to address this issue, including the preparation of a "white paper".

IRS CONSIDERS INCREASING 93% FIXED RATIO AND OTHER FAVORABLE CHANGES TO REGULATION SECTION 1.882-5

On July 14th, the Internal Revenue Service issued a notice that responds to a number of issues under regulation section 1.882-5 that the Institute has been pressing the IRS to address for some time.

Most welcome is the IRS' indication that its review of recent data suggests that the 93% fixed ratio is too low. The notice requests internationally headquartered banks to submit data and other information to assist the IRS in determining whether the fixed ratio should be increased to 94 - 96%. The notice also states that the IRS is considering not allowing banks that elect the fixed ratio to also use the fair market value method (rather than tax basis) to determine the amount of their U.S. assets.

In addition, the notice states that the regulation will be revised to allow banks to elect on an annual basis to use a 30-day LIBOR rate to compute their excess interest under the adjusted U.S. booked liabilities method, instead of having to determine the actual dollar borrowing rate of their non-U.S. branches and offices.

Finally, the notice provides some guidance for determining interest expense under the risk-weighted capital method that is sanctioned by the Japanese and U.K. treaties, and confirms that banks headquartered in those countries may continue to apply regulation section 1.882-5.

The Institute will be submitting comments in response to this notice, including (at the invitation of the IRS) suggestions for additional guidance relating to the issues covered by the notice. We also urge member institutions and national and regional banking associations to submit comments to the Treasury and IRS expressing strong support for their initiative in proposing these changes.

INSTITUTE CONSIDERS EFFORT ON PROPOSED RULES FOR SECURITIES VALUATIONS

As previously reported, the IRS recently issued guidance for dealers (and electing traders) in securities, commodities, currencies and derivatives (collectively, "securities") in determining the "marked to market" value of their securities positions under Internal Revenue Code section 475. When finalized, the proposed regulations will provide an elective safe harbor that will permit these taxpayers to use the "fair values" of their positions in securities, as reported on their U.S. GAAP financial statements, as the fair market values of those positions for purposes of section 475, generally without risk of audit challenge to those valuations by the IRS.

In releasing this proposal, the IRS is seeking to avert the sort of audit controversies that have arisen regarding the application of the mark-to-market requirement, including in particular as to the valuation of derivatives and the adjustments that most financial institutions make to mid-market prices to account for credit risks and certain administrative costs. One such audit resulted in the *Banc One* case, in which the Institute joined in an *amicus* brief filed by a group of industry associations.

Unfortunately, the proposed regulations do not provide clear guidance as to their application to internationally headquartered financial institutions and present two significant issues concerning their qualification for the safe harbor:

- U.S. branches of foreign banks file only balance sheets (prepared in accordance with U.S. GAAP principles) with the Fed, not income statements. While the Preamble indicates that the IRS intended the safe harbor to apply to such branches, it evidently did not appreciate that only balance sheets are filed.
- Many internationally headquartered financial institutions engage in cross-border dealing activities where the positions are booked in a foreign office or affiliate but all or a portion of the profits from those activities are taxed in the United States. In these situations, the positions usually are not reported on U.S. GAAP financial statements.

With respect to the first issue, which is relatively straightforward, the Institute would request in a comment letter that the final regulations clarify that the filing of balance sheets by branches is acceptable, particularly in view of the fact that a branch needs to prepare an income statement in order to properly prepare the balance sheet. Regarding the second, more difficult issue, the Institute would hope to persuade the IRS that it should accept non-U.S.-GAAP financial statements that satisfy certain criteria. It is our understanding that there is a need for the Institute to pursue this issue because it is not likely to receive extensive treatment in the submissions of other associations.

In the absence of sufficient support from member institutions, the Institute will not be in a position to make a submission to the IRS on the non-U.S. GAAP financial statement issue.

INSTITUTE CONTINUES EARNINGS STRIPPING EFFORTS

The Institute is continuing to monitor closely developments in Washington regarding possible proposals to amend the “earnings stripping” rules, which limit the amount of interest expense that foreign-owned businesses can deduct under certain circumstances.

On June 16th, the Institute met with staff members of the House and Senate tax committees to discuss the Institute’s perspectives on the earnings stripping rules.

Latest indications are that the Treasury Department’s study and report to Congress regarding the effectiveness of the existing rules will not be ready for some time, well after the June 30th deadline set by Congress.

The Institute also expressed concern regarding a provision that was contained in a version of the Highway Bill that was passed by the Senate earlier this year (and that had been contained in proposed legislation last year) which would extend the earnings stripping rules to corporate partners in respect of partnership debt by applying the earnings stripping rules separately at both the partner and the partnership level. This proposal would inappropriately discriminate against activities conducted through partnerships. The staff members indicated their understanding of the Institute’s concern, and indeed, the final version of the bill adopted by Congress omitted that provision.

INSTITUTE WORKS OUT DETAILS OF PROPOSAL TO ALLOW BRANCHES TO FILE CONSOLIDATED RETURNS WITH SUBSIDIARIES

As previously reported, following a meeting with the Institute’s tax committee, interested member banks and professional liaison firms, the Institute has commenced a lobbying effort to persuade Congress to amend the tax law so as to enable branches to file consolidated returns with subsidiaries. A principal benefit of such a change in the law would be to allow losses of U.S. subsidiaries to offset income of the branch and

vice versa. As currently drafted, the proposal would not modify other aspects of the taxation of branches, such as Treasury Regulation section 1.882-5 governing interest expense and the branch profits tax under section 884 of the Internal Revenue Code.

A number of interested member banks have joined the working group that will participate in making decisions regarding this effort, would attend meetings in Washington and would help defray the costs of the Institute's tax counsel. Additional members would be welcome.

Over the last month, the legislative proposal has been refined to better address specific situations faced by member banks that are part of the working group.

INSTITUTE EXPLORING FURTHER OPTIONS REGARDING OECD DISCUSSION DRAFT ON TAXATION OF PERMANENT ESTABLISHMENTS

The OECD Working Party continues its work on its draft report on the attribution of profits to branches of banks and other permanent establishments (PEs), and earlier this month, the OECD released a draft of Part IV of its report, dealing with insurance companies.

The Institute continues to explore ways to persuade the OECD to modify its agreed upon method to take account of concerns expressed by the Institute and other industry groups. In coordination with the European Banking Federation, the Institute is seeking a broader dialogue and unified effort with groups that are being organized by non-financial industries to express their concerns regarding the draft report.

In addition, we continue to believe that if the financial industry wishes to secure improvements in the manner in which PEs will be taxed under the OECD approach, it will be important for banking associations to discuss the industry's concerns with their respective country's tax representatives to the OECD.

Our preliminary assessment is that the draft report's proposed treatment of insurance companies – essentially attributing investment profit to where the underwriting functions take place and downplaying the importance of the key entrepreneurial risk-taking functions in respect of investment activity – is inconsistent with the approach taken by the report in respect of banking and global dealing activities. This and other inconsistencies in the treatment of different industries may present an opportunity to argue for reconsideration of the OECD's approach.