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UPDATE ON IMPLEMENTATION OF THE GRAMM-LEACH-BLILEY ACT

Attention remains focused on the “well capitalized” and “well managed” standards applied by the Federal Reserve Board to international banks that seek treatment as “financial holding companies” under the Gramm-Leach-Bliley (GLB) Act in order to engage in expanded financial activities in the United States, such as merchant banking and insurance underwriting.

In further discussions with the Board on this subject, the Institute, the European Commission and others have emphasized their continuing concerns regarding (i) the application of a leverage test to international banks, even though such a test is not part of the Basel Capital Accord; (ii) the use of the composite examination rating of each U.S. branch and agency – rather than a composite rating of such offices in the aggregate – in determining whether an international bank is well managed; and (iii) the requirement that the capital and management standards be met not only by an international bank that seeks to engage in activities permissible for financial holding companies, but also by any affiliate of such bank that itself is an international bank that conducts banking operations in the United States but does not seek to engage in such activities (the Institute has proposed that in such cases the standards be applied only to the first international bank both separately and on a consolidated basis after taking full account of the affiliated international bank). These issues remain under consideration by the Board, and the interim rule adopted in January accordingly has not yet been finalized.

The Board has indicated its willingness to be flexible in applying these standards to international banks, and, indeed, has stated that several international banks that do not meet the numerical criteria for being well capitalized – *i.e.*, a Tier 1 and total risk-based capital ratio of at least 6% and 10%, respectively, and a minimum leverage ratio (Tier 1 capital to total assets unadjusted for risk) of at least 3% – nevertheless have been designated as financial

holding companies. The Institute welcomes input from member banks regarding their experience with the Board’s interim rule, as well as the impact of other provisions of the GLB Act on their operations.

The Institute is also addressing issues arising under the securities “push out” provisions of the GLB Act, which apply to all international banks with U.S. banking operations, as well as to all domestic banks, regardless of whether they seek to become financial holding companies. Briefly, these provisions require that banks, including U.S. branches and agencies of international banks, transfer (“push out”) to an SEC-registered broker-dealer all securities activities they currently conduct directly, except for those activities that the GLB Act specifically excludes from the push out (see the November 1999 issue of *International Banking Focus*). The Institute is seeking clarification of several important interpretive questions regarding the push out provisions, particularly as they apply to private banking activities. As the push out provisions are effective in less than one year (May 12, 2001), and the establishment of a broker-dealer affiliate may entail considerable time, effort and expense, it is important for international banks to review their existing securities operations for compliance with the requirements of the GLB Act.

Enactment of the GLB Act has triggered discussion within the financial community of the feasibility of creating a federal insurance charter. The Institute is monitoring these developments and their implications for international banks that may wish to establish or expand insurance activities in the United States. For example, the availability of a federal insurance charter option could present new possibilities for international banks to establish federally-licensed branches of non-U.S. insurance companies to conduct activities in the United States. The Institute encourages further input from member banks and their professional advisers regarding proposals that would be helpful to internationally headquartered banking/insurance groups.

INSTITUTE CONTINUES TO SEEK REVISIONS TO ASSET PLEDGE REQUIREMENTS APPLICABLE TO U.S. BRANCHES AND AGENCIES OF INTERNATIONAL BANKS UNDER STATE AND FEDERAL LAW

Executive Summary

Representatives of Institute member banks recently met separately with the New York State Superintendent of Banks and the Chief Counsel of the Office of the Comptroller of the Currency (OCC) to exchange views regarding a variety of regulatory and supervisory issues, including the Institute's proposals to substantially reduce or eliminate entirely (except as otherwise may be determined necessary on a case-by-case basis) the asset pledge requirements applicable to U.S. branches and agencies of international banks. The Institute is refining its proposals based on these meetings and looks forward to further discussions on this subject with the appropriate state and federal banking agencies.

The Institute's asset pledge initiative has been undertaken at the urging of member banks, many of which are required under applicable state or federal law to pledge hundreds of millions of dollars of assets (and, in some instances, more than one billion dollars of assets) that could be deployed to potentially more profitable purposes. Moreover, the assets that may be pledged in satisfaction of these requirements typically are restricted to highly liquid instruments such as commercial paper, certificates of deposit and bankers' acceptances, which carry a lower rate of return than loans and other longer term and less liquid balance sheet assets.

In reviewing existing asset pledge requirements, a notable feature is the variety of approaches taken. These range from imposing requirements based on a fixed percentage (as much as 5%) of total liabilities to unrelated third parties to permitting the appropriate banking authority full discretion to determine whether or not to apply an asset pledge requirement. The latter approach is taken in Illinois, where international banks generally are not subject to an asset pledge requirement, but the Commissioner of Banks reserves the right to impose such a requirement where deemed necessary and appropriate given the circumstances of a particular institution.

Asset pledge requirements have been carried over from an era of banking preceding the widespread adoption of risk-based approaches to

supervision and the establishment of international risk-based capital standards. The Institute believes that in light of these developments it is worth reconsidering the basis on which asset pledge requirements are founded. In this regard, the Institute has proposed that a substantial reduction in existing asset pledge requirements be coupled with an expansion of the type of assets that may be pledged (e.g., any asset, including loans, that may be eligible as collateral with the Federal Reserve), thereby providing maximum flexibility to banks that may be subject to an asset pledge.

Most fundamentally, the Institute has raised the question whether it is still appropriate to view the asset pledge as a necessary tool (and one that is separate from the overall assets of the branch or agency, which are subject to ongoing bank regulatory examination) for the protection of depositors and other creditors of a branch or agency, or whether the asset pledge should now be viewed primarily as a means to assure that there will be sufficient and readily available funds on hand to pay the initial expenses arising in the event it becomes necessary to liquidate a branch or agency, which is an extremely rare occurrence. As to this question, it is noted that the results of a survey of more than 40 countries recently conducted by the Institute indicate that the United States and Canada are the only countries that impose asset pledge requirements on non-domestic banks operating within their territory.

ANTI-MONEY LAUNDERING LEGISLATION PASSED BY THE HOUSE BANKING COMMITTEE INCLUDES TECHNICAL AMENDMENTS SUGGESTED BY THE INSTITUTE TO CLARIFY THE TREATMENT OF INTERNATIONAL BANKS

Executive Summary

On June 8th, the House Committee on Banking and Financial Services by a vote of 31 to 1 approved the “International Counter-Money Laundering and Foreign Anticorruption Act of 2000” (H.R. 3886). H.R. 3886 would provide the Treasury Department broad discretionary authority to identify specific foreign jurisdictions, financial institutions and classes of transactions that are of “primary money laundering concern” to the United States and to impose on domestic financial institutions, including the U.S. branches and agencies of international banks, “special measures” to address these concerns. Such measures range from enhanced due diligence (“know your customer”) requirements to the prohibition of opening or maintaining certain accounts in the U.S. through which money laundering transactions could be effected.

The Committee adopted two technical amendments to the bill that were suggested by the Institute to clarify the treatment of international banks. The first amendment provides that in assessing the potential competitive impact a “special measure” may have on a “financial institution organized in the United States” the Treasury Department should also consider the impact on U.S. branches and agencies of international banks. The second amendment specifies that international banks receive the same protection from lawsuits provided under the bill to “insured depository institutions” when disclosing in employment references information regarding employee misconduct.

Comparison of Anti-Money Laundering Bills Pending in Congress

By granting the Treasury Department broad discretion to impose special anti-money laundering measures, H.R. 3886 takes a significantly narrower approach to money laundering than bills introduced late last year. Whereas H.R. 3886 seeks to tailor its special anti-money laundering measures to the particular problems that may be presented by specific foreign jurisdictions, financial institutions and classes of transactions, these other bills would impose broad restrictions on whole categories of activities – e.g., by prohibiting correspondent banking with institutions not subject to “consolidated supervision” and imposing beneficial ownership disclosure requirements with respect to

the accounts of “foreign entities” – without regard to whether such measures are warranted by the circumstances of a particular situation (see the November 1999 issue of *International Banking Focus*). The Institute and others have emphasized the importance of adopting a more flexible legislative approach to these issues.

There is some similarity between H.R. 3886 and the approach that has been adopted by the Financial Action Task Force on Money Laundering (FATF), which on June 22nd issued a report naming 15 jurisdictions that have failed to take adequate measures to combat international money laundering. The report strongly urges these jurisdictions to adopt remedial measures as expeditiously as possible, and indicates that if such action is not taken, then the FATF member countries “would need to consider the adoption of counter-measures”. Publication of

the FATF report followed the Financial Stability Forum's release of a statement on May 26th categorizing offshore financial jurisdictions into one of three broad groups according to the perceived quality of their supervision and perceived degree of their cooperation with efforts to promote adherence to international standards. It should be acknowledged that a number of the jurisdictions named have objected strenuously to their being characterized in this manner.

Amendments to H.R. 3886 Suggested by the Institute

As introduced in the House, H.R. 3886 required the Treasury Department, when imposing any "special measure" authorized under the bill, to take into account whether such measure would create a significant competitive disadvantage for "financial institutions organized in the United States." While this language clearly covers U.S. depository institution subsidiaries of international banks, it was uncertain whether it also covered U.S. branches and agencies of international banks. To eliminate this ambiguity, the Institute suggested an amendment providing that the Treasury Department consider the competitive impact on financial institutions organized or licensed in the United States, thereby clarifying that this provision covers all U.S. banking operations of international banks.

The Committee by voice vote unanimously adopted this amendment.

Another provision of H.R. 3886 prevents lawsuits against any "insured depository institution" that discloses information concerning misconduct by a current or former officer, employee or other "institution affiliated party" in response to a request by another insured depository institution for a written employment reference. The Committee by voice vote unanimously adopted an amendment suggested by the Institute clarifying that the same protection applies to any uninsured U.S. branch or agency of an international bank.

Legislative Prospects in the Remainder of the 106th Congress

With less than three months remaining before its adjournment, Congress has yet to develop any consensus on the various anti-money laundering bills that have been introduced. The Administration supports passage of H.R. 3886 and has urged Congress to pass legislation implementing its "National Money Laundering Strategy for 2000", but there is as yet no indication on the part of the Congressional leadership of a willingness to do so, particularly in the Senate, where Senator Gramm has focused the attention of the Senate Banking Committee on other legislative priorities.

INSTITUTE PURSUES EFFORTS REGARDING COMPUTATION OF CAPITAL FOR PURPOSES OF DETERMINING A BANK'S DEDUCTIBLE INTEREST EXPENSE

Executive Summary

The Institute has been following up on its efforts to persuade the Treasury Department and the IRS to cease considering, in the context of an OECD Steering Committee, a possible approach, based on the Basel risk-weighted capital standards, for determining the amount of interest expense that a multinational bank would be entitled to deduct for tax purposes in the various countries in which the bank conducts business.

As part of these efforts, attention has focused on a possible alternative approach that might be proposed for consideration by the OECD Steering Committee. This alternative approach, which is a refinement of a proposal first made by the Institute in May 1996, would allocate a bank's worldwide capital among its branches in accordance with the

relative amount of assets shown on the books of each branch, as determined for financial (or regulatory) purposes.

A consensus has been developing that the Institute should submit this alternative approach to the Treasury Department and the IRS for consideration by the OECD Steering Committee. The Institute expects to make that submission in September, after soliciting further input from member banks.

As previously reported, the Institute has held several meetings in the course of the past year with Treasury Department and IRS representatives to express its concerns regarding the approach that is being explored by the Treasury Department and an OECD Steering Committee of possibly adopting a uniform international approach, based on the Basel risk-weighted capital standards, for determining the amount of interest expense that a multinational bank would be entitled to deduct for tax purposes in the various countries in which the bank conducts business. Under the approach that is being discussed, the amount of capital that would be allocated to a bank's branches in each country would be based on the relative amount of risk-weighted assets and off-balance sheet exposures attributable to the branches in that country, compared to the total amount of risk-weighted assets and off-balance sheet exposures of the bank as a global entity.

The Treasury Department and the IRS favor replacing the existing 1.882-5 regulations with an OECD-sanctioned Basel-based approach because, among other reasons, it would potentially achieve greater international conformity in the allocation of capital for tax purposes and would enable the IRS to address the uncertainties created by the *NatWest* decision.

However, the adoption of a Basel-based approach to determining a bank's deductible interest expense could have a significant adverse impact on the worldwide tax position of many multinational banks. Preliminary indications are that the Basel-based approach generally would increase the amount of capital allocated to a multinational bank's U.S. and other non-home country branches (because banks tend to concentrate their low-risk weighted assets in their home office), thereby shifting deductible interest expense from the U.S. and other branches to the home country and increasing the tax

burden on multinational banks outside their home country. The overall impact of a Basel-based approach on the worldwide tax position of any particular bank will depend on the interplay of numerous factors.

Moreover, the Institute believes that even after allocating capital to the various branches of a bank under the Basel-based approach, those branches could not conduct the business that they conduct or fund their activities at the attractive borrowing rates that they incur if they were treated as completely separate entities unrelated to the bank. Accordingly, adjustments need to be made for the intangible benefits that arise from each branch being part of the bank as a whole.

Following a May 2nd meeting with representatives of the Treasury Department and the IRS, the Institute circulated for comment a summary of the arguments that the Institute has been articulating against use of a Basel capital-based approach and of a possible alternative approach. This summary is available in the member area of the Institute's web site at the following address: www.iib.org/member/5-19SummaryofArguments.pdf.

Very generally, under the alternative approach, a bank's worldwide capital would be allocated among its branches in accordance with the relative amount of assets shown on the books of each branch, as determined for financial (or regulatory) accounting purposes (*i.e.*, not on a risk-weighted basis and without regard to off-balance sheet exposures). However, adjustments would be made for (1) branch-booked assets that do not generate income taxable in that country and assets that generate taxable income but are booked elsewhere, and (2) securities repos and other situations in which direct tracing is appropriate. This alternative approach is a refinement of a

proposal first advanced by the Institute in its May 1996 comments on regulation section 1.882-5.

A Town Hall Meeting of interested member banks, accounting firms and legal advisers on July 18th discussed the overall strategy that the Institute should pursue. It was recognized that although many banks have learned to live with the existing rules under regulation section 1.882-5 (despite its many flaws), there was a risk that the OECD and

various member countries (including eventually the United States) would adopt a Basel capital-based approach unless they were persuaded that there is a better alternative approach. Accordingly, a consensus emerged in favor of submitting the alternative approach outlined in the summary to the Treasury Department and the IRS. The Institute expects to make that submission in September, after soliciting further input from member banks.

INSTITUTE DEVELOPING STRATEGIES REGARDING POSSIBLE NEW YORK STATE BANK TAX REVISIONS

Executive Summary

The New York State and City tax departments are considering potentially far-reaching changes to the New York State and City bank tax law and its relationship to the general corporation tax. These changes could have a significant impact on the tax liability of member banks.

As previously reported, the Institute has been meeting with the New York State and City tax authorities and other representatives of the banking, insurance and securities industries as part of a Financial Services Modernization Task Force to discuss the tax policy issues arising from the recent federal financial modernization legislation (the Gramm-Leach-Bliley Act). The next meeting is scheduled for August 10th. In addition, at the request of the State tax department, the Institute submitted a preliminary analysis of the salient provisions of the bank tax law (Article 32) and the general corporation tax law (Article 9A) that we consider to be beneficial or detrimental to the international banking community.

On July 18th, the Institute held a Town Hall Meeting of representatives of interested member banks, accounting firms and legal advisers to discuss the positions that the Institute should be advocating as part of the Task Force. Particular attention is being given to aspects of the tax rules that are of special interest to the international banking community and that therefore are unlikely to be advocated by other industry representatives. Member banks are urged to raise issues of concern to them with the Institute and to express their views on the Institute's tentative positions as summarized below.

At the Town Hall Meeting, there was a general consensus that, to the extent possible, the Institute's efforts should be directed to preserving the separate tax rules for banks under Article 32 and

the flexibility in practice to choose between the different regimes under Article 32 and 9A with respect to banks' securities and other nonbank affiliates. Nonetheless, it was recognized that the

State tax department may seek to combine the separate tax laws for banks and insurance companies with the general corporation tax, subject to a limited number of special rules for banks and insurance companies.

With this perspective, the participants at the Town Hall Meeting identified several key provisions of interest to Institute member banks, including the following:

- *The tax base of non-US entities.* It is important to preserve the Article 32 “water’s edge” approach, whereby a non-US bank’s NY tax base is limited to its “effectively connected income” for federal income tax purposes. Member banks generally favored having this rule extended to replace the worldwide apportionment approach under Article 9A, although there was some sentiment in favor of an elective worldwide apportionment approach to provide additional flexibility.
- *Combined Reports.* There was a strong sentiment favoring having combined reporting be elective on the part of taxpayers. Also, it was felt that US branches of international banks should be eligible to file combined reports with their US subsidiaries, and that US corporations that are New York taxpayers should be allowed to elect to file combined tax returns even if their parent corporation is a foreign corporation not taxable in New York. Finally, there was some sentiment in favor of permitting combination between banks and non-banks (with the allocation formulas being applied on a separate company basis).
- *International Banking Facility (“IBF”).* Member banks favored the retention of these special provisions.
- *Bad Debt Reserves.* Member banks also favored the retention of the bad debt reserve rules under Article 32 for banks.
- *Allocation Factors.* There was general agreement that separate allocation factors, tailored to the specific circumstances of banks, needed to be preserved, although it is less clear to what extent these rules should apply to non-bank affiliates. Member banks were asked to comment on the degree to which the Institute should advocate a change in the receipts factor so as to source receipts from loans to the location of the customer rather than to the location of the income producing activity.
- *Investment Income.* It was generally recognized that the investment allocation approach of Article 9A (whereby investment income is allocated based upon the allocation percentage of the corporation from which the income is derived) is more favorable to many securities firms than the treatment of investment income under Article 32 (under which such income is subject to the general business income allocation and apportionment factors, but there is an exclusion for 22½ % of interest income from US and NY State obligations). A key objective of any tax revisions should be to enable non-banking affiliates of banks to use the investment allocation approach that is available under Article 9A. However, concern was expressed that in certain circumstances the Article 9A approach could produce less favorable results because it requires a disallowance of interest expense attributable to investment assets. Member banks were invited to quantify the differences between these approaches.

- *Subsidiary Capital.* It was recognized that any melding of Articles 9A and 32 would necessitate developing a uniform set of rules for subsidiary capital and income (such as dividends, interest and capital gains) therefrom.
- *Alternative Tax on Assets.* There was a strong sentiment in favor of having the alternative tax for banks, based on assets, conformed to the

Article 9A rule, which caps the maximum tax at \$350,000.

The Institute welcomes comments by member banks and other interested parties regarding the positions that the Institute should be taking on the Task Force.

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