



# INTERNATIONAL BANKING FOCUS

A Bimonthly Publication of the  
INSTITUTE OF INTERNATIONAL BANKERS

Volume XXII, Number 2  
March 27, 2000

## HIGHLIGHTS

### LEGISLATIVE

Federal Reserve amends interim rule regarding the eligibility of international banks to be treated as financial holding companies under the Gramm-Leach-Bliley Act.....2

Page

### REGULATORY

Institute proposes major revisions to New York State Banking Department's asset pledge requirement.....3

### TAX

Treasury and IRS representatives discuss agenda for coming year at Institute's Annual Washington Conference and plan to meet with the Institute on capital issues.....4

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## FEDERAL RESERVE REVISES ITS INTERIM RULE TO PERMIT INTERNATIONAL BANKS TO USE 31-DAY NOTICE PROCEDURE APPLICABLE TO DOMESTIC BANKS SEEKING TO BECOME FINANCIAL HOLDING COMPANIES

On March 15<sup>th</sup>, the Federal Reserve Board announced the adoption of amendments to its interim rule regarding the eligibility of international banks to be treated as financial holding companies under the Gramm-Leach-Bliley Act. (The interim rule as originally adopted is discussed in the January 2000 issue of *International Banking Focus*.) Each of the amendments took effect immediately.

Responding to the concerns raised by the Institute and others, the Board amended the procedures by which an international bank may elect to be treated as a financial holding company to conform them to the procedures applicable to elections filed by domestic banking organizations. **As a result of this amendment, international banks are no longer subject to the quasi-application process required under the rule as originally adopted. Instead, the rule now provides that an election by an international bank to be treated as a financial holding company will become effective on the 31<sup>st</sup> day after filing unless the Board finds the election ineffective or the international bank agrees to extend the review period (international banks may continue to utilize the “pre-clearance” process prior to filing a formal election).** The rule further provides that the Board will find an election ineffective if either the applicable capital and management standards are not met or “the Board does not have sufficient information” to assess whether these standards are met.

Significantly, the Board did not make any substantive change to the capital and management standards applicable to international banks. For example, international banks remain subject under the well capitalized standard to a minimum 3% leverage requirement (as measured by the ratio of Tier 1 capital to total assets unadjusted for risk).

On March 24<sup>th</sup>, the Institute submitted a comment letter to the Board on the interim rule as originally adopted in January, suggesting that the

“well capitalized” standard should be based entirely on the internationally agreed upon Basel risk-based capital methodology, rather than on any U.S. leverage test. The Institute also suggested that the “well managed” standard should be applied on the basis of a composite rating of an international bank’s U.S. branch operations as a whole instead of the separate rating of each office. In addition, instead of a requirement that a bank’s home country supervisor consider the overall operations of the bank to be satisfactory, the Institute recommended that the Board should only determine that an international bank’s election is ineffective if the Board concludes that the global management is not satisfactory after consultation with the home country supervisor. (The comment letter is available in the member area of the Institute’s web site at [www.IIB.org/member](http://www.IIB.org/member).)

A second amendment announced by the Board on March 15<sup>th</sup> involved the addition of a statement in the interim rule “encouraging” international banks to use the “pre-clearance” process if they are chartered in countries where no other bank from that country has received a comprehensive consolidated supervision (CCS) determination (including a determination that the home country supervisor is “actively working toward” a system of CCS). In addition, **the Board is requesting comment on whether an international bank should be required to meet a CCS standard in order to be treated as a financial holding company.** The interim rule continues to provide that CCS is one of the factors that the Board may consider in determining whether an international bank meets the applicable capital and management standards. **In its comment on the amendments to the interim rule (due by April 17<sup>th</sup>), the Institute will argue that satisfaction of the CCS standard should not be added as a formal requirement of the rule.**

The Board also adopted a technical amendment to the rule on March 15<sup>th</sup> to clarify that, in order for an international bank to become a financial

holding company, each of its U.S. depository institution subsidiaries must be well capitalized and well managed and satisfy any applicable CRA requirement.

## **THE INSTITUTE PROPOSES MAJOR REVISIONS TO THE NEW YORK STATE BANKING DEPARTMENT'S ASSET PLEDGE REQUIREMENT**

Continuing an overall effort to reduce asset pledge requirements applicable to U.S. branches and agencies of international banks, the Institute has sent a letter to the New York State Banking Department recommending major revisions of its asset pledge regulation (the letter, with its enclosures, is available in the member area of the Institute's web site at [www.IIB.org/member](http://www.IIB.org/member)). Specifically, the Institute proposes that the New York asset pledge requirement be revised to (i) establish an upper limit of \$10 million on the amount of assets required to be deposited thereunder by New York branches and agencies and (ii) expand the scope of assets that may be deposited in satisfaction of the asset pledge requirement to include any asset that is eligible as collateral at the Federal Reserve discount window, subject to such conditions as may be determined at the discretion of the Superintendent. While the proposal thus calls for a capping of the amount of the asset pledge, it nevertheless is contemplated that New York branches and agencies would remain subject to the \$1 million minimum amount prescribed under the existing regulation.

As an alternative to imposing an upper limit on the amount of assets required to be deposited under the asset pledge, the Institute has also proposed that consideration be given to modifying the asset pledge requirement so that New York

branches and agencies in general would not be required to pledge any assets. Under this approach, which would be similar to the arrangements that apply to Illinois branches and agencies of international banks, the Superintendent would retain the discretion to impose an asset pledge requirement on a case-by-case basis as warranted by the circumstances of a particular branch or agency.

As explained in its letter, the Institute believes that its proposal would permit New York branches and agencies greater flexibility in managing their assets and liabilities while ensuring that there would still be sufficient assets on hand in New York to pay the initial expenses of a liquidation, which is the primary purpose of the asset pledge requirement. The Institute plans further discussions with the Banking Department on the proposal. In addition, the Institute is involved in discussions with other state banking authorities and the Office of the Comptroller of the Currency regarding revisions to their asset pledge requirements.

## **U.S. TREASURY DEPARTMENT AND IRS DESCRIBE AGENDA FOR THE COMING YEAR AND PLAN TO MEET WITH THE INSTITUTE ON CAPITAL ISSUES**

During the Institute's Annual Washington Conference on March 6<sup>th</sup> – 7<sup>th</sup>, U.S. Treasury Department and IRS representatives discussed pending and future projects of interest to the international banking community. Additionally, the Treasury Department and the IRS are scheduling a meeting with the Institute in the coming month to discuss an issue of great importance to international banks – the proper allocation and taxation of capital, both in the context of global dealing activities and in determining an international bank's deductible interest expense in the United States.

The discussion at the Washington Conference focused on the following topics:

### **Qualified Intermediary (“QI”) Agreements and the Final Withholding Regulations**

Philip Garlett of the IRS office of Associate Chief Counsel (International), emphasized the importance for international banks and their securities and trust company affiliates that are engaged in custodial businesses to begin the process of applying for a QI agreement and implementing the substantial changes to their operating systems that will be necessary to comply with the new withholding tax and information reporting regulations, which will become effective at the end of this year. According to Mr. Garlett, the IRS is unlikely to depart in material respects from the terms of the Model QI Agreement released in January.

The IRS will be issuing clarifications of the withholding regulations and will also be finalizing the temporary regulations issued under section 894(c) regarding the substantive rules for establishing that a person is entitled to a reduced rate of withholding tax on dividends, interest, etc. under an income tax treaty, particularly in the case of so-called hybrid entities.

### **Global Dealing Regulations, Capital and Interest Expense Allocation**

Patricia Brown, the Treasury Department's Deputy International Tax Counsel, stated that a priority agenda item for this year is the finalization of the proposed regulations, issued in March 1998, concerning cross-border dealing operations in foreign currencies, securities and derivatives. As advocated by the Institute, the new rules adopt an arm's length approach for determining the amount of profits from a cross-border dealing operation that is subject to U.S. taxation.

Of importance to all member banks, the proposed regulations would provide relief for interbranch transactions in foreign exchange and other financial products between an international bank's U.S. operations and its head office or other branches outside the United States.

Ms. Brown observed that the Treasury Department has endeavored to coordinate its basic policies regarding global dealing with those of other countries, through the OECD Working Group as well as bilateral discussions, with a view to reducing inconsistent positions among countries that could result in substantial multiple taxation exposures to dealers in securities, derivatives and foreign currencies.

The treatment of capital, and how it should be allocated among different business locations of an international bank for tax purposes, is a controversial issue on which discussions are continuing within the OECD. This issue affects both the determination of the amount of profit from a global dealing activity that is properly allocable to a particular country and the determination of the deductible interest expense of an international bank in a particular country.

Traditionally, the IRS has adopted the position that capital is fungible and that accordingly

the deductible interest expense of an international bank's U.S. branch is to be determined under the allocation formula of Treasury regulation section 1.882-5. In the context of the proposed global dealing regulations, the IRS has taken the position that the profit attributable to capital generally should be taxed where the capital is employed (which, according to the proposed regulations, is where the traders, marketers and risk managers that are responsible for the global dealing activities operate).

Ms. Brown acknowledged that other countries have different views regarding the taxation of capital. For example, some countries believe that capital should be allocated for tax purposes in the same manner as it is allocated under the Basel risk-weighted capital standards. As reported in previous issues of *International Banking Focus*, the United States is considering such an approach. In addition, Ms. Brown noted that the implications of the *NatWest* case, which held that the section 1.882-5 formula contravenes the U.S.-U.K. tax treaty, are being evaluated in this context. Ms. Brown expressed the hope that a greater international consensus will emerge in the coming months, which could be reflected in the final global dealing regulations. However, Ms. Brown indicated that further guidance regarding interest allocation issues will take considerably more time to develop.

As indicated above, the Institute is planning to meet with the Treasury Department and the IRS in the coming month to discuss capital-related issues.

## **New Corporate Tax Shelter Regulations**

John Staples, IRS Assistant Chief Counsel (International) emphasized that the recently issued temporary regulations relating to corporate tax shelters were a first step in the Clinton Administration's efforts to curb abusive tax planning activities by corporations and promoters. In brief, the new regulations impose (1) disclosure requirements for corporate taxpayers that engage in potential tax shelter transactions, (2) disclosure requirements on the promoters of confidential tax shelters, and (3) requirements that promoters of tax shelters keep lists of parties that were sold an interest in a corporate tax shelter. According to Mr. Staples, the Administration will continue in its efforts to bolster the disclosure requirements of the temporary regulations with increased penalties and other legislative initiatives.

Because the definition of potential tax shelter transactions is very broad and may cover a wide range of capital markets and other transactions providing tax benefits to participants, international banks and their affiliates will need to set up internal mechanisms for monitoring and complying with these new requirements.