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HIGHLIGHTS

Page

LEGISLATIVE

Institute addresses the use of Section 114 of the Gramm-Leach-Bliley Act to apply Sections 23A and 23B of the Federal Reserve Act to certain lending by U.S. branches of international banks that qualify as financial holding companies……………………………………………………………...…………2

REGULATORY

Institute makes additional submissions on the Federal Reserve interim rules implementing the Gramm-Leach-Bliley Act.………..…………..…………….………3

TAX

Treasury and IRS indicate further flexibility in forthcoming global dealing regulations ………..…………..…………………………………..………..…4

Institute continues discussions with Treasury regarding use of Basel risk-based capital standards to allocate capital to an international bank's branches in individual countries to determine deductible interest expense………..5

IRS announces further changes regarding Qualified Intermediaries and revises new withholding regulations……………………………………………..7

New York State passes one-year tax legislation and creates task force to consider the tax policy implications of financial services legislation under the Gramm-Leach-Bliley Act …………………………………….…………8

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INSTITUTE ADDRESSES THE USE OF SECTION 114 OF THE GRAMM-LEACH-BLILEY ACT TO APPLY SECTIONS 23A AND 23B TO CERTAIN LENDING BY U.S. BRANCHES OF INTERNATIONAL BANKS THAT QUALIFY AS FINANCIAL HOLDING COMPANIES

As reported in prior issues of *International Banking Focus*, Section 114 of the Gramm-Leach-Bliley (GLB) Act authorizes the appropriate federal banking agency to impose prudential safeguards governing transactions between depository institutions, their subsidiaries and affiliates so as to avoid, among other items, significant risk to the safety and soundness of the institution and other adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest or unsound banking practices. The Federal Reserve Board is granted sole authority to determine whether such safeguards should apply under Section 114 with respect to transactions involving the U.S. branches and agencies of international banks and their U.S. affiliates. However, the Board's authority under Section 114 does not apply to the non-U.S. operations of international banks vis-à-vis their U.S. affiliates, such as head office funding of U.S. securities and other affiliates.

The Board specifically cited Section 114 as the basis for its adopting on March 10, 2000 an interim rule applying Sections 23A and 23B of the Federal Reserve Act to certain transactions between U.S. branches and agencies of international banks that qualify as financial holding companies and their U.S. affiliates that are engaged in securities underwriting and dealing activities in the United States permissible under the GLB Act. In effect, this rule applies to international banks that qualify as financial holding companies the Section 23A/B operating standard applicable to international banks' conduct of "Section 20" securities activities in the United States. Similarly, in its interim rule on merchant banking activities (see the following article) the Board has applied Sections 23A and 23B to covered transactions between the U.S. branches and agencies of any international bank that qualifies as a financial holding company and (i) any U.S. affiliate engaged in merchant banking activities in the United States and (ii) any company controlled by such bank through the exercise of its merchant banking authority under the GLB Act.

In its comment letters on these two interim rules, the Institute has taken the position that the authority granted under Section 114 should be used sparingly and applied only in the most compelling circumstances. In both cases, the Institute has stated that it would be more consistent with the purpose of Section 114 <u>not</u> to apply restrictions under Sections 23A and 23B to transactions between U.S. branches and agencies of international banks and their U.S. affiliates that are engaged in securities underwriting or merchant banking activities permissible under the GLB Act.

The letters explain that when it passed the International Banking Act of 1978 Congress made the policy determination that Section 23A should not apply to transactions involving U.S. branches and agencies of international banks (this policy was extended to include Section 23B when it was enacted in 1987). The letters further state that this policy has remained unchanged since 1978 and that nothing in the GLB Act indicates a Congressional intent to change existing law in this area. The letters cite additional policy considerations supporting the Institute's position and observe that over a period of many decades there is no evidence of any abuse or misuse of U.S. branches and agencies of international banks in funding and other transactions with their U.S. affiliates. Moreover, there is no evidence that international banks have enjoyed any type of competitive advantage over U.S. banks with respect to such transactions.

Questions regarding the application of Sections 23A and 23B to the U.S. branches and agencies of international banks are likely to receive increased attention from the Board in coming months. For example, the Gramm-Leach-Bliley Act directs the Board, not later than May 12, 2001, to adopt final rules under Sections 23A and 23B "to address as covered transactions credit exposure

arising out of derivative transactions between member banks and their affiliates and intraday extensions of credit by member banks to their affiliates." The Institute will monitor these developments as they may affect the U.S. operations of international banks.

INSTITUTE SUBMITS ADDITIONAL COMMENTS ON INTERIM RULES ADOPTED BY THE FEDERAL RESERVE BOARD IMPLEMENTING THE FINANCIAL HOLDING COMPANY AND MERCHANT BANKING PROVISIONS OF THE GRAMM-LEACH-BLILEY ACT

Financial Holding Company Capital and Management Standards

As of May 26, 2000, fourteen international banks and more than 200 domestic bank holding companies have made effective elections as financial holding companies under the Gramm-Leach-Bliley Act. The Board has revised its procedures for acting on financial holding company elections filed by international banks to conform them more closely to the procedures applied to elections filed by domestic bank holding companies (see the March 2000 issue of *International Banking Focus*) and has demonstrated flexibility in its application of the "well capitalized" and "well managed" standards to international banks. However, under the well capitalized standard international banks remain subject to a leverage test, which we understand from discussions with the Federal Reserve functions in effect as a "screen" rather than a bar.

The Institute continues to urge the Board to revise the well capitalized standard to base it entirely on the internationally agreed upon Basel risk-based capital methodology, rather than on any U.S. leverage test. In addition, the Institute continues to believe that the well managed standard should be modified so that it is based on the composite assessment of an international bank's U.S. branches and agencies in the aggregate rather than on the composite rating of each branch or agency individually. The Institute has also suggested that in connection with its review of any financial holding company election filed by an international bank that controls another international bank that operates its own U.S. branches or agencies but does not itself seek to qualify as a financial holding company, the Board should not apply the capital and management standards separately to each international bank, and instead should apply them only to the first international bank both separately and on a consolidated basis after taking full account of the other bank. The Institute further discussed these issues in a May 16, 2000 letter to Federal Reserve Board Governor Laurence Meyer.

Expanding the Financial Holding Company Standards to Include A "Comprehensive Consolidated Supervision" Requirement

Responding to the Board's request for comment on whether, in addition to the "well capitalized" and "well managed" standards, international banks should be required to meet a "comprehensive consolidated supervision" (CCS) standard in order to qualify as financial holding companies, the Institute in an April 17, 2000 letter to the Board argued strongly against such a requirement. The Institute noted that there is no basis in the GLB Act for applying a CCS standard to an international bank that conducts its banking business in the United States exclusively through a U.S. incorporated bank subsidiary. Likewise, the Institute stated that there is no evidence that Congress intended that such a standard be applied under the GLB Act to international banks that operate U.S. branches and agencies.

The Institute recognized, however, that it may be appropriate for the Board, when warranted by the circumstances of a particular case, to take into account the extent to which an international bank with a U.S. branch or agency is subject to comprehensive consolidated supervision as a factor

that is relevant to its determination of whether the bank is well capitalized and well managed. As an example, the Institute stated that the existence of strong consolidated supervision should be a positive factor to take into account under the second method for determining whether an international bank is well capitalized.

Limitations on Merchant Banking Activities

The Institute has urged the Board to adopt a flexible approach in regulating the merchant banking activities of financial holding companies under the GLB Act. On March 17th, the Board and the Treasury Department jointly adopted an interim rule on merchant banking. Among other things, the interim rule (i) limits the aggregate amount of a financial holding company's merchant banking investments, (ii) prescribes a maximum holding period for merchant banking investments, (iii) sets forth risk management, reporting and recordkeeping requirements and (iv) applies Sections 23A and 23B of the Federal Reserve Act to covered transactions between a U.S. branch of an international bank that qualifies as a financial holding company and any U.S. affiliate engaged in merchant banking activities and any company that is controlled by such bank through the exercise of its merchant banking authority under the GLB Act.

In a separate release issued in conjunction with the interim rule, the Board requested comment on a proposal relating to the regulatory capital treatment of investments in non-financial companies by bank holding companies under the Board's capital adequacy guidelines. Under the proposal, a bank holding company would be required to apply a 50% capital charge to all of its merchant banking and other investments in non-financial companies. The proposal is intended as "a precaution that is necessary to prevent the buildup within banking organizations of excessive risk from merchant banking and other investment activities" and reflects the Board's view that "similar investment activities should be given the same capital treatment regardless of the source of legal authority to make the investment" (quoting the preamble to the Board's proposal).

The Institute's May 22, 2000 comment letter expresses the broad view, which is also being articulated by domestic banking associations/organizations, that (i) there should not be any aggregate limit imposed on merchant banking investments, (ii) greater flexibility should be shown with regard to the holding period for merchant banking investments and (iii) bank holding companies should not be required to make any regulatory capital deduction for their investments in non-financial companies. As discussed in the preceding article, the letter also sets forth the Institute's position that restrictions under Sections 23A and 23B should not be applied to transactions by U.S. branches and agencies of international banks that qualify as financial holding companies in connection with such banks' merchant banking activities under the GLB Act.

U.S. TREASURY DEPARTMENT AND IRS INDICATE FURTHER FLEXIBILITY IN FORTHCOMING GLOBAL DEALING REGULATIONS

Executive Summary

The Institute met with U.S. Treasury Department and Internal Revenue Service representatives on April 6th to continue ongoing discussions regarding the proposed global dealing regulations. The Treasury and IRS representatives indicated that it was their intention to release final regulations within the next few months.

The meeting focused on the important issue of how capital and risks associated with capital (such as credit risk) should be addressed in the context of global dealing. Treasury and IRS representatives acknowledged the validity of the Institute's arguments that the proposed regulations were overly constraining in suggesting that the only relevant factor in determining how to allocate residual profit from a global dealing activity is where market risks are assumed and managed. Consequently, the final regulations are likely to permit taxpayers to take account of where credit risk and other risks are assumed and managed (in addition to market risks). This would represent a significant improvement in the regulations.

The proposed global dealing regulations, issued in March 1998, contain workable rules for the tax treatment of 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.

The proposed regulations are of great significance to the international banking community. When finalized, they will dramatically improve the substantive rules governing the U.S. taxation of the securities, derivatives and foreign currency dealing operations of international banks and their affiliates.

Under the proposed regulations, the amount of profits from a cross-border dealing operation that are taxable by the United States—regardless of whether the U.S. activity is conducted through a branch or a corporation or partnership—is to be determined on the basis of the arm's length principle generally applicable to other transfer pricing situations. Thus, the portion of the profits taxable by the United States would be limited to the relative economic value of the contribution of the U.S. branch or affiliate to the activity.

While the Institute has expressed its strong support for the overall approach of the proposed regulations, the Institute has criticized certain specific aspects, including their approach to capital and risks associated with capital. On the basis of the latest meeting, the Institute is optimistic that the final regulations will allow for greater flexibility in the treatment of this issue.

INSTITUTE PURSUES INTENSIVE DISCUSSIONS WITH TREASURY DEPARTMENT REGARDING ITS CONSIDERATION OF A BASEL-BASED RISK-WEIGHTED CAPITAL APPROACH TO DETERMINING A BANK'S DEDUCTIBLE INTEREST EXPENSE

The Institute met on May 2nd with Treasury Department and IRS representatives to continue its discussions 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.

As previously reported, 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.

As previously reported, the Institute has held several meetings in the course of the past year to express its concerns regarding this approach to the U.S. Treasury Department and the Internal Revenue Service. The positions expressed by the Institute were developed in a series of meetings with the Institute's Tax Committee, interested member banks, accounting firms and tax counsel. The Institute's preliminary thoughts were set forth in an outline (previously circulated) that was submitted to the Treasury Department and the IRS in August 1999. The outline is available in the member area of the Institute's web site (www.iib.org/member).

Earlier this month, the Institute circulated for comment a more developed summary of the arguments that the Institute has been articulating against the use of a Basel capital-based approach. This summary, dated May 19, 2000, also is available in the member area of the Institute's web site.

In the course of various meetings and discussions, a possible alternative approach has been emerging for determining a multinational bank's deductible interest expense in individual countries. This possible alternative approach is described in Part III of the paper recently circulated by the Institute. Very generally, under this 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.

The Institute circulated this possible alternative to solicit the reactions of Institute member banks and other banking associations, to stimulate further discussions, and in particular to see whether a broad consensus might develop in favor of this approach.

IRS ANNOUNCES FURTHER CHANGES REGARDNG QUALIFIED INTERMEDIARIES ("QIs") AND REVISES NEW WITHHOLDING REGULATIONS

On May 15th, the IRS released further guidance regarding the QI procedures and also revised the final withholding regulations in a variety of technical respects, in response to comments from the Institute and other interested parties.

The final withholding and reporting regulations, which will become effective on January 1, 2001, will require extensive changes to the operating systems and procedures of international banks and their affiliates, and most financial institutions will need to expend substantial time and effort during this year to modify their operational systems and procedures to comply with the regulations, regardless of whether they become QIs. The QI procedures are intended to reduce in certain important respects the information gathering and reporting burdens that non-U.S. financial intermediaries and their customers would otherwise bear under the new rules.

In response to criticism by the Institute and other interested parties, the IRS announced that it would not restrict the QI procedures to financial institutions operating in countries with which the U.S. has a tax treaty or information exchange agreement. However, the IRS will continue to insist that the institution's country must have "know your customer" ("KYC") rules that are acceptable to the IRS before the IRS will enter into a QI agreement with the institution. An important exception is that the IRS will permit a branch of a financial institution (but not a separate affiliated legal entity) located in a country without acceptable KYC rules to be part of the financial institution's QI agreement provided that the branch agrees to apply the institution's home country KYC rules.

The IRS also announced that it will apply stricter audit and enforcement standards to financial institutions and their branches that are located in countries that are tax havens or that impose bank secrecy rules.

The rules for financial intermediaries that are not QIs have been relaxed in one respect, in that those institutions will be permitted to assign payees to withholding rate pools and provide specific information to the withholding agent by January 31 of the following year regarding the allocation of income among payees within the pools. However, the non-QI still must furnish to the withholding agent, prior to each payment, all other required information and documentation (e.g., a Form W-8) for each payee as well as allocation information for U.S. non-exempt recipients. In addition, the revised regulations explicitly provide that a non-QI may be subject to penalties for failure to provide the necessary information. Thus, many financial intermediaries that do not become QIs burdensome compliance requirements.

On the other hand, the QI procedures are themselves complicated and their implementation will require a material commitment of resources by every financial intermediary. International banks and their affiliates which act as financial intermediaries with respect to U.S. securities must now evaluate the benefits and costs of becoming a QI. In any event, however, regardless of whether a financial intermediary becomes a QI, it will need to implement significant changes to its operating systems and procedures before 2001 in order to comply with the new regulations.

In order to assist Institute member banks in understanding the new rules, the Institute will be conducting a full day workshop as part of its Annual Tax Seminar, on Monday June 19th, on the practical aspects of implementing QI procedures and complying with the new regulations. The workshop is designed to assist those people from the head office and the U.S. who are responsible for the institution's efforts to comply with these complicated new rules.

NEW YORK STATE TAX LEGISLATION AND INITIATIVES TO CONSIDER THE TAX POLICY IMPLICATIONS OF THE GRAMM-LEACH-BLILEY ACT

It is generally recognized that it will be necessary to revise the New York State and City tax rules to take account of the recent federal financial modernization legislation (the Gramm-Leach-Bliley (GLB) Act). To that end, the New York State Department of Taxation and Finance has formed a government/industry Financial Services Modernization Task Force to identify and analyze the tax policy issues arising from implementation of the GLB Act. The initial meeting of the Task Force was on April 17th.

The Institute is participating in the Task Force together with other representatives of the banking, insurance and securities industries. In connection with the next meeting of the Task Force on June 12th, the Institute has prepared preliminary comments on the provisions of Article 32 (bank franchise tax) and Article 9-A (corporation franchise tax) of the New York State Tax Law that are of special significance to international banks.

The Institute is continuing to examine these issues and welcomes comments and suggestions from member banks regarding changes to current New York tax law that would be beneficial to their operations.

The New York State tax budget legislation, enacted on May 15th, addressed the most pressing concern on a temporary (one year basis) by ensuring that an institution's qualification as a financial holding company under the GLB Act will not prejudice the eligibility of its securities subsidiaries to continue to be subject to the general corporation franchise tax (Article 9-A and the corresponding New York City provisions) rather than to the bank franchise tax (Article 32 and the corresponding New York City provisions).

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