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The Institute addresses the legislative, regulatory and tax issues confronting **internationally headquartered** financial institutions that engage in banking, securities and/or insurance activities in the United States.

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INSTITUTE CONTINUES TO URGE ELIMINATION OF A U.S.-SPECIFIC LEVERAGE TEST FROM THE “COMPARABLE” CAPITAL STANDARD APPLIED TO INTERNATIONAL BANKS UNDER THE GRAMM-LEACH-BLILEY ACT IN FAVOR OF SOLE RELIANCE ON BASEL RISK-BASED CAPITAL MEASURES

Executive Summary

Issues regarding the “comparable” capital and management standards applicable to international banks under the interim rule adopted by the Federal Reserve Board in January 2000 remain under active consideration, with final Board action on the interim rule expected during the next few months. Board staff members have emphasized to the Institute that international banks that do not meet the 3% minimum leverage test and/or the minimum 6% Tier 1 and 10% total risk-based capital tests set forth in the interim rule nevertheless may be designated as financial holding companies upon demonstrating to the Board that their capital is otherwise comparable to that of a “well capitalized” U.S. bank after taking into account such considerations as the international bank’s long-term debt ratings, the composition of its capital and differences in home country accounting standards.

The Institute believes that this approach is very constructive, but we continue to have serious, fundamental concerns with the application (even on a flexible basis) of a U.S.-specific leverage test to international banks. Following up on its ongoing dialogue with representatives of the Federal Reserve on the interim rule, the Institute on November 7, 2000, sent a letter to Chairman Greenspan and others at the Board setting forth the strong statutory and policy arguments favoring elimination of a U.S.-specific leverage test from the comparable capital standard and reliance solely on the Basel risk-based capital measures (the letter is available on the Institute’s Internet homepage (www.iib.org)).

The Institute’s letter concludes that the Board’s imposition of a leverage test on international banks in connection with its interim implementation of the statutory standard represents a major departure from its prior policy decisions and its capital equivalency findings reported to Congress. These prior regulatory and policy determinations were not put into question by the Gramm-Leach-Bliley Act, and there was no indication in the discussions leading up to the legislation’s enactment that the comparable capital standard would require any deviation from these well-established precedents. Accordingly, the Institute’s letter strongly urges the Board to reconsider this action as it deliberates finalizing the interim rule.

The Institute’s letter notes that the language of the Gramm-Leach-Bliley (GLB) Act does not specifically require the imposition of a U.S.-specific leverage test on international banks in connection with applying to them a capital standard that is

“comparable” to the well capitalized standard applied to U.S. banks. The letter states further that the great majority of international banks operating in the United States are not subject to a leverage test under their home country capital standards and that

for these banks the imposition of such a requirement as a condition to the expansion of their activities in the United States as financial holding companies may be highly disruptive to the execution of their business strategies outside the United States and the management of their overall operations.

The letter also states that there is no indication that Congress intended the “comparable” capital standard contemplated by the GLB Act to have such a potentially burdensome and serious impact on international banks that seek to operate in the United States as a financial holding company. Of fundamental importance, since enactment of the International Banking Act of 1978 it has been the Board’s stated policy not to extend U.S. bank supervisory standards extra-territorially to international banks, and the Board has never before applied a leverage test to international banks.

In this connection, the letter discusses the occasions prior to the interim rule where the Board addressed the specific question of whether a leverage test is necessary to achieve equivalency in assessing the capital of international banks vis-à-vis U.S. banks. In each case, the Board concluded, after careful deliberation, that a leverage test is not required for this purpose. For example, in the June

1992 “Capital Equivalency Report” prepared jointly with the Department of the Treasury, the Board specifically advised Congress that a leverage requirement “may be of limited relevance to internationally active foreign banks” and concluded that a U.S.-specific leverage test is not necessary to ensure equivalence in capital standards. This conclusion was not changed when the Report was update in June 1994.

By imposing a U.S.-specific leverage test on international banks that seek to engage in expanded financial activities in the United States as financial holding companies, the interim rule significantly changes the “rules of the game” by which such banks conduct their business around the world. The Institute’s letter emphasizes that this is inconsistent with the well established policy of consolidated supervision by the home country regulator, which recognizes that deference should be given to home country administration of Basel capital standards. The letter observes that U.S. banks and regulators properly would question efforts by other countries to impose host-country specific capital standards not measured under Basel risk-based principles on U.S. banks as a condition to their expansion in a host country.

UPDATE ON INSTITUTE EFFORTS TO ACHIEVE SUBSTANTIAL REDUCTIONS IN ASSET PLEDGE REQUIREMENTS APPLICABLE TO U.S. BRANCHES AND AGENCIES OF INTERNATIONAL BANKS

Executive Summary

Discussions continue with state banking authorities, the OCC and the FDIC regarding ways to reduce substantially the amount of assets U.S. branches and agencies of international banks are required to keep on deposit with U.S. custodian banks to assure that, in the event the branch or agency is liquidated, there will be sufficient funds on hand to pay the initial expenses of the liquidation. For many branches and agencies, existing asset pledge requirements are equal to a fixed percentage (up to 5%) of their total third-party liabilities, a formula which results in an ongoing requirement to pledge hundreds of millions (and, for the largest operations, several billion) dollars of liquid assets. These amounts exceed by a significant measure the amount that would be required to cover initial liquidation expenses. Moreover, our discussions with member banks indicate that the negative carry incurred when purchasing assets to satisfy these requirements ranges

from 20 to 60 basis points and that the opportunity cost of complying with the asset pledge ranges from 55 to 160 basis points. The Institute has proposed that the required amount of pledged assets be capped at a level substantially below these existing requirements. It is contemplated that the amount of this cap would include a cushion sufficient to ensure payment of initial liquidation expenses.

Reflecting the diversity inherent in the U.S. dual banking system, the Institute is pursuing a variety of approaches to revising existing asset pledge requirements. Several states provide for an asset pledge requirement in their statutes but leave the amount of the pledge to the discretion of the state banking agency. In New York, the applicable requirements are set forth in regulations adopted by the Superintendent of Banks. Consequently, the changes proposed by the Institute do not require any authorizing New York legislation and can be effected solely through regulatory action (for example, in July 1999, at the urging of the Institute, the Superintendent's asset pledge regulation was amended to exclude liabilities relating to repurchase transactions from the calculation of the asset pledge requirement). We have had a very good exchange of views with representatives of the New York Banking Department on asset pledge issues, and we are planning a meeting of a small group of senior bankers with Superintendent McCaul to explain further the Institute's proposal and underscore the importance of this issue to our community.

Like New York, Connecticut law leaves the amount of the asset pledge to the discretion of the Commissioner of Banks, who has fixed the amount at 3% of total third-party liabilities. A representative of the Connecticut Banking Department spoke favorably of the Institute's asset pledge proposal at our recent Regulatory Examination and Compliance Seminar, and we are engaged in further discussions with the Department regarding how the Connecticut asset pledge might be modified.

Illinois law provides for an asset pledge "when deemed necessary and appropriate in the opinion of the Commissioner" of Banks and Real Estate. Currently, international banks licensed to operate a banking office in Illinois generally are not required to pledge assets, although the Commissioner may impose an asset pledge

requirement on a case-by-case basis. Speaking at the Regulatory Examination and Compliance Seminar, a representative of the Commissioner's office indicated that consideration is being given to devising an alternative approach that may involve the imposition of a "capped" asset pledge requirement. We are continuing to focus on this question, and also are discussing with interested member banks the asset pledge requirements applicable under California and Florida law.

At the federal level, asset pledge requirements for OCC-licensed branches and agencies are set forth in the International Banking Act of 1978, which fixes the amount of the pledge at 5% of total third-party liabilities. Consequently, the Institute's proposed reduction in the asset pledge would require Congressional action amending the statute. The Institute is considering the most appropriate strategy for obtaining the necessary legislation.

In contemplating changes to asset pledge requirements, the question arises whether reducing the amount of the pledge would harm depositors and other creditors. This question is relevant only in the context of the liquidation of a branch or agency as it is only in such a case that the pledged assets vest in the control of the person in charge of the liquidation (in New York, for example, this person is the Superintendent of Banks). It is fundamental to the Institute's proposal that in such a situation the amount of the asset pledge would be sufficient to cover the initial expenses of the liquidation, with the assets of the liquidated branch or agency otherwise available in their entirety for paying the claims of depositors and other creditors (indeed, under the "ring fence" provisions of New York law the Superintendent of Banks as liquidator has control over and use of all of the assets of a New York branch or agency of an international bank as well as any other assets of the bank situated in New York, even if not part of its branch or agency). Moreover,

the protections available and in operation against the risk of failure have been significantly enhanced over the last decade through the development of more robust risk-based supervisory standards. These

measures are reinforced by the extensive enforcement powers each licensing authority has at its disposal to address problem situations as they arise.

INSTITUTE SEEKS MODIFICATIONS TO CERTAIN KEY ASPECTS OF THE FEDERAL RESERVE'S PROPOSAL TO REVISE FORM FR Y-7 AND REPLACE FORM FR Y-7A WITH A NEW FORM FR Y-10F

Executive Summary

The Federal Reserve Board has issued for comment proposed revisions to the annual reports required from international banks on Forms FR Y-7 and FR Y-7A. Of particular significance, the Board proposes to (i) change the due date for the Form FR Y-7 from four months to 90 calendar days after the end of a reporting institution's fiscal year, (ii) raise the threshold for reporting investments in nonbanking companies from 5% to 25% and thereby decrease the number of companies required to be reported, (iii) replace Form FR Y-7A with a new Form FR Y-10F, which would be filed on an event-generated basis rather than annually, and (iv) include in the Form FR Y-10F structure data on offshore branches that are managed or controlled from the U.S. (such data currently is not reported in the Form FR Y-7A). The purpose of these changes is to reduce burden and system costs, make the forms easier to use and make the reporting of structure data for domestic bank holding companies and international banks more similar.

The Institute's November 20, 2000 comment letter, which is available on the Institute's Internet homepage (www.iib.org), expresses strong support for certain aspects of the Board's proposal, including raising the reporting threshold for investments in nonbanking companies, changing the current reporting of the exact percentage ownership of nonbanking investments on Form FR Y-7A to a "bucket" approach on Form FR Y-10F and eliminating the reporting of investments in DPC companies. However, the letter raises very serious concerns regarding the proposed reduction of the due date for filing reports on Form FR Y-7 and urges the Board either to retain the existing four-month filing deadline or, preferably, revise the due date to be a specified period of time after a reporting bank's year-end financial statements are provided to, or acted upon by, its shareholders in connection with their annual meeting.

The letter also raises very serious concerns regarding the proposal to require the reporting and updating of all structure data on an event-generated basis on proposed Form FR Y-10F and urges the Board to adopt a revised approach whereby all international banks would submit an FR Y-10F report annually in connection with filing the FR Y-7 report, with event-generated reports limited to certain changes to the structure of a bank's U.S. banking operations and certain U.S. nonbanking transactions.

The Institute's letter acknowledges the Board's desire to achieve greater consistency in the reporting requirements applicable to domestic bank holding companies and international banks, but expresses the concern that in striving for this goal insufficient weight has been given to the legal, structural and practical problems that global financial institutions headquartered outside the United States experience in obtaining the financial information and structure data required on Forms FR Y-7 and FR Y-10F and reporting it to the Board by the prescribed filing deadlines. Shortening the due date for the FR Y-7 report and requiring the filing of FR Y-10F reports on an event-generated basis regardless of the materiality of the information reported would exacerbate the impact of these limitations on international banks and increase the burden and cost of compliance.

These problems are especially pronounced with respect to obtaining information on non-U.S. companies that a reporting bank does not actually control as a corporate matter but nevertheless is deemed to control under the Bank Holding Company Act because it owns a 25% or greater voting equity interest. Financial information on such companies typically is not available to a reporting bank until the company's annual shareholders' meeting, which may not occur until after the due date for the FR Y-7 report. The Institute's letter further explains that it frequently is extremely difficult for an international bank to obtain from these companies the type of information required by the FR Y-10F report, aspects of which, such as the designation of a company's "primary" and "secondary" activities (however measured), are not otherwise publicly available. In many instances, such companies do not view themselves as being a controlled affiliate of a reporting bank and/or are under no legal compulsion to cooperate with its requests for information. Indeed, as is the case, for example, in Germany, there may be legal prohibitions against a company disclosing information to its shareholders on a preferential basis, or a company may have the right to refuse shareholder requests that might result in public disclosure of information that the company treats as confidential or proprietary in nature.

Reporting banks are also constrained in submitting to the Board their own year-end financial statements, which commonly are not publicly released until they have been approved by the bank's highest level governing body. Typically, this approval is granted in contemplation of the bank's annual shareholders' meeting and the finalization of the bank's financial statements for distribution to shareholders in connection therewith. The timing of this approval is determined both by applicable home country law and customary home country practice, with the result that a bank's year-end financial statements in many cases are not available until a time that is either very near to or after the current FR Y-7 four-month filing deadline. Making a timely filing in this situation is further complicated where home country law authorizes the shareholders at their annual meeting to take binding action that would materially affect the reporting of the bank's year-end financial statements. Moreover, the law in certain countries prohibits release of financial information until after the shareholders' meeting.

On the basis of these considerations, the Institute's letter proposes that the due date for the FR Y-7 reports be extended to a specified period of time (perhaps up to 60 calendar days) after the *later* of (i) the date on which a reporting bank, in accordance with applicable home country legal requirements and its customary practices, distributes its financial statements to its shareholders in contemplation of the annual meeting of shareholders and (ii) where such financial statements are subject to binding action by shareholders at the annual shareholders' meeting, the date of such meeting.

In light of the significance of the changes contemplated by the proposal, and in order to provide international banks adequate time to adapt their existing home country-based reporting systems to the proposed new requirements, the letter also urges the Board to (i) delay the effective date of the revisions to Form FR Y-7 so that they would apply beginning with the fiscal year of a bank ending December 31, 2001 or thereafter and (ii) likewise delay implementation of the new Form FR Y-10F until January 1, 2002.

The Board also proposes to require use of the four-digit North American Industry Classification

System (NAICS) codes in place of four-digit Standard Industrial Classification (SIC) codes to report commercial activities. The Institute's letter notes that under regulation K the permissibility of such activities is determined by reference to the four-digit SIC codes – a system that has been an integral part of the Board's regulation of these activities for more than 20 years – and urges the Board to clarify that the utilization of NAICS codes in place of SIC codes will not result in any narrowing of the authority under Regulation K to engage in these activities.

In addition, the letter seeks clarification of certain aspects of the revised organizational chart attached to Form FR Y-7 and urges the Board to develop a system that would permit international banks the option to file the FR Y-7 and FR Y-10F reports electronically.

The Institute is conducting a survey of its member banks to help develop a more detailed understanding of their experience with these reporting requirements and to estimate the amount of time and the expense they commit to these efforts. The preliminary results indicate that the estimates accompanying the Board's proposal substantially understate the effort and resources dedicated by international banks to collecting and reporting the required information. For example, most of the respondents estimate that they devote more than 50 hours to completing the Form FR Y-7 report, with one bank estimating 150 hours and another estimating 225 hours. We urge member banks that have not already responded to the survey to do so as quickly as possible. We are contemplating meeting with Board staff to discuss the results of the survey and further consider their implications once all the results have been reported and compiled.

FEDERAL RESERVE ANNOUNCES ENHANCEMENTS TO THE FBO SUPERVISION PROGRAM, INCLUDING UPDATING AND STREAMLINING THE “STRENGTH OF SUPPORT ASSESSMENT” (SOSA) PROCESS AND DISCLOSING A BANK’S SOSA RANKING TO BOTH THE BANK AND ITS HOME COUNTRY SUPERVISOR

Established in March 1995, the FBO Supervision Program constitutes a comprehensive scheme for coordinating the supervision of the U.S. operations of international banks. The Federal Reserve's responsibilities under the program include preparation of a “strength of support assessment” (SOSA), which evaluates an international bank on a global basis, including consideration of the system of supervision in the bank's home country, the record of home country governmental support of its banking system and transfer risks. The purpose of the SOSA is to determine whether an international bank has the internal and external resources to provide the necessary financial, liquidity and managerial support to its U.S. operations.

In cooperation and coordination with the other federal and state banking authorities involved in supervising the U.S. operations of international banks, the Federal Reserve Board on October 23, 2000 announced that it is taking a number of steps to enhance the FBO Supervision Program (this announcement appears in SR 00-14 (SUP), which is available on the Federal Reserve's web site at

www.federalreserve.gov/boarddocs/SRLETTERS/2000/SR0014.HTM). These enhancements were further discussed by Stephen Hoffman, Deputy Associate Director of the Board's Division of Banking Supervision and Regulation, at the Institute's recent Regulatory Examination and Compliance Seminar.

The changes to the Program will make the SOSA a more flexible and robust supervisory resource for the Federal Reserve, promote further cooperation with home country supervisors, and provide international banks more meaningful information regarding supervisory assessments of their U.S. operations. As described by the Federal Reserve, the principal enhancements to the Program include the following:

- More Frequent Updates of SOSA Rankings. In addition to an annual review, an international bank's SOSA ranking will be updated “whenever significant events occur that could have a material impact on [the bank's] ability to

maintain the safety and soundness of its U.S. operations.”

- Streamlining SOSA Rankings. The current five-part ranking designations (“A” to “E”) are being replaced with three designations of “1” (representing the lowest degree of supervisory concern) to “3” (representing the highest degree of supervisory concern). The reduction of SOSA designations is intended to “more closely align FBO assessments with the supervisory strategies of their U.S. operations.”
- Sharing of SOSA Rankings. In a very significant change from prior practice, an international bank’s SOSA ranking, as well as the rationale for the ranking, will be shared with the bank’s senior management and home country supervisor.
- Assignment of a Combined ROCA Rating for Branches and Agencies. A new composite rating of all of an international bank’s U.S.

branches and agencies will be given in addition to ROCA ratings for individual offices and will be factored into the bank’s Combined U.S. Operations Rating. The Institute has recommended the development of such a composite rating in its comments on the Board’s application of the “well managed” standard to international banks under the Gramm-Leach-Bliley Act (see the July 2000 issue of *International Banking Focus*). The October 23rd announcement, however, did not indicate whether the new composite rating would also be utilized for this purpose.

- Inclusion of an “Institutional Overview” as a Component of the SOSA Process Separate from the SOSA Ranking. The Institutional Overview discusses a bank’s structure, business strategy and processes, financial performance, funding and liquidity, and governance. As such, it is intended to function as a critical part of the SOSA process.

INSTITUTE URGES U.S. TREASURY AND IRS TO ISSUE TRANSITIONAL RELIEF REGARDING IMPLEMENTATION OF NEW QUALIFIED INTERMEDIARY (“QI”) RULES

Executive Summary

The Institute submitted a letter to the U.S. Treasury Department and the Internal Revenue Service on November 22nd requesting transitional relief regarding the implementation of the new withholding and reporting rules for payments to non-U.S. persons, including the new procedures for Qualified Intermediaries (“QIs”), which are scheduled to become effective on January 1, 2001. The urgency of the Institute’s request arose from the concern that U.S. withholding agents may begin widespread and massive withholding commencing on January 1 because many of their customers, including non-U.S. intermediaries that are in the process of obtaining QI status, will not be in full compliance with the new requirements.

The Institute’s letter, which is addressed to the Treasury’s Assistant Secretary for Tax Policy and the IRS Commissioner, expresses the concern that if such widespread, massive withholding were to occur, it would severely undermine the credibility of the IRS, which has endeavored to induce non-U.S. institutions to become QIs by assuring them that the IRS is primarily interested in creating an environment of voluntary compliance with

the new reporting rules and universal adoption of the QI regime, rather than in collecting additional tax. There is also a serious risk that widespread, massive withholding, which would be unexpected by most non-U.S. investors, could undermine their confidence in the U.S. capital market. The letter is available on the Institute's Internet homepage.

As previously reported, non-U.S. financial intermediaries must decide whether to enter into agreements with the IRS to become QIs under the new regulations relating to withholding taxes and information reporting requirements on payments (including interest and dividends) made from U.S. sources to non-U.S. persons. 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. However, 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 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 their operating systems and procedures before 2001 in order to comply with the new regulations.

The concerns that are reflected in the Institute's letter as well as our recommendations for transitional relief were developed by the Institute's Tax Committee, representatives of member banks and their professional advisors in connection with a meeting that was held on November 15th with a team from the IRS that was interested in gathering information regarding the QI process.

The Institute's letter justifies the request for transitional relief based on the slow implementation of the QI application and approval process by the IRS; the delays that financial institutions are experiencing in obtaining adequate documentation from customers; the impracticality of the current guidance regarding partnerships, trusts and other forms of collective investment vehicles; and the inevitable mistakes, lapses and delays in implementing the necessary, extensive changes to the operating, administrative, computer information

and reporting systems of the financial intermediaries.

The Institute's letter recommends that the IRS announce the following transitional measures:

1. *Interim QI status.* A withholding agent should treat an intermediary as a QI from the date that the intermediary informs the withholding agent that it has filed a QI application with the IRS. Such interim QI status will be effective until the earlier of September 30, 2001, the grant of formal QI status (and the issuance of a QI EIN), or 30 days after an IRS denial of the QI application. (We recommended a September 30th date for the transitional rules in paragraphs 1 and 2 in order to provide reasonable time for intermediaries in many countries that have not yet applied for approval of their KYC rules and/or QI status to learn about the new rules and their implications (after suffering withholding or the threat of withholding) and make the necessary applications.)

2. *Interim approval of KYC rules.* A country whose KYC rules have been submitted to the IRS for review will be treated on an interim basis as an eligible country for QI purposes until the earlier of September 30, 2001, the issuance by the IRS of a KYC attachment for that country, or 30 days after an IRS denial of the KYC application.

3. *Interim reliance on internal records regarding identity of non-QI beneficial owners.* For 2001, U.S. withholding agents and QIs may rely on reasonably maintained internal records to establish the identity of non-QI beneficial owners, while they secure technically complying documentation. **(A significant related issue that is emerging from the QI KYC attachments being released by the IRS, which we believe has not received sufficient attention, is whether it will be feasible for QIs to obtain on a timely basis new documentation from virtually all customers whose accounts were opened before the effective date of the relevant**

KYC rules. At many institutions, there are millions of such accounts.)

4. *Confirm that QIs will not be subject to audits or liability for first year.* While we believe this is implicit in the model QI agreement and related guidance already issued by the IRS, it would be helpful if the IRS could explicitly confirm that a QI will not be subject to audits or tax liabilities for underwithholding in respect of the first year of its QI status.

5. *Pass-through entities.* Until the issuance of workable rules by the IRS, a QI or U.S. withholding agent may accept a Form W-8 IMY from a partnership, trust or other pass-through entity certifying that the entity has/will provide the identity and beneficial ownership interest of each direct and indirect non-exempt U.S. beneficial owner, accompanied by Forms W-9, and a certification regarding the applicable withholding rates (by pools) in respect of the remaining beneficial ownership interests.

6. *Branches and Subsidiaries in non-KYC Countries.* For 2001, a QI should be eligible to apply rules similar to those set forth in paragraph 5 above with respect to branches and subsidiaries of the QI that are located in countries for which the IRS has not issued a KYC attachment, in order to enable those intermediaries to implement alternative workable solutions during the course of the year.

7. *Refunds.* Upon becoming a QI or a withholding foreign partnership or trust in 2001, an intermediary may file a collective refund claim directly with the IRS to recover amounts withheld in 2001.

8. *Web site.* If feasible as a technological and institutional matter, the IRS should set up a web site on which intermediaries can obtain from the IRS, on a timely basis, practical answers to implementation issues as they arise. The web site can develop into a source of generally available information regarding these issues.

INSTITUTE RECOMMENDS RULES FOR COORDINATING BETWEEN NEW GLOBAL DEALING AND INTEREST ALLOCATION REGULATIONS

Executive Summary

On November 16th, the Institute met with the U.S. Treasury Department and the Internal Revenue Service to discuss the important issue of how the profit split method under the global dealing regulations should be coordinated with the rules under regulation section 1.882-5 for determining deductible interest expense. The Institute set forth its recommendations regarding this matter in a letter to the Treasury Department and the IRS on November 30th, which is available on the Institute's Internet homepage.

As previously reported, the IRS is actively working on finalizing the global dealing regulations. The Institute believes that the final regulations will incorporate many of the Institute's recommendations on other aspects of the proposed regulations, including appropriate retroactive application and greater flexibility in applying the arm's-length principle under the regulations.

With respect to coordinating the global dealing regulations with the interest allocation rules, the Institute's letter reiterated its concerns regarding the approach of the proposed regulation, which

requires that interest expense be excluded from the operating profit that is subject to allocation under a profit split method, and that the interest allocation rules under regulation section 1.882-5 be applied to

such gross interest expense of a global dealing operation.

The Institute suggested that the regulations should be modified so as to more closely correspond to the likely practice of other tax authorities, by applying the profit split method to the operating profit as determined after deduction of interest expense shown on the books of the global dealing operation. In addition, consistent with the positions previously developed by the Institute, the Institute recommended that the internal funding costs of a global dealing book (such as through securities

repos, securities loans and short sales) should be directly traced to the global dealing profit rather than being subject to a capital “haircut” under regulation section 1.882-5. Thus, under the Institute’s recommendation, the regulation section 1.882-5 “haircut” for imputed capital would be limited to the net funding provided by the treasury desk, and would be applied as an adjustment to the portion of the global dealing profit allocable to the United States.

OECD CONTINUES DELIBERATIONS REGARDING THE POSSIBLE RECOMMENDATION OF A BASEL CAPITAL-BASED APPROACH FOR DETERMINING A BANK’S DEDUCTIBLE INTEREST EXPENSE

Executive Summary

The Institute understands that the OECD Steering Committee is continuing its deliberations regarding the possible development of a uniform international approach, which would be based on the Basel risk-weighted capital standards, for determining the amount of interest expense deductible by a multinational bank in each country in which it conducts business. The Institute expects the OECD Steering Committee to release for public comment, sometime in the first half of next year, a draft report regarding this matter.

As previously reported, the Institute is very concerned that the adoption of a Basel capital-based approach for determining a bank’s deductible interest expense could have a significant adverse impact on the worldwide tax position of many multinational banks. In addition, the Institute has raised significant technical, practical and policy arguments against this approach in a series of meetings with, and written submissions to, the U.S. Treasury Department, and has suggested an alternative approach (see our September 13, 2000 submission, which is available on the Institute’s member web site).

Although there will be an opportunity to comment on the Basel capital-based approach if and when the OECD releases its draft report, the Institute believes that it would be desirable for member banks and national banking associations to maintain a dialogue regarding this matter with their home country representatives on the OECD Steering Committee and to express concerns regarding the possible adoption of such an approach.

Very generally, under the Basel capital-based approach, 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 Institute is very concerned that the adoption of a Basel capital-based approach for 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.

Under the alternative approach suggested by the Institute, 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, as would be the case under a Basel capital-based approach). 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. The Institute believes that this approach would produce sensible and reasonable results, and would be fair, administratively workable and easily verifiable.

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