NATIONAL TREATMENT UNDER U.S. LAWS AND REGULATIONS[1]

INTRODUCTION

The prevailing policy of the United States has been, and continues to be, to provide national treatment to foreign investors in their establishment and operation of financial institutions within the United States. The adoption of a policy of national treatment by the United States arose from the conviction that competition in financial services is healthy and beneficial. The U.S. financial markets, U.S. borrowers, U.S. investors, and the economy as a whole have benefitted from the presence of foreign financial institutions. The openness of U.S. financial markets helps to reinforce U.S. efforts to encourage greater financial market liberalization in foreign countries that do not yet provide substantially full market access and national treatment.

The purpose of this chapter is to highlight changes in U.S. law and regulation since publication of the 1994 National Treatment Study that are relevant to the treatment accorded to foreign financial services firms. This chapter draws upon the 1994 Study in order to provide a context for discussion of new developments but, to the extent possible, it avoids repetition of material set out in previous studies.

This chapter is organized into six sections, including this Introduction. The second section discusses the application of the principle of national treatment. Section 3 examines the treatment accorded foreign banking organizations under U.S. banking law. Sections 4 and 5 provide parallel accounts of the treatment of foreign institutions active in U.S. securities and futures markets. These sections also address regulations affecting the ability to introduce new products into the U.S. securities, options, and futures markets. Concluding remarks appear in Section 6.

THE APPLICATION OF THE PRINCIPLE OF NATIONAL TREATMENT

In the financial services area, U.S. policy has been to accord national treatment to foreign financial institutions under U.S. law and regulation. As practiced, national treatment accords substantially the same treatment to foreign financial institutions in the United States as is extended to U.S. financial firms in like circumstances. This ensures that national treatment affords equality of competitive opportunity to foreign financial institutions in the U.S. market. This approach provides a level playing field in the United States for foreign and domestic financial institutions. This chapter highlights the extent to which national treatment, including equality of competitive opportunity in financial services, has been maintained and, in some cases, expanded under U.S. law and regulation

[1] The information contained herein has been reviewed by the staffs of the contributing departments and agencies, but should not be deemed interpretative advice of the respective staffs, or regarded as legally binding guidance.

since 1994.

Assuring equality of competitive opportunity may require differential treatment of foreign financial institutions compared to domestic financial institutions. Providing identical treatment may not always be sufficient to ensure that foreign financial institutions enjoy equality of competitive opportunity in U.S. financial markets or that prudential concerns are met. Differential treatment is sometimes necessary in order to accommodate legal and regulatory systems and banking structures in foreign countries that may differ from those in the United States. Providing equality of competitive opportunity, therefore, sets a higher standard of fairness than *de jure* national treatment, based simply on identical treatment in law and regulation.

This same definition of national treatment has been the foundation of U.S. efforts to encourage other countries to liberalize their financial markets. As in the United States, identical treatment of foreign and domestic financial institutions may not always be sufficient to ensure equality of competitive opportunity in foreign markets.

NATIONAL TREATMENT UNDER U.S. BANKING LAW

Entry and Operation of Foreign Banks in the United States

The United States generally offers investor choice with regard to the form of entry that a foreign financial institution may use to establish a U.S. presence in banking. The dual banking system in the United States provides the opportunity for either a federal or state license.[2] The principal forms of establishment are: a federally or state-chartered commercial bank subsidiary; a federally or state-licensed branch or agency; a representative office; an Edge Corporation subsidiary chartered by the Federal Reserve; an Agreement Corporation organized under state law but subject to Federal Reserve regulation; and investment companies organized under New York State law.

Establishment of branches or agencies of foreign banks is prohibited by law in some states of the United States, but those states that are considered important financial centers permit foreign bank branches and/or agencies – e.g., New York, California, Illinois, Texas, Florida, and Georgia.

Edge Corporations are specialized entities that engage in international or foreign banking and other international business activities. Both domestic and foreign banks are permitted to establish Edge Corporations. These companies are not subject to restrictions on interstate branching (see Interstate Banking and Branching below).

[2] The Office of the Comptroller of the Currency (OCC) charters national banks and licenses federal branches and agencies. Individual state banking authorities license state banks, branches, and agencies.

Branches and agencies are the preferred form of establishment by foreign banks; there were 296 and 173, respectively, at the end of March 1998. In addition, there were 108 foreign bank-owned bank subsidiaries, three investment companies, and 21 Edge Corporations and Agreement Corporations. These U.S. operations of foreign banks control US$1.2 trillion in assets, approximately 24 percent of the total assets of the U.S. commercial banking system. In addition, there were about 144 representative offices of foreign banks in the United States.[3]

The International Banking Act of 1978

Foreign banks with U.S. branches or agencies were first subjected to federal regulation with the passage of the International Banking Act of 1978 (IBA). The IBA required foreign banks operating offices in the United States to maintain reserves against deposit liabilities and limited their activities and geographic expansion in the United States in accordance with the comparable limitations applicable to U.S. banking organizations.

The IBA, in providing for the first time for federally licensed branches and agencies of foreign banks, required that such branches or agencies generally operate under the same restrictions and conditions applicable to a national bank operating at the same location.[4]

As originally enacted, the IBA did not extend to foreign banks a number of federal requirements imposed on U. S. banks. For example, it did not require a foreign bank to meet uniform national

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[3] Source: Federal Reserve Board.

[4] Pursuant to the IBA, the OCC, the licensor and primary supervisor of federal branches and agencies, requires the parent bank to establish and maintain a *capital equivalency deposit* (CED) with a Federal Reserve member bank. Prudential in nature, the CED is technically a pledge of assets to the OCC calculated as a percentage of third-party liabilities of the branch or agency; the CED provides a cushion of protection for depositors and other creditors. Lending, investment, and other limits for federal branches and agencies are *not* limited by the CED; rather, they are based on the consolidated worldwide parent capital. A few states have explicit *asset pledge requirements,* which are similar to a CED and broadly constitute the amounts the chartering authorities expect all foreign banks to have in the jurisdiction in order to do business. In addition, *asset maintenance requirements* may be imposed by state or federal authorities on a case-by-case basis in circumstances where serious prudential concerns have been identified. The amounts imposed generally represent a specified percentage excess of qualifying assets over third-party liabilities of the branch or agency.

The Federal Deposit Insurance Corporation (FDIC) has an asset pledge requirement for foreign banks with insured branches. The amount to be pledged must be equal to 5 percent of the average of the insured branch's third-party liabilities for the last 30 calendar days of the most recent calendar quarter. Whenever the FDIC is obligated to pay the insured deposits of an insured branch, the assets pledged will become the property of the FDIC to be used to the extent necessary to protect the deposit insurance fund. The pledged assets can be held at a depository institution in any state, but the foreign branch must get prior written approval of the FDIC of the selected depository institution. Additionally, an insured branch of a foreign bank is also subject to an asset maintenance requirement. The branch is required to maintain on a daily basis eligible assets in an amount not less than 106 percent of the preceding quarter's average book value of the branch's third party liabilities.

standards for foreign bank entry into the U.S. market, nor did it provide for a federal role in the licensing or termination of a state-licensed branch or agency of a foreign bank. The Congress saw the need for additional federal regulation of foreign banks in the United States largely as a result of concerns raised by the alleged fraudulent or illegal activities of foreign banks such as the Bank of Commerce and Credit International (BCCI) and Banca Nazionale del Lavoro (BNL).

Foreign Bank Supervision Enhancement Act of 1991

Problems in bank supervision, principally those associated with BCCI and BNL, led to the enactment of the Foreign Bank Supervision Enhancement Act of 1991 (FBSEA), which strengthened the federal regulators' supervisory authority with respect to foreign banks. The FBSEA authorized greater federal oversight of foreign banks in order to ensure that multistate U.S. offices of foreign banks were regulated, supervised, and examined within the same broad framework as U.S. banks. The FBSEA amended existing U.S. law in several ways, most notably with respect to uniform standards and creating a federal approval requirement for all foreign banks seeking to establish U.S. offices, whether licensed by federal or state authorities. (Certain of these provisions were amended in 1996. See discussion of 1996 legislation below.)

Establishing offices. Section 202(a) of the FBSEA amended the IBA to require prior approval of the Federal Reserve Board (FRB) for the establishment of state-licensed and federally licensed branches and agencies, and representative offices of foreign banks, or to acquire ownership or control of a commercial lending company. This is in addition to the existing licensing approval by the federal regulator – OCC – or state primary regulator, mandated by the IBA. It further provided mandatory and discretionary criteria for FRB approval of applications to establish offices.

Under the statute, the FRB may not approve applications to establish branches or agencies unless it determines, among other things, that: (1) the applicant foreign bank engages directly in banking outside the United States; (2) the applicant foreign bank is subject to comprehensive supervision on a consolidated basis by home country authorities,[5] subject to certain narrow exceptions discussed below; and (3) the foreign bank has furnished the FRB the information necessary to assess adequately the application. In considering applications for representative offices, the FRB may take into account the same standards applicable to the establishment of branches and agencies and may impose any additional requirements that it determines are necessary.

Although requiring that applicant foreign banks be subject to comprehensive consolidated supervision (CCS) is not necessarily the norm worldwide, it is consistent with the "minimum

[5] This requirement has been interpreted by the FRB to mean, among other things, that the applicant's home country supervisor receives sufficient information on the worldwide operations of the foreign bank (including the relationships of the bank to any affiliate) to assess the foreign bank's overall financial condition and compliance with law and regulation.

standards" established by the Basle Committee on Bank Supervision in 1992. The federal banking supervisors have emphasized multilateral and bilateral outreach activities that encourage foreign supervisors to implement a system of CCS, explain what such a system should entail, and provide technical assistance to achieve that end, if requested.

Authority to terminate offices. The FBSEA also permits the FRB to order a foreign bank that operates a state-licensed branch or agency or commercial lending company subsidiary in the United States to terminate its activities if the FRB finds that the foreign bank is not subject to CCS by its home country supervisor, and the home country authorities are not making demonstrable progress in establishing arrangements for comprehensive supervision or regulation of the foreign bank on a consolidated basis, or it has reasonable cause to believe that the foreign bank or an affiliate has committed a violation of law or engaged in an unsafe or unsound banking practice in the United States.

With respect to federal branches or agencies, the FRB may transmit a recommendation to the Comptroller of the Currency that the license should be terminated. The FRB may also order the termination of the activities of a representative office on the basis of the standards, procedures, and requirements applicable to branches and agencies.

Bank acquisitions. Section 207 of the FBSEA made foreign banks maintaining a branch, agency, or commercial lending company in the United States subject to section 3 of the Bank Holding Company Act of 1956 (BHC Act) in the same manner and to the same extent as U.S. bank holding companies. Following this change, if a foreign bank maintaining a branch or agency in the United States wishes to acquire more than 5 percent of the voting shares of a U.S. bank or bank holding company, it must file an application with the FRB under the BHC Act. Foreign banks generally must meet the same standards as U.S. banks, including capital position and financial resources, when acquiring bank or nonbank subsidiaries in the United States.

Retail deposits. Section 214(a) provides that no foreign bank may accept or maintain *retail* deposits of less than US$100,000, except through an insured banking subsidiary. Branches that were insured prior to December 19, 1991, are grandfathered.

Examinations and Federal Reserve examination fees. The FBSEA clarifies and strengthens the FRB's authority to make sure that multistate foreign bank operations are examined in a comprehensive and coordinated manner. The FBSEA also requires that each branch and agency of a foreign bank be examined at least once each year. Section 203(a) further authorizes the FRB to examine any office, subsidiary bank, commercial lending company or affiliate of a foreign banking organization, coordinating to the extent possible with the other relevant supervisors.

Section 203(a) also states that the cost of such examinations that the Federal Reserve undertakes shall be assessed against and collected from the foreign bank or its parent holding company only to

the extent that domestic banks are charged. The FRB is not required to impose fees on domestic banks that it examines, although all U.S. banks are assessed to some extent for federal banking supervision.

The FDIC does not charge fees for its examinations. Insured institutions pay an insurance premium, which is based on the amount of their insured deposits and their financial condition. The OCC assesses fees based on the size of the bank or branch or agency.

Limitations on powers. The FBSEA prohibits state branches or agencies from engaging in any activity that is impermissible for a federal branch or agency unless the FRB determines that the activity is consistent with sound banking practices, and in the case of an insured branch, the FDIC has determined that the activity would not pose a significant risk to the deposit insurance fund.

Limits on loans to one borrower. Similarly, under the FBSEA, state branches and agencies are subject to the same loans-to-one-borrower limitations that are applicable to federal branches and agencies, i.e., the limits applicable to national banks.

Reporting of stock loans. Because of the experience with BCCI, in which that institution was found to have acquired illegal control of several U.S. banks through loans to nominees, Congress amended section 7 of the Federal Deposit Insurance (FDI) Act to extend to foreign banks and their affiliates requirements that they report to federal banking regulators loans secured by 25 percent or more of an insured institution's voting stock. The reporting requirements include any "credit outstanding" and clarify that loans by one organization to a group of persons acting together to gain control of a U.S. bank must be reported.[6]

Consumer laws. In addition, the FBSEA placed the enforcement of foreign banks' compliance with consumer laws with the appropriate federal banking agencies, thus placing foreign banks in a position comparable to that of domestic banks.

Criteria for continued operations. Under the FBSEA the FRB is required, in consultation with the Secretary of the Treasury, to develop and to publish criteria for evaluating the operation of any foreign bank that was established in the United States prior to enactment of the FBSEA and that the FRB determines is not subject to comprehensive supervision or regulation on a consolidated basis. These criteria are for evaluative purposes and provide a framework for the continued operation in appropriate circumstances of foreign offices established in the United States before the FBSEA was enacted, even in the absence of CCS.

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[6] The statute defines "credit outstanding" to include: (1) any loan or extension of credit; (2) issuance of a guarantee, acceptance or letter of credit (including an endorsement or standby letter of credit); and (3) any other type of transaction that extends credit or financing.

The final regulations, which became effective in March 1996, provide that, after determining that a foreign bank is not subject to CCS, the FRB shall consider the following criteria in determining whether the foreign bank's U.S. operations should be permitted to continue, and if so, whether any supervisory constraints should be placed upon the bank in connection with those operations:

1. the proportion of the foreign bank's total assets and total liabilities that are located or booked in its home country, as well as the distribution and location of its assets and liabilities that are located or booked elsewhere;

2. the extent to which the operations and assets of the foreign bank and any affiliates are subject to supervision by its home country supervisors;

3. whether the appropriate authorities in the home country of such foreign bank are actively working to establish arrangements for the CCS of such bank and whether demonstrable progress is being made;

4. whether the foreign bank has effective and reliable systems of internal controls and management information and reporting that enable its management properly to oversee its worldwide operations;

5. whether the foreign bank's home country supervisor has any objection to the bank continuing to operate in the United States;

6. whether the foreign bank's home country supervisor and the home country supervisor of any parent of the foreign bank share material information regarding the operations of the foreign bank with other supervisory authorities;

7. the relationship of the U.S. operations to the other operations of the foreign bank, including whether the foreign bank maintains funds in its U.S. offices that are in excess of amounts due to its U.S. officers from the foreign bank's non-U.S. offices;

8. the soundness of the foreign bank's overall financial condition;

9. the managerial resources of the foreign bank, including the competence, experience, and integrity of the officers and directors and the integrity of its principal shareholders;

10. the scope and frequency of external audits of the foreign bank;

11. the operating record of the foreign bank generally and its role in the banking system of its home country;

12. the foreign bank's record of compliance with relevant laws, as well as the adequacy of its money laundering controls and procedures, with respect to its worldwide operations;

13. the operating record of the U.S. offices of the foreign bank;

14. the views and recommendations of the OCC or the state banking regulators in those states in which the foreign bank has operations, as appropriate;

15. whether the foreign bank, if requested, has provided the FRB with adequate assurances that such information will be made available on the operations or activities of the foreign bank and any of its affiliates as the FRB deems necessary to determine and to enforce compliance with the IBA, the BHC Act, and other applicable federal banking statutes; and

16. any other information relevant to the safety and soundness of the U.S. operations of the foreign bank.

Any foreign bank that the FRB determines is not subject to CCS may be required to enter into an agreement to conduct its U.S. operations subject to such restrictions as the FRB, having considered the above criteria, determines to be appropriate in order to assure the safety and soundness of its U.S. operations. A foreign bank that fails to comply with such restrictions may be subject to enforcement action.

Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA)

Congress enacted the Federal Deposit Insurance Corporation Improvement Act of 1991 in response to the widespread bank and thrift failures of the middle and late 1980s. These failures strained the resources of the existing statutory deposit insurance fund. The primary purposes of FDICIA were to: provide a means to recapitalize the Bank Insurance Fund (BIF), improve supervision and examination of insured depository institutions, require the least-cost resolution of insured depository institutions, and reform both the financial services industry and the federal deposit insurance system. Although title II of FDICIA, FBSEA, was directed specifically at the regulation of foreign banks in the United States, other provisions of FDICIA also affect the supervision of these banks, as well as that of U.S.-owned banking organizations.

Annual audits. FDICIA amended section 36 of the FDI Act to add new requirements for annual independent audits and reports that apply both to domestic banks and to the insured U.S. branches of foreign banks with assets of more than US$150 million. One of these requirements is that each institution have an independent audit committee comprised of outside directors. In its final rule implementing the statute, the FDIC exempted insured (foreign bank) branches from this requirement because such branches do not have a separate board of directors. However, such branches are encouraged to make reasonable good faith efforts to see that similar duties are performed by persons

whose qualifications are consistent with the requirements of the rule as applicable to the particular branch.

In 1996, Congress authorized the federal banking agencies to permit the independent audit committee to be made up of less than all, but no fewer than a majority of, outside directors if the agency determines that the institution has encountered hardships in recruiting and retaining a sufficient number of competent outside directors to serve on the committee. Congress also eliminated the independent auditor attestation requirement for compliance with safety and soundness laws.

Prompt corrective action. FDICIA added section 38 to the FDI Act authorizing or requiring the bank regulatory agencies to take certain supervisory actions when an insured depository institution falls within the lower range of five specifically enumerated capital categories. These categories are, in turn, based on capital maintenance regulations.

Insured branches of foreign banks are required, in lieu of capital, to maintain a pledge of assets and a certain volume of eligible assets, which is analogous to a domestic bank's required capital.[7] Therefore, for purposes of prompt corrective action, the levels of capitalization for insured foreign bank branches that may trigger supervisory actions are based on the asset pledge and volume of eligible assets.[8] As of March 31, 1998, there were 27 insured branches of foreign banks in the United States, all of which were established before enactment of the FBSEA.

Risk-based assessments. FDICIA also amended section 7 of the FDI Act to require the FDIC to establish a system of risk-based deposit insurance assessments. For domestic banks, one of the criteria for determining assessments is the adequacy of capitalization maintained by those banks. Again, because insured branches of foreign banks are required to maintain a pledge of assets and a certain volume of eligible assets in lieu of the capital required for domestic banks, the risk-based assessments for such branches refer to the branches' positions against those requirements.[9]

Crime Control Act of 1990

Section 2597 of the Crime Control Act of 1990 brings branches and agencies of foreign banks and Edge and Agreement Corporations within the scope of the federal criminal code with respect to financial crimes. These crimes include both those committed by banks and their employees and

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[7] *See* 12 CFR § 347.210-211.

[8] *See* 12 CFR § 325.103(c).

[9] *See* 12 CFR § 327.4 (a)(1)(i)(B).

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those committed against banks.[10]

Annunzio-Wylie Anti-Money Laundering Act

The Annunzio-Wylie Anti-Money Laundering Act, enacted as title XV of the Housing and Community Development Act of 1992, provides for the termination of the charters/licenses of financial institutions that are convicted of certain money laundering crimes.[11] The provisions are generally consistent with the treatment accorded under that act to U.S. financial institutions convicted of money laundering crimes.

Government Securities Act Amendments of 1993

The Government Securities Act Amendments of 1993 (GSA Amendments)[12] amended section 3(a)(34)(G) of the Securities Exchange Act of 1934, to clarify that, for purposes of the Exchange Act, the FRB is the "appropriate regulatory agency" for *uninsured* state-licensed branches of a foreign bank that are active as brokers or dealers in U.S. government securities and the FDIC is the appropriate regulatory agency for *insured* state-licensed branches of foreign banks.[13] This authority

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[10] Section 2597 of the Crime Control Act of 1990 amends the definition of "financial institution" in title 18 of the U.S. Code to include branches and agencies of foreign banks and Edge and Agreement corporations and amends certain sections of title 18 to cover branches, agencies, and Edge and Agreement corporations where they were previously omitted. Among the amended sections dealing with crimes by banks or their employees are: section 212 (offer of loan or gratuity to bank examiner); section 656 (theft, embezzlement, or misapplication of bank funds by bank officer or employee); section 1004 (certification of checks before amount has been deposited); section 1005 (making false bank entries, reports, and transactions); and section 1906 (unauthorized disclosure of information from a bank examination report). Among the amended sections of title 18 providing foreign bank offices with protection from crimes against banks are: section 655 (theft by examiner); section 1014 (making false statements in loan and credit applications); and section 2113 (bank robbery).

[11] Section 1502 of the act requires the Comptroller of the Currency to issue a notice of its intention to terminate the license of a federal branch or agency upon the Comptroller's receipt of written notice from the U.S. Attorney General of the branch's or agency's conviction of a money laundering offense under 18 U.S.C. §§ 1956 or 1957. The OCC retains final discretion over whether or not to terminate the federal branch's or agency's license. For criminal offenses of the currency transaction reporting requirements under 31 U.S.C. § 5322, the Annunzio-Wylie Act gives the OCC discretion in determining whether or not to initiate termination proceedings.

Sections 1503 and 1507 of the Annunzio-Wylie Act impose similar requirements on the FDIC, with respect to terminating the deposit insurance of insured state-licensed branches of a foreign bank, and on the FRB, with respect to terminating the activities of state agencies, uninsured state branches, and commercial lending subsidiaries of a foreign bank.

[12] *See* 15 U.S.C. § 78c(a).

[13] The FRB is also the appropriate regulatory agency for state member banks, foreign banks, state-licensed agencies of foreign banks, and commercial lending companies owned or controlled by foreign banks.

follows the general division of regulatory responsibility for supervising state-licensed branches of foreign banks. The GSA Amendments also confirmed that the FRB is the appropriate regulatory agency for Edge and Agreement Corporations acting as government securities brokers or dealers.

In addition, the GSA Amendments provided the SEC, the Treasury, and the appropriate federal banking regulatory agencies with expanded authority to monitor the government securities market, to detect and to prosecute fraudulent or manipulative activities, to permit the appropriate regulatory agencies to establish and to enforce sales practice regulations in this market, and to monitor the public availability of market information.

Interstate Banking and Branching

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Riegle-Neal Act), signed by President Clinton on September 29, 1994, established a federal framework for interstate banking and branching in the United States for both domestic and foreign banks. The Riegle-Neal Act affords foreign banks national treatment with respect to interstate banking and branching.

The Riegle-Neal Act provides three avenues of interstate expansion for foreign and domestic banks:

- interstate banking by multistate acquisition of banks;
- interstate branching by acquiring and consolidating banks or bank branches in more than one state; and
- interstate branching by establishing *de novo* branches or agencies in more than one state.

Nationwide interstate banking by acquisition. The statute permits adequately capitalized and managed bank holding companies (a term that includes foreign banks) to acquire a bank in any state subject to certain limitations. As discussed below, many states have placed minimum age requirements on the banks within their jurisdiction that may be acquired.

In addition, the Riegle-Neal Act provides a 10 percent cap on the amount of nationwide deposits that an acquirer may control following the interstate acquisition. Also, there is generally a 30 percent cap on the amount of deposits in a single state that an acquirer may control following a second, not an initial, acquisition in that state or in any other state where the acquired institution is present. Concentration limits must be nondiscriminatory, applying equally to all out-of-state acquirers.

Interstate branching by merger. The responsible banking regulators may approve a merger transaction between banks whose main offices are located in different states, subject to certain

limitations. The surviving bank would then convert the merged bank's offices into branches. Concentration limits similar to those applicable to interstate banking acquisitions also apply to interstate branching by merger, except for mergers involving only affiliated banks. The individual states may require that the target bank have been in existence for a minimum period of time, but not more than five years.

As discussed below, two states have enacted laws to "opt out" of interstate branching by merger, although one of these states, Texas, subsequently reversed its position. A bank from a state that opts out may not participate in interstate branching by merger. The remaining states permit some form of interstate branching by merger.

Interstate branching by de novo establishment of branches. A bank may establish and operate a *de novo* branch in a state in which the bank does not already operate so long as the host state has expressly authorized *de novo* interstate branching by state statute. States may enact such statutes at any time.

National treatment is now afforded to foreign banks in relation to the following interstate authority:

- Opportunities for acquiring a U.S. bank located in a state other than the home state of the bank holding company or for merging with U.S. banks having different home states, are available to foreign banks to the same extent as to U.S. bank holding companies.

- A foreign bank in general may establish and operate a branch or agency in any state outside its home state to the same extent as a domestic bank with the same home state as the foreign bank.

- A U.S. bank controlled by a foreign bank may establish branches outside its home state to the same extent as other U.S. banks.

To address perceived competitive advantages of wholesale branches of foreign banks compared to domestic banks, Congress introduced four specific foreign bank provisions (all in section 107). In addition, the legislation includes a community credit provision applicable to foreign and domestic banks (section 109). These provisions of the interstate banking and branching legislation do not deviate from the principle of according national treatment to foreign banks.

Meeting community credit needs (section 107). If a foreign bank acquires an existing bank or branch in a state in which the foreign bank does not maintain a branch, the Community Reinvestment Act (CRA) shall continue to apply to each branch of the foreign bank that results from the acquisition. The CRA requirement shall not apply to any branch that receives only such deposits as are permissible for an Edge Corporation.

The foreign bank CRA requirement was narrowly drafted to apply only in the case of an initial interstate entry by a foreign bank through the *acquisition* of an existing entity that, prior to acquisition, was subject to CRA. The provision explicitly provides that the CRA requirement will not apply if the branch takes only those deposits that are permissible for an Edge Corporation (e.g., deposits from foreign governments, foreign persons, foreign banks, and International Banking Facilities and nonretail deposits related to international or foreign business). U.S. banks also acquire banks or branches subject to CRA, but the Edge type deposit alternative is not a realistic option for a U.S.-incorporated bank. The U.S. bank would have to relinquish its bank charter in order to avoid the CRA.

Review of regulations on deposit taking (section 107). The FDIC and OCC revised their regulations, effective in 1996, to restrict the amount and types of retail deposits of less than US$100,000 which can be accepted by an uninsured federal or state-licensed branch of a foreign bank.[14]

Management of shell branches (section 107). Under the IBA, a U.S. branch or agency of a foreign bank may not, through an offshore shell branch that it manages or controls, manage types of activities that a U.S. bank is not permitted to manage at a foreign branch or subsidiary. The provision is intended to help avoid any potential for a foreign bank to use its U.S. branches or agencies to manage types of activities through offshore shell branches that U.S. banks could not manage. Generally speaking, a "shell" branch is an entity having no personnel or operations in the jurisdiction where it is established and authorized to do business. The restrictions would not apply to foreign banks' non-U.S. offices that are not "managed or controlled" from a U.S. office.

Consumer protection laws (section 107). The IBA was amended to affirm that branches and agencies of foreign banks and commercial lending companies are subject to consumer protection laws. This provision reaffirms existing law and practice.

Deposit production offices (section 109). This provision is intended to ensure that the interstate branching authority provided by the Riegle-Neal Act would not result in the taking of deposits from a community without banks reasonably helping to meet the credit needs of that community. In September 1997, the OCC, FRB, and the FDIC issued a joint rule implementing section 109, which became effective in October 1997. The final rule prohibits any bank from establishing or acquiring a branch or branches outside its home state under the Riegle-Neal Act primarily for the purpose of deposit production. In addition, the rule provides guidelines for determining whether such bank is reasonably helping to meet the credit needs of the communities served by these branches.

The rule applies to any bank that established or acquired, directly or indirectly, a branch under the authority of the Riegle-Neal Act or amendments to any other provision of law made by the Riegle-

[14] *See* 12 CFR § 347.206 (FDIC); § 28.16 (OCC).

Neal Act. These branches are referred to as "covered interstate branches." The rule provides that, beginning no later than one year after a bank established or acquired a covered interstate branch, the appropriate agency will determine whether the bank satisfies a "loan-to-deposit ratio screen" based on reasonably available data.

The loan-to-deposit ratio screen compares the bank's loan-to-deposit ratio within the state where the bank's covered interstate branches are located (the bank's statewide loan-to-deposit ratio) with the loan-to-deposit ratio of banks whose home state is that state (host state loan-to-deposit ratio). If the loan-to-deposit ratio screen indicated that the bank's statewide loan-to-deposit ratio is at least 50 percent of the host state loan-to-deposit ratio, no further analysis is required. If, however, the appropriate agency determines that the bank's statewide loan-to-deposit ratio is less than 50 percent of the host state loan-to-deposit ratio, or determines that reasonably available data does not exist that permits the agency to determine the bank's statewide loan-to-deposit ratio, the agency will perform a "credit needs determination."

Under the credit needs determination, the appropriate agency reviews the loan portfolio of the bank and determines whether the bank is reasonably helping to meet the credit needs of the communities served by the bank in the host state. The agency will consider the following in making a credit needs determination: (1) whether the covered interstate branches were formerly part of a failed or failing depository institution; (2) whether the covered interstate branches were acquired under circumstances where there was a low loan-to-deposit ratio because of the nature of the acquired institution's business; (3) whether the covered interstate branches have a higher concentration of commercial or credit card lending, trust services, or other specialized activities; (4) the ratings received by the bank under the Community Reinvestment Act; (5) economic conditions, including the level of loan demand, within the communities served by the covered interstate branches; and (6) the safe and sound operation and condition of the bank. A bank that fails the loan-to-deposit ratio screen and that receives a determination that it was not reasonably helping to meet the credit needs of the communities served by the bank's interstate branches could be subject to sanctions after a hearing under section 8(h) of the FDI Act.

The final rule noted that limited branches (i.e., offices that only accept internationally-related deposits permissible for an Edge corporation) and agencies operated by foreign banks outside their home state are not subject to the provisions of section 109. In addition, the rule stated that, in making a credit needs determination for institutions not evaluated under the Community Reinvestment Act, the agencies intend to give substantial weight to the specialized activities of such institutions. As an example, the rule noted that most branches of foreign banks derive substantially all of their deposits from uninsured, wholesale deposit markets, which are generally national or international in scope, and generally are not established primarily to gather deposits in their host state.

Nonbanking Activities of Foreign Banks

Foreign banks that engage in commercial banking in the United States, whether through branches, agencies, commercial lending company subsidiaries or bank subsidiaries, are subject to the provisions of the BHC Act. The BHC Act provides that a bank holding company or foreign bank may engage in the United States only in banking activities or *activities closely related to banking.* Under this standard, a foreign bank may engage in a wide range of financial activities in the United States, such as consumer and commercial lending, trust activities, leasing, data processing, investment advisory and private placement services, foreign exchange activities, and operating thrift institutions. Foreign banks may also engage in securities underwriting and dealing activities through subsidiaries, which are described further in the next section.

Although the BHC Act generally prohibits bank holding companies from engaging in nonfinancial activities, there are two exceptions that are available only to foreign banks. First, foreign banks that became subject to the International Banking Act of 1978 were grandfathered to retain any nonbanking activities in which they were engaged at that time; 17 foreign banks were grandfathered to operate securities affiliates, even though no similar grandfathering was provided to U.S. bank holding companies. Almost half of these 17 foreign banks have subsequently relinquished their grandfather rights, either in connection with an acquisition of a U.S. bank subsidiary or through the merging of its grandfathered securities company with its Section 20 subsidiary.

Second, in order to prevent disruptions in the relationships between foreign banks and their foreign commercial and industrial affiliates, these affiliates are allowed to engage in the United States in the same nonfinancial activities that they conduct abroad. A foreign affiliate is not allowed to conduct financial activities in the United States except on the same basis as an affiliate of a U.S. bank holding company.

Securities Activities of Banking Organizations in the United States

The Glass-Steagall Act of 1933

The Glass-Steagall Act, enacted in 1933, established a separation between commercial and investment banking in the United States. Under this law and Federal Reserve and OCC regulation, banks are generally prohibited from underwriting or dealing in securities of nongovernmental issuers. The IBA extends this restriction to the U.S. branches and agencies of foreign banks.

Although banks in the United States are generally prohibited from underwriting or dealing in securities of corporate issuers, subsidiaries of bank holding companies may engage in such activities, and banks may engage in many other securities activities. A foreign bank is in the same general position as a U.S. bank or bank holding company with respect to its ability to conduct securities activities in the United States and is thus accorded national treatment. U.S. banks and bank holding

companies may underwrite and deal in government securities, and they may engage directly or indirectly in the brokerage of all types of securities.

U.S. banks and subsidiaries of bank holding companies may also act as agent in the private placement of all types of securities. This activity, which is not considered underwriting because it is not offered on public markets, must be conducted within the limits of U.S. securities law and within certain prudential limits that generally prohibit an affiliated bank from purchasing for its own account or providing a credit enhancement for any security privately placed by a securities affiliate. The federal bank supervisors have approved numerous foreign banks to engage in this activity.

Section 20 Approvals

Since 1989, under the FRB's interpretation of Section 20 of the Glass-Steagall Act, the FRB has approved applications by U.S. bank holding companies and foreign banking organizations to underwrite and deal in all types of debt and equity securities subject to revenue limitations and certain additional prudential restrictions or conditions. As discussed in more detail below, these restrictions were originally implemented as conditions to the approvals, but have recently been restructured as regulatory operating standards.

Certain conditions the FRB applied to domestic bank holding companies have been adjusted to account for the status of the foreign banks and to minimize any extraterritorial impact of the framework's requirements. These adjustments included that the foreign bank meet the risk-based capital adequacy standards of its *home country* supervisor consistent with internationally accepted standards under the Basle Capital Accord.

As of September 30, 1998, the FRB had approved 50 companies to engage in underwriting and dealing in securities. Of these, 18 were owned by foreign banks.

Primary Dealers

The core participants in the U.S. government securities market are 32 primary dealers (compared with 39 in 1994), half of which are foreign-owned. A primary dealer is a firm that has established a trading relationship with the Federal Reserve Bank of New York (FRBNY). Some primary dealers are banks or bank subsidiaries, some are departments of general securities broker-dealers (including subsidiaries of bank holding companies), and others are firms specializing in government securities and other money market instruments.

Firms designated primary dealers by the Federal Reserve voluntarily report weekly to FRBNY on their volume of trading and their positions (holdings) in government and government agency issues. They also provide weekly reports on financing and periodic reports on their financial condition.

In order to be added to the list of primary dealers, a firm is expected to: (1) make markets in the full range of Treasury issues for a reasonably diverse group of customers; (2) participate meaningfully in Treasury auctions; (3) be committed to continuing as a market-maker in these securities over the long term; (4) have management depth and experience and good internal controls; and (5) have sufficient capital to support its activities and prudently manage its risk exposure. Minimum absolute levels of capital are specified (US$100 million for commercial banks and US$50 million for broker/dealers) to help ensure that primary dealers are able to enter into transactions with the Federal Reserve in sufficient size to maintain the efficiency of open market operations.

In its relations with primary dealers, the FRBNY accords foreign-owned dealers essentially the same treatment as domestically owned dealers, subject to the constraints of the Primary Dealers Act of 1988. That act requires the Federal Reserve to determine whether U.S. firms operating in the government debt markets of certain foreign countries have "the same competitive opportunities" as domestic companies operating in those markets. If a country does not offer "the same competitive opportunities" to U.S. firms, a person (including a company) from that country may not control a primary dealer in the United States. The Federal Reserve "may not designate or permit the continuation of any prior designation" of a firm from that country as a primary dealer.

Pursuant to the act, the Federal Reserve conducted extensive studies of the government debt markets in the United Kingdom, Japan, Switzerland, Germany, France, and the Netherlands. It determined that U.S. firms are accorded "the same competitive opportunities" as domestic firms in those countries. The act excludes from its coverage firms from a country with which the United States has a trade agreement or was as of January 1, 1987, negotiating to enter into a trade agreement with the United States, and firms that had been designated as primary dealers prior to July 31, 1987. As a result of these provisions, several firms either were exempt from the act or were grandfathered. As of July 20, 1998, 16 primary dealers were owned by foreign firms from six countries, compared with 19 foreign-controlled primary dealers from seven countries in 1994.

Futures, Options, and other Derivatives and Commodities Activities

Registration. Commodity futures and option transactions are governed by the Commodity Exchange Act (CEA). Any bank or bank holding company acting in the capacity of a futures commission merchant (FCM), introducing broker (IB), commodity trading adviser (CTA), or commodity pool operator (CPO) must register in the appropriate capacity with the Commodity Futures Trading Commission (CFTC).[15] Banks and bank holding companies have performed brokerage (FCM or IB)

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[15] An FCM is defined as any person who solicits or accepts orders to buy or sell futures or option contracts and who, in connection with an order, accepts any money or other property (or extends credit) to margin, guarantee, or secure the contracts resulting from the order.

An IB is any person who solicits or accepts orders to buy or sell futures or option contracts, but who does not accept

and investment advisory (CTA) services and have acted as fiduciaries for pooled investment funds (CPO) in connection with a variety of futures and options contracts. Both foreign and domestic banks are subject to the same requirements with respect to their futures and commodity option activities; foreign-owned banks in the United States and foreign bank holding companies are treated the same as U.S. banks and bank holding companies.

Under the CEA, whether a person is required to register with the CFTC is generally a function of that person's location in the United States and contacts with U.S. markets and/or customers resident in the United States. The CFTC has not required persons located outside the United States who provide commodity-related brokerage and advisory services to non-U.S. persons regarding instruments traded on a U.S. futures exchange to register with the CFTC. However, other regulatory obligations such as position reporting apply as noted herein. A U.S. FCM with customers that want to trade on a foreign exchange where the U.S. FCM is not a clearing member must establish a customer omnibus account with a clearing member of such foreign exchange to execute the transactions. All funds of such customers will be channeled into the omnibus account maintained by the U.S. FCM for transactions on behalf of its U.S. customers.

Foreign banks that are permitted to act directly in a brokerage capacity in their home jurisdictions are not considered to be "located outside the United States" for purposes of relief from registration if such banks maintain branches in the United States. Although not required to register with the CFTC, any bank or bank holding company acting in the futures or commodity option markets solely for *proprietary* purposes is deemed to be a trader under rules of the CFTC and thus is subject to all CFTC regulatory requirements applicable to traders, including large trader reporting of futures and options positions. These requirements apply irrespective of the trader's location in the United States or abroad.

In an attempt to avoid duplicative regulation, the CFTC has taken cognizance of the "otherwise regulated" status of banks. Banks generally are excluded from the definition of "commodity pool operator" pursuant to CFTC Rule 4.5 with respect to their handling of the assets of any trust, custodial account or other separate unit of investment for which they act as a fiduciary and for which they are vested with investment authority.

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any money or property (or extend credit) to margin, guarantee, or secure the contracts.

A CTA is any person who, for compensation or profit, is engaged in the business of providing advisory services to others concerning futures or options contracts. The CEA specifically excludes from the definition of "commodity trading adviser" certain persons, including banks and news reporters, publishers, and editors, who provide commodity advice that is "solely incidental" to the conduct of their business or profession.

A CPO is any person who solicits funds from others for the purpose of pooling the funds for use in investing in futures or options contracts. Certain "otherwise regulated" persons and entities such as a bank, an insurance company, or an investment company may be excluded from the definition of CPO with respect to their operation of "qualifying entities."

Transactions by banking organizations. Under the CEA, a foreign bank doing business in the United States is accorded national treatment, including equality of competitive opportunity, and is treated no less advantageously than a domestic bank. Under relevant federal and state banking laws, foreign and domestic banks operating in the United States are subject to certain restrictions upon the scope of their activities related to commodity futures and options. These restrictions generally are designed to limit bank activities to banking-related functions and to protect the financial soundness of banks and the banking system. In substantially similar guidelines relating to certain derivatives activities of the banks subject to their oversight, the OCC and the FRB stress that banks' use of the specified derivatives contracts must be in accordance with "safe and sound banking practices and with levels of activity reasonably related to the bank's business needs and capacity to fulfill [its] obligations under the contracts."

Under the BHC Act and the Federal Reserve's Regulation Y, as recently revised, bank holding companies are expressly authorized to act as FCMs and CTAs for unaffiliated persons in the execution, clearance, or execution and clearance of any futures contract and option on a futures contract traded on an exchange in the United States or abroad if: (i) the activity is conducted through a separately incorporated subsidiary of the bank holding company (which may engage in activities other than FCM activities, including permissible advisory and trading activities); and (ii) the parent bank holding company does not provide a guarantee or otherwise become liable to the exchange or clearing association other than for those trades conducted by the subsidiary for its own account or for the account of any affiliate.

Under the revised regulations, a nonbanking subsidiary of a bank holding company, including a Section 20 Subsidiary, may act as an FCM regarding any exchange-traded futures contract and option on a futures contract based on a financial or nonfinancial commodity. The regulations also permit lending activities in combination with FCM activities.

The OCC has concluded that national banks and their subsidiaries may enter into derivative transactions for their *own account* where the bank may lawfully trade, deal in or purchase the underlying instrument or product for its own account.[16] The OCC has imposed prudential and supervisory conditions governing the manner in which these activities are conducted.[17] The OCC has recognized that a national bank may enter into derivative transactions for its own account to hedge risk exposure, to engage in arbitrage activities, and as part of the bank's dealer-bank trading

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[16] Many states authorize state-chartered banks to engage in the same derivatives activities as national banks.

[17] OCC Banking Circular 277 provides guidance on risk management practices for national banks and federal branches and agencies engaging in financial derivatives activities, including participation as an end-user or as a financial intermediary. It specifically addresses credit, market, liquidity, operations, and legal risk management systems. Circular 277 provides that a bank should have comprehensive written policies and procedures to govern its use of financial derivatives and that senior management should establish an independent unit or individual responsible for measuring and reporting risk exposure.

activities. In connection with a bank subsidiary's derivatives activities, the OCC has also approved exchange membership, floor trading, and market making activities.

National banks may also enter into derivative transactions as *agent* for their customers. The OCC has recognized that the purchase and sale of derivative instruments as agent for customers are part of the business of banking and thus within the powers of national banks and their operating subsidiaries.[18, 19] This authority exists regardless of the underlying commodity upon which the futures (or other derivative instruments) are based, because the futures or option (or other derivative instrument) itself is a financial instrument. Accordingly, the OCC has permitted operating subsidiaries of national banks to register as FCMs and to *solicit, accept, and execute customer orders* for futures, options, options on futures and other exchange-traded and over-the-counter (OTC) instruments as an incident to the business of banking. The OCC has also approved the expansion of a national bank operating subsidiary's FCM activities to include the provision of execution, clearing, and advisory services for customer transactions in both financial and nonfinancial futures and options and to become members of exchanges and clearing associations affiliated with such exchanges.[20]

A national bank may also enter into derivatives transactions as *principal* where the bank is serving as a financial intermediary for its customers, whether or not the bank has the power to act as principal for its own account with respect to the underlying instrument or product. For example, the OCC has permitted national banks to enter into matched and unmatched commodity price index swap transactions in order to assist their customers that desire to limit certain financial risks resulting from variations in commodity prices, and to hedge such transactions on a portfolio basis. Just as with its deposit and lending activities, in matched and unmatched swap transactions a bank acts as a financial intermediary on behalf of its customers, making and receiving payments.

National banks can generally hedge the market risk associated with such commodity-based derivatives activities by entering into exchange-traded and OTC cash-settled transactions, such as exchange-traded futures and options contracts and OTC spot, forward, and option contracts. In some instances, however, both exchange-traded and OTC transactions that are cash-settled may provide less than completely accurate hedges. Accordingly, the OCC has concluded that it is legally permissible for a national bank to engage in *physical commodity transactions* in order to manage the

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[18] *See* 12 U.S.C. § 24(Seventh).

[19] The use of the word "agent" in this context is not meant to connote any characterization of the relationship between a bank or its subsidiary when acting as an FCM and its customer under the Commodity Exchange Act and rules thereunder. The CFTC views that relationship as one of principal-to-principal.

[20] With respect to customer accounts, national banks and their subsidiaries are authorized to execute transactions in option and futures contracts provided that the bank is authorized to execute transactions for the account of customers in the underlying financial product or instrument.

risks arising out of commodity derivatives transactions. Given the potential additional risks associated with physical hedging activities, however, a national bank may not engage in such activities unless it has submitted a detailed plan for such activities to the OCC, and the plan has been approved in writing by the OCC's supervisory staff.

State member banks are chartered under state law, and must have authority under state law to engage in derivatives transactions. In some states, state member banks have been permitted to use exchange-traded interest rate and foreign exchange derivatives to hedge interest rate and foreign exchange exposure.[21] In at least one state, banks are permitted to act as FCMs, engaging in trading for customers and for their own account in exchange-traded interest rate and foreign exchange derivatives. This activity generally takes place in a subsidiary.

A small number of state-chartered banks that are members of the Federal Reserve System ("member banks") engage in derivative transactions linked to equities or commodities other than interest rates or foreign currencies. Some of these transactions are related to traditional bank activities in commodities such as gold and silver, but some state member banks have obtained approval from their state regulatory authorities for activities involving a wider range of commodity-linked and equity-linked transactions. State member banks have been permitted by some state regulatory authorities to engage as a principal in OTC derivative transactions linked to commodities or equities and to use exchange-traded derivatives to hedge exposure created by OTC transactions.

The FRB has required state member banks engaging as principal in derivatives transactions linked to commodities or securities that the state member bank is not authorized to purchase and hold directly (other than transactions entered into on a perfectly matched basis) to obtain the approval of the FRB to continue such activities. State member banks that currently are not engaged in such transactions will be required to seek FRB approval to commence such activities in the future.

Banks are major participants – both as end-users and as financial intermediaries – in the large and developing swap transactions market. The CFTC has issued a rule pertaining to swaps transactions that provides greater legal certainty for the swaps market than the CFTC's earlier swaps policy statement. Swaps transactions that comply with the criteria of the rule are not generally subject to the regulatory provisions of the CEA, but they may be subject to the anti-fraud provisions of the CEA.

The marketing of "hybrid" instruments that couple elements of futures contracts with certain banking instruments such as depository obligations has raised issues concerning the treatment of such instruments by the CFTC under the CEA and CFTC regulations. The CFTC issued a rule amending its hybrid instrument exemption. The rule applies to certain hybrid instruments that combine

[21] E.g., California and New York.

characteristics of commodity futures contracts or commodity options with equity, debt, or depository instruments. Under the rule, hybrid instruments that are predominantly securities, debt, or depository instruments are exempt from CFTC regulation in deference to the primary regulator.

Insurance Activities of Banking Organizations

Banks and bank holding companies are generally not permitted to sell and underwrite insurance except in limited circumstances. National banks are permitted to sell, underwrite, and reinsure insurance that is credit-related or otherwise part of, or incidental to, the business of banking. National banks may also act as insurance agents in towns with a population of less than 5,000 where the bank is located and doing business, even if the principal office of the bank is located in a community with a larger population. National banks are also permitted to act as brokers to sell variable rate as well as fixed-rate annuities, which the OCC regards as financial investments rather than insurance. State insurance laws and regulations generally apply to national banks if their provisions do not prohibit or significantly interfere with bank insurance authorities.

Recent Developments in the United States

There have been several significant developments since 1994 in the United States regarding the national treatment accorded to foreign firms in the financial services sector. The most important development occurred in December 1997, when the United States entered into a binding agreement for financial services under the General Agreement on Trade in Services (GATS) in the World Trade Organization (WTO). Under this agreement, the United States submitted a schedule of binding commitments regarding market access and national treatment for foreign firms in the banking, securities, and insurance areas.

The U.S. banking and securities commitments provide a broad commitment of national treatment to foreign firms, with certain narrow reservations reflecting existing federal and state laws. The schedule also included a statement of the Administration's support for Glass-Steagall reform on a national treatment basis. The WTO Financial Services Agreement is discussed in Chapter 3 of this study.

In addition, there have been a number of statutory and regulatory developments since 1994 that affect foreign banks. The most important, discussed below in greater detail, are:

- legislation enacted by the various states implementing the Riegle-Neal Act;
- the Federal Reserve's initiation in 1995 of a new program for coordinating the supervision of the U.S. operations of foreign banks with U.S. offices supervised by different U.S. banking supervisory agencies;

- creation by the Conference of State Bank Supervisors (CSBS) of a working group on international bank supervision and a draft framework for streamlining supervision of foreign banks with interstate operations similar to the program developed for domestic banks;

- the FDIC's implementation of a streamlined approach to supervising banking companies with multi-chartered operations.

- the OCC's initiatives for coordinating the supervision of the U.S. banking operations of foreign banks;

- the enactment of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 that included amendments to the IBA affecting the entry of foreign banks into the United States and examination of their U.S. operations;

- the Federal Reserve's increase of the amount of total revenue that securities underwriting and dealing subsidiaries of bank holding companies (so-called "Section 20 Subsidiaries") may derive from underwriting and dealing in bank-ineligible securities pursuant to section 20 of the Glass-Steagall Act;

- the Federal Reserve's streamlining of the prudential restrictions ("firewalls") applicable to the activities of Section 20 Subsidiaries, and reformatting the restrictions as regulatory operating standards;

- the Federal Reserve's revision of its Regulation Y governing the U.S. operations of domestic and foreign banking organizations to streamline the application process and expand the range of nonbanking activities permissible for bank holding companies;

- the Federal Reserve's publication for comment of a proposed revision to its Regulation K governing the cross-border operations of U.S. and foreign banking organizations;

- the OCC's completion of a comprehensive review and revision of its international banking activities regulation and other regulations to eliminate unnecessary regulatory burden, promote competitiveness, and make the rules simpler;

- the OCC's reduction of assessment fees of foreign banks with more than one federal branch or agency, as well as of some national banks;

- the OCC's lightening of the regulatory burden on federal branches and agencies by modifying its supervisory strategy;

- the OCC's determination that additional activities are permissible for national banks and federal branches and agencies, such as mortgage reinsurance activities, insurance agency activities, and delivery of products and services to customers through electronic means, including Internet banking;

- the FDIC's revision to its Part 347, which consolidates, updates, and streamlines rules that apply to international banking to improve efficiency, reduce costs, and modernize requirements; and

- H.R. 10, a bill that would have repealed the provisions of the Glass-Steagall Act that restrict banks from affiliating with securities underwriters and would have otherwise modernized certain aspects of the financial service system.

State Implementation of the Riegle-Neal Act

As discussed above, the Riegle-Neal Act was enacted by Congress in September 1994. As of September 1995, interstate banking by acquisition was in effect in all 50 states and, as a result, any bank holding company, including foreign banking organizations, may acquire a bank subsidiary in any state without geographic restriction.

With respect to interstate branching, by July 8, 1997, 50 states, the District of Columbia, and Puerto Rico had enacted legislation on interstate branching by merger. Only Montana and Texas adopted legislation intended to prohibit interstate branching by merger, and Texas subsequently reversed its position. In the majority of states, out-of-state banks are not permitted to acquire only a portion of an in-state bank's branch network, but rather must acquire the entire bank. Most states require that an in-state bank be in existence a minimum of 3 to 5 years before being eligible for acquisition by an out-of-state bank under the Riegle-Neal Act. Legislation has been passed in 13 states (plus Puerto Rico and the District of Columbia) permitting some form of interstate *de novo* branching.

In general, a foreign bank may establish and operate a federally or state-licensed branch or agency in any state outside its home state to the same extent as a domestic bank with the same home state as the foreign bank. In addition, a U.S. bank controlled by a foreign bank may establish branches outside its home state to the same extent as other U.S. banks.

FBO Supervision Program

Consistent with economic efficiency and national treatment, foreign banking organizations (FBOs) are free to conduct their U.S. activities through a variety of forms. As a result, however, FBOs may be subject to a number of state and federal statutes, and various aspects of their operations may be supervised and regulated by both state and federal banking supervisory authorities.

In order to ensure coordination of supervisory efforts, avoid duplication and reduce burden, as well as provide a more uniform approach to FBO supervision, in 1995 a joint program to coordinate the supervision of the U.S. operations of FBOs was initiated among federal and state bank supervisors, particularly with respect to their examination plans, examination results, and, where applicable, their proposed supervisory follow-up actions (the "FBO Supervision Program"). The FBO Supervision Program encompasses all branches and agencies established by FBOs in the United States, all U.S. banks that are subsidiaries of FBOs, and all non-bank subsidiaries of FBOs authorized by the FRB to operate under section 4 of the Bank Holding Company Act.[22] As part of this program, the Federal Reserve, as the supervisor with overall responsibility for the U.S. operations of individual FBOs, also began annual assessments of the combined U.S. operations of each FBO. The OCC also prepares annual assessments. The FBO Supervision Program was revised in June 1998 to bring it into alignment with the Risk-Focused Framework for the Supervision of Large Complex Institutions applicable to domestic banks and bank holding companies. Under this framework, the appropriate bank supervisor prepares a Risk Matrix and Risk Assessment, Supervisory Plan, Examination Program, and Scope Memorandum for each FBO which are used in planning and coordinating the examination and supervision of FBOs.

Generally, each U.S. banking office of an FBO is subject to one safety and soundness examination at least every 12 months unless the office is eligible for less frequent examination. The agency responsible for the examination of an office is also responsible for completion of the examination and preparation of the examination report for that entity. In the case of joint examinations, the examining agencies will strive to issue only one report of examination for that office of the FBO.

An important component of the FBO program is the integration of individual examination findings into an assessment of an FBO's entire U.S. operations. This assessment provides the FBO, as well as the U.S. supervisory agencies, with a view of the overall condition of the U.S. operations, and helps put into context the strengths and weaknesses of individual offices.

Following the conclusion of the last examination of an FBO's U.S. operations in a given annual supervisory cycle, a Summary of Condition is prepared for the FBO. The Summary of Condition is a single-component rating for the FBO's combined U.S. operations. The evaluation includes an assessment of all risk factors, focusing on the components of the ROCA rating system. The Summary of Condition and rating of the FBO's combined U.S. operations represent important tools that are to be utilized in reaching decisions regarding the scope and frequency of future examinations and appropriate supervisory measures. The Summary of Condition is prepared as a letter to the

[22] As of October 31, 1998, FBOs operated 398 state-licensed branches or agencies, with total assets of US$855 billion, and 64 federally licensed branches or agencies, with total assets of US$74 billion. In addition, 61 state-chartered banks (total assets of US$130 billion) and 24 national banks (total assets of US$139 billion) were subsidiaries of FBOs. Finally, 680 non-bank subsidiaries of FBOs, with total assets of US$805 billion, were operating under authority of the Bank Holding Company Act.

FBO's head office management and highlights those areas of overall strength and systemic weaknesses in the FBO's U.S. operations. These results are also shared with the FBO's home country supervisor.

CSBS Initiatives for Coordination of FBO Supervision

In October 1997, the Conference of State Bank Supervisors (CSBS) formed the International Working Group, which will seek to improve the coordination and consistency of supervision of state-licensed foreign banking organizations operating in more than one state. The working group is composed of the heads of banking supervision for several states that are important international banking centers, such as New York, California, and Florida, as well as representatives from the Federal Reserve System and the FDIC.

In June 1998, the CSBS published a working draft of an agreement for coordination of examinations of foreign banking organizations with state-chartered or licensed operations in more than one state. The draft agreement, the Nationwide Foreign Banking Organization and Examination Coordination Agreement, is patterned after a similar arrangement recently developed for interstate domestic banking organizations. Under the draft agreement, the U.S. banking operations of all FBOs with multi-state operations would be subject to a supervision and examination process directed by a "State Coordinator." The state supervisors sharing responsibility for an FBO would choose a single state regulator to act as the FBO's State Coordinator. The State Coordinator for an FBO would act as the single point of contact for coordination of the supervision and examination of the FBO's state-licensed and chartered operations, and to the extent applicable, for coordination of release of supervisory information and resolution of multi-state consumer complaints related to the FBO. Each individual state supervisor would remain primarily responsible for supervising its own state-licensed or chartered foreign bank operations, and for informing the State Coordinator of any information received from the FBO or a locally licensed office. In addition, the draft agreement recognizes that any given state's law governs the operations of a state-licensed foreign bank office within that state's borders.

The State Coordinator, the responsible Federal Reserve Bank, and where applicable the FDIC would be responsible for developing a written comprehensive supervisory plan tailored to the FBO's structure and risk profile of the FBO's state-licensed operations in the United States. The comprehensive plan may include, but is not limited to, the following:

- a risk assessment and risk matrix of the FBO's U.S. operations;

- an examination plan that details the type, scope, timing, and location of on-site safety and soundness and specialty examinations;

- review and assessment of pending issues, such as the status of applications and compliance with supervisory actions;
- off-site monitoring plans; and
- such other matters as are necessary to promote the safety and soundness of the FBO's U.S. operations.

To the extent permitted under applicable law and regulation, examinations could be conducted on a joint basis or on an alternate year basis between participating state and federal bank supervisory agencies. The State Coordinator would receive copies of all examination reports or examination memoranda reflecting the findings, recommendations, and conclusions derived from the on-site examination of each office subject to examination. The State Coordinator, the responsible Federal Reserve Bank, and where applicable the FDIC, in cooperation with other participating federal and state supervisors, will use this information, together with other supervisory information deemed appropriate, in preparing an assessment of the state-licensed U.S. operations of the FBO.

In addition to examinations, the draft agreement provides for coordination of multi-state applications by FBOs. An FBO with multi-state offices filing an application for more than one office will file an application with its State Coordinator indicating activities applied for and locations at which these activities are to be conducted. The State Coordinator would copy the application to the affected state supervisors for their action and coordinate responses to the FBO. Each state supervisor would be responsible for the processing of applications regarding an FBO's offices in its state.

FDIC Initiatives for Coordination of FBO Supervision

The FDIC has reorganized its supervisory approach so that one individual is assigned responsibility for each banking company, including each FBO. This individual has continual responsibility to monitor an FBO and serves as the FDIC point of contact for FBO management. This approach simplifies the supervisory process for FBOs that operate multiple facilities in the United States.

OCC Initiatives for Coordination of FBO Supervision

At the federal level, the OCC's supervision of the federal branches and agencies of FBOs is centralized through the Northeastern District Office in New York, New York. This single point of contact helps ensure consistency in the examination process, supervisory decisions, and regulatory responses to questions and issues. This becomes even more significant when an FBO has multi-state branches. The OCC assigns responsibility for each FBO to one examiner. This examiner becomes the portfolio manager for a specified institution and is responsible for all supervisory manners regarding this institution. Through the supervisory strategies developed for each federal branch and agency, a seamless, continuous supervisory process is ensured that includes quarterly off-site

reviews and on-site examinations of federal branches.

Economic Growth and Regulatory Paperwork Reduction Act of 1996

Home country supervision. The Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA) was signed into law in September 1996 and contained amendments to the IBA affecting a foreign bank's entry into and operation in the U.S. market. In addition to approval from the OCC or a state supervisor, and in some cases the FDIC, the IBA requires foreign banks to obtain FRB approval prior to establishing a branch or agency office, or acquiring control of a subsidiary bank, in the United States. As discussed above, the IBA mandated that in order for the FRB to approve such an application, it must find that the applicant foreign bank is subject to "comprehensive supervision or regulation on a consolidated basis" by the appropriate authorities in its home country.

Recognizing the need for more flexibility in relation to this standard, Congress in EGRPRA amended the IBA to permit the FRB, in its discretion, to approve a branch or agency application without a determination that the foreign bank is currently subject to CCS. The amendment provides an exception to the CCS requirement in cases where the FRB is unable to find that the applicant is subject to CCS, but can find that the appropriate authorities in the applicant's home country are "actively working to establish arrangements for the consolidated supervision" of the applicant. In deciding whether to exercise its discretion to approve an application under this exception, the IBA requires the FRB to consider whether the foreign bank has adopted and implements procedures to combat money-laundering. Another factor the FRB may take into account is whether the home country of the foreign bank is developing a legal regime to address money laundering or is participating in multilateral efforts to combat money laundering.

Time limit for FRB action on foreign bank applications. EGRPRA also amended the IBA to impose statutory time limits on the FRB's consideration of applications submitted by foreign banks to establish a branch or agency office in the United States. Pursuant to EGRPRA's amendments, the FRB generally is required to take final action on such applications not later than 180 days after receipt of the application. The FRB may extend the review period for an additional 180 days after providing notice of the extension to the applicant and explaining the reasons for the extension. A foreign bank is permitted to waive the 180-day requirement for final action.

Examination fees. EGRPRA also amended a provision of the IBA regarding examination fees for foreign banks. Prior to EGRPRA, the IBA mandated that the cost of the Federal Reserve's examination of a foreign bank's U.S. operations be assessed against and collected from the foreign bank, while there was no similar requirement with respect to the costs of examinations of domestic banks. EGRPRA amended this provision to clarify that examination costs would be assessed by the FRB against foreign banks only to the extent that fees are collected by the FRB for examination of any state member bank.

Examination schedule. In addition, EGRPRA amended the IBA to provide that offices of foreign banks should be subject to on-site examination as frequently as domestic national and state banks. Prior to this amendment, the IBA stated that each branch and agency of a foreign bank must be examined at least once during each 12-month period in an on-site examination. Although national and state banks must be examined every 12 months, the FDI Act permits the federal banking agencies to examine national and state banks with total assets of US$250 million or less every 18 months, rather than every 12 months, provided they satisfy certain eligibility requirements. In order to extend similar treatment to U.S. offices of foreign banks, the Federal Reserve, the FDIC, and the OCC adopted regulations that make U.S. branches and agencies of foreign banks with total assets of US$250 million or less eligible to be considered for an 18-month examination cycle rather than a 12-month cycle if they meet certain qualifying criteria, which are similar to the criteria applied to domestic banks.

Increase in Section 20 Revenue Limit

In December 1996, the FRB announced an increase in the amount of revenue that a Section 20 Subsidiary could permissibly derive from underwriting and dealing in bank-ineligible securities (i.e., securities that a Federal Reserve member bank would not be permitted to underwrite or deal in) from 10 percent to 25 percent of its total revenue. The increase became effective in March 1997.

Section 20 of the Glass-Steagall Act provides that a member bank may not be affiliated with a company that is "engaged principally" in underwriting and dealing in securities. Since 1987, the FRB has permitted bank holding company subsidiaries to underwrite and deal in bank-ineligible securities. The FRB has established a revenue test to determine whether a company is "engaged principally" in underwriting and dealing for purposes of section 20. Through several interpretive steps in a series of orders, the FRB's revenue test was developed to provide that a Section 20 Subsidiary could derive no more than 10 percent of its total revenue from underwriting and dealing in bank-ineligible securities and still be considered not to be "engaged principally" in underwriting and dealing.

In July 1996, the FRB proposed to increase the revenue limit from 10 percent of total revenue to 25 percent. The FRB based this proposed increase on the experience it has gained through supervision of Section 20 Subsidiaries over the years. The FRB stated its belief that the limitation of 10 percent of total revenue it adopted in 1987, without benefit of this experience, had unduly restricted the underwriting and dealing activity of Section 20 Subsidiaries. The FRB noted that changes in the product mix that Section 20 Subsidiaries are permitted to offer and development in the securities markets had affected the relationship between revenue and activity since 1987. After receiving public comment on the proposal, the FRB concluded that a Section 20 Subsidiary will not be engaged principally in underwriting and dealing for purposes of section 20 so long as ineligible revenue does not exceed 25 percent of total revenue.

Revision of the Section 20 Firewalls

In August 1997, the FRB announced its decision to streamline or eliminate many of the Section 20 firewalls that have proven to be unduly burdensome or unnecessary in light of other laws or regulations, and consolidate the remaining restrictions in a series of eight "operating standards," which became effective on October 31, 1997. The FRB concluded that the narrower set of restrictions will be fully consistent with safety and soundness and should improve operating efficiencies at Section 20 Subsidiaries and increase options for their customers.

As discussed above, beginning in 1987, the FRB has issued a series of orders authorizing bank holding companies to establish Section 20 Subsidiaries to engage in underwriting and dealing within the limits of the Glass-Steagall Act. In those orders, the FRB established a series of prudential restrictions (the "firewalls") as conditions for approval under the Bank Holding Company Act. The firewalls were designed to prevent securities underwriting and dealing risks from being passed from a Section 20 Subsidiary to an affiliated insured depository institution, and thus to the federal safety net, and to mitigate the potential for conflicts of interest, unfair competition, and other adverse effects that may arise from the affiliation of commercial and investment banks.

In January 1997, the FRB requested comment on its proposal to rescind many of the firewalls and consolidate the remainder in operating standards to be published in the Code of Federal Regulations. The proposal was developed through the FRB's comprehensive review of its regulations and written policies that was required by section 303 of the Riegle Community Development and Regulatory Improvement Act of 1994. That statute directs the FRB and other banking agencies to streamline their regulations to improve efficiency, reduce unnecessary costs, and eliminate unwarranted constraints on credit availability. In the proposal, the FRB stated that in its experience the risks of securities underwriting and dealing had proven to be manageable in a bank holding company framework, and that other activities posing similar risks for which no firewalls were erected had been successfully undertaken and managed. The FRB concluded that the great majority of risks of affiliation of commercial and investment banks are addressed by other provisions of law and regulations, including the securities laws and regulations of the Securities and Exchange Commission, National Association of Securities Dealers, and securities exchanges that apply to a Section 20 Subsidiary just like any other broker-dealer. In certain areas, however, the FRB determined that there are unique risks of affiliation that are not adequately addressed by other laws, and adopted the operating standards to address those risks.

The transition from firewalls to the new operating standards will result in bank holding companies being able to operate Section 20 Subsidiaries in a less costly and more efficient manner. These benefits and reduction in burden are available to U.S. and foreign banking organizations on an equal footing.

Revision of Regulation Y

In 1997, the Federal Reserve issued a revision of its Regulation Y which governs the operations of U.S. bank holding companies and foreign banking organizations that are subject to the BHC Act. The revisions were designed to eliminate unnecessary regulatory burden and operating restrictions and streamline the application/notice process for expansion of activities. The revisions include:

- a streamlined and expedited review process for bank and nonbanking proposals by bank holding companies and foreign banking organizations that qualify as "well-capitalized" and "well-managed";
- expansion of the list of nonbanking activities and removal of a number of restrictions on those activities that are outmoded, have been superceded by FRB order, or are unnecessary restrictions that would not apply to insured banks that conduct the same activity;
- amendments to the tying restrictions, including a "safe harbor" for foreign transactions; and
- other changes to eliminate unnecessary regulatory burden and to streamline and modernize Regulation Y.

Streamlined application procedures. In order to assure national treatment of foreign banking organizations under the streamlined procedures, the revision includes a number of provisions that specifically accommodate foreign banking organizations. For purposes of eligibility for the streamlined review process, the revision defines a "well-capitalized" bank holding company to require, among other things, that the organization maintain a total risk-based capital ratio of 10 percent or greater and a Tier 1 risk-based capital ratio of 6 percent or greater, on a consolidated basis both before and immediately following consummation of the proposal. The revision provides that a foreign banking organization may use the capital terms and definitions of its home country provided that those standards are consistent in all respects with the Basle Capital Accord. If the home country has not adopted those standards, the foreign banking organization may use the streamlined procedures if it obtains from the FRB a prior determination that its capital is equivalent to the capital that would be required of a U.S. banking organization for these purposes. For purposes of determining eligibility for the streamlined procedures, the revision states that U.S. branches and agencies of foreign banking organizations shall be deemed to have the same capital ratios as the foreign banking organization.

For purposes of determining whether a foreign banking organization meets the "well-managed" requirement for the streamlined procedures, the revision requires that: (i) the largest U.S. branch, agency, or depository institution controlled by the foreign bank have received at least a "satisfactory" composite examination rating from its U.S. banking supervisor; (ii) U.S. branches, agencies and depository institutions representing at least 80 percent of the U.S. risk-weighted assets controlled