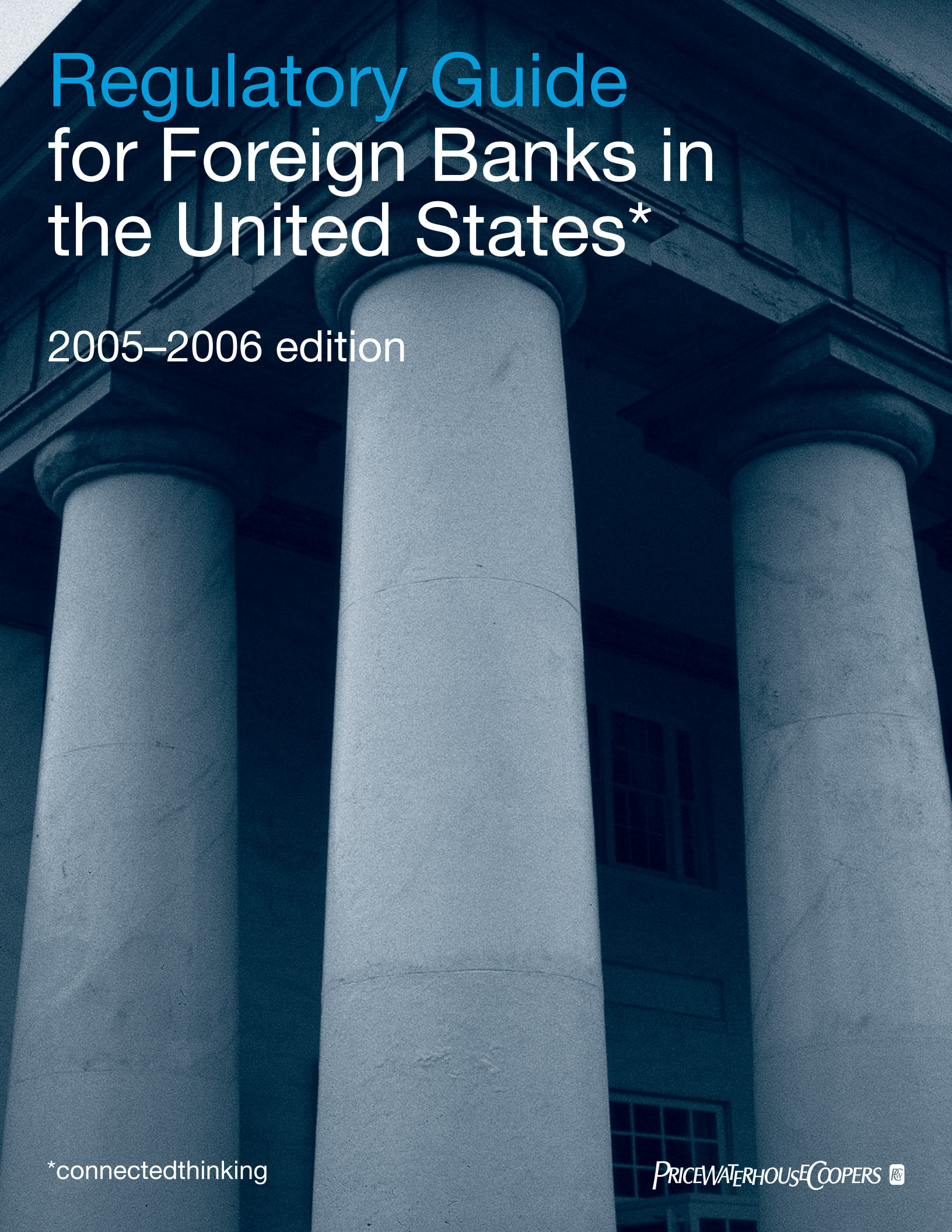

Regulatory Guide for Foreign Banks in the United States*

2005–2006 edition

*connectedthinking

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Welcome to the 2005-2006 Edition of PwC's Regulatory Guide for Foreign Banks ("Guide") in the United States. We have shared the Guide with our clients, colleagues and friends for many years. The Guide serves three purposes:

- It is an introduction to U.S. regulation for foreign banks and their senior management new to the U.S. market. We describe the many forms of business organization available to foreign banks, who regulates these operations and how an institution obtains a license or approval to begin operations.

- It is a compendium of the many complex issues that foreign banks must navigate in doing business here to ensure they meet regulatory expectations. We describe in some detail how foreign bank operations in the United States are supervised and examined and the key regulatory issues they face in conducting their business.

- And it is an opportunity for us to bring you our insights on trends shaping the banking industry in the United States and the many roles of foreign banks in that industry. As an integral part of the U.S. banking system, foreign banks are always dealing with new risks, new competitive challenges and new market developments.

Since we last published the Guide in 2003, foreign banks, like domestic banks, have faced a more challenging compliance environment in anti-money laundering and anti-terrorism regulation. For that reason, we now have a separate chapter devoted to managing compliance risks in these critical areas.

As the Leader of our Foreign Bank Practice in the United States, I hope that you find this latest edition of the Guide to be helpful and insightful.

Sincerely yours,

John W. Campbell
Partner, Regulatory Advisory Services
Leader, U.S. Foreign Bank Practice
Leader, Global Anti-Money Laundering Practice

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Purpose of This Guide

This Guide highlights many regulatory considerations important to foreign banks establishing and operating offices and subsidiaries in the United States. We have written it to emphasize the requirements and expectations of the U.S. Federal bank regulatory agencies: the Board of Governors of the Federal Reserve System (the "Fed"), the U.S. Treasury Department's Office of the Comptroller of the Currency ("OCC") and the Federal Deposit Insurance Corporation ("FDIC"). In addition, we have included summaries of basic regulatory requirements of the four states with the largest number of foreign bank offices—New York, California, Illinois and Florida.

Banking regulation in the United States is highly complex. Any foreign bank contemplating the establishment of a U.S. office or subsidiary or considering expansion of or changes in its U.S. operations, either directly or as a result of mergers or consolidations outside the United States, will undoubtedly hold many discussions with its regulatory advisors, lawyers, other banks operating in the United States, and Federal and state supervisory officials. This Guide provides a framework for those discussions.

About PricewaterhouseCoopers

PricewaterhouseCoopers (PwC) is one of the world's largest professional services firms. We provide industry-focused assurance, tax and advisory services in five continents. With an international presence in over 139 countries, we leverage the strengths of our global colleagues, which include more than 120,000 people worldwide, servicing more than 500 of the Fortune 1000.

Our financial services practice is comprised of 33,000 professionals and spans key industry sectors, including banking, capital markets, investment management, insurance and real estate. In addition to offering industry-focused teams, our professionals have deep knowledge of functional skills areas, such as regulatory issues.

Regulatory Advisory Services

The Regulatory Advisory Services practice ("RAS") of PricewaterhouseCoopers in Washington, D.C. prepared this Guide. RAS renders professional advisory services to foreign banks in many key areas *(see RAS profile on the inside back cover of the Guide).* RAS staff is experienced in advising foreign and domestic banks about strategic options, safety and soundness and financial risk management issues, regulatory examinations, compliance, remedial action plans, applications, nonbank operations and other areas of regulation or supervision. RAS is prepared to help foreign financial institutions successfully negotiate the maze of regulatory requirements in the United States.

While this publication seeks to provide authoritative information as of July 31, 2005 (unless otherwise indicated), neither the authors nor PricewaterhouseCoopers intend for this Guide to render legal, accounting or other professional advice on specific situations or for specific clients. Any reader requiring professional advice or other expert assistance should seek the services of PricewaterhouseCoopers or other appropriate professionals.

 For more information or assistance, please contact RAS *(see inside front cover)* or contact a PricewaterhouseCoopers office convenient to you.

Additional Service Capabilities

This Guide focuses on regulatory matters; however, increased complexities in the regulatory environment affecting the financial services industry, and foreign banks in particular, have been accompanied by additional complexities in the auditing, accounting, disclosure, corporate governance, information systems, business process and tax areas, among others. While this Guide does not cover these nonregulatory issues affecting foreign banks or their offices or subsidiaries doing business in the United States, PricewaterhouseCoopers provides a broad array of services dealing with these and other issues.

In addition to RAS, we have other specialized regulatory groups serving the financial services industry:

- The Capital Markets RAS, which includes former senior regulators from the Securities and Exchange Commission ("SEC"), the New York Stock Exchange and the National Association of Securities Dealers ("NASD"). This group provides a full range of regulatory and compliance services for capital markets and broker-dealer clients.

- The Investment Management Industry Regulatory Group—includes professionals who possess first-hand experience working for investment management, securities and fund companies, and the agencies that regulate them. They include former SEC regional administrators, supervisory attorneys and examiners, NASD directors and supervisors, and former compliance officers for mutual fund complexes and investment managers. Their knowledge of SEC, Internal Revenue service ("IRS), and NASD issues and requirements enhances your ability to stay abreast of regulatory change.

- Investment Management Regulatory Compliance Control Group ("IMRCCG"), which consists of professionals who possess first-hand experience working for investment management, hedge funds, offshore corporations, securities, banking, and insurance companies, and the agencies that regulate them. Their knowledge of SEC, IRS, Commodity Futures Trading Commission and NASD issues and requirements enhances your ability to take advantage of regulatory change. IMRCCG has conducted both comprehensive and targeted reviews of all aspects of mutual fund, investment advisor, and distributor compliance, as well as internal controls for many U.S. mutual fund complexes and over one hundred fund service providers, including fund administrators and transfer agents.

- The Insurance Regulatory and Compliance Solutions ("IRCS") Practice, which consists of former insurance commissioners from New York, Maryland, Ohio, North Carolina, California, Illinois, and Massachusetts, have excellent working relationships with insurance regulators. IRCS provides us access to decision-makers, insight into regulatory processes, and information on the regulatory environment—all of which allow us to help you develop well thought-out positions.

PricewaterhouseCoopers' financial services practice accounts for more than 20 percent of our firm's global revenues and cuts across industry sectors, geographies and functional skill areas. We help clients develop methodologies that provide competitive advantage and enhance business performance. Through operational processes, technology solutions and executable strategies, we help create the framework for a winning enterprise.

Please contact your local PricewaterhouseCoopers office for more information regarding these other services.

Acknowledgments

We are grateful to Gary Welsh for again serving as the principal editor of this Guide and to Monique Maranto, Celeste Mitchell and Michael VanHuysen for substantial professional contributions. Special thanks are due Catherine Hay for her invaluable publication assistance, and Adam West for his integration of textual and artistic design.

Inquiries

If you have any questions or comments concerning the Guide, please call Gary Welsh at 202-414-4311. Inquiries concerning our U.S. Foreign Bank or Anti-Money Laundering Practices should be directed to John Campbell at 646-471-7120. Also please contact the local office of PricewaterhouseCoopers if you have more general inquiries.

Other Publications

RAS also publishes on a periodic basis other Guides or Handbooks for various aspects of banking, bank regulation or compliance in the United States. Among these publications are the following:

- *Guide to Regulation W of the Federal Reserve Board (2003)* (electronic version can be found on PricewaterhouseCoopers' website, www.pwc.com).

- Guide to Understanding the Allowance for Loan Losses of Banks—for U.S. Domestic Banks and U.S. Branches and Agencies of Foreign Banking Organizations—Fourth Edition (2002) (Hardcopy).

To order any of the above, please contact the RAS office in Washington, D.C. *(see inside front cover).*

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Overview of Banking in the United States

Regulatory Guide for Foreign Banks in the United States*

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Chapter 1
Overview of Banking in the United States

Banks and Other Financial Intermediaries

The United States has many different providers of financial services. To distinguish among them, we use the term "bank" to describe the segment of the U.S. financial services industry that holds charters from the Federal government or from a state government to conduct the general business of banking. Institutions cannot accept demand deposits (current accounts) without a bank charter.

U.S. banks engage in a broad range of commercial and retail banking and financial activities, including, for example, the making of commercial, residential mortgage and consumer loans, and engaging in trust and payment activities. Historically, however, banks have emphasized accepting demand deposits (with the associated functions of clearing checks and providing a payments system) and serving the credit needs of industry, commerce and agriculture (making commercial and industrial loans).

Commercial Banks

In this Guide, we refer to institutions engaged in these traditional banking functions as commercial banks to distinguish them from other types of U.S. deposit-taking institutions. The Federal government through the Bank Insurance Fund ("BIF") of the FDIC insures deposits in commercial banks. Commercial banks generally exercise a broader range of powers than other more specialized U.S. depository institutions, such as savings associations and credit unions.

Commercial banks may accept demand, savings, time and money market deposits, and make third-party payments on checks drawn on customer accounts. In addition, the Federal or state laws pertaining to a commercial bank's activities allow it to engage in a variety of other banking activities specifically enumerated in statute or regulation or considered by interpretation to be part of the business of banking or incidental thereto. State banks sometimes exercise broader powers than national banks, although Federal law limits state bank activities, as principal, which could pose risks to the deposit insurance fund. As of December 31, 2004, there were 7,630 commercial banks in the United States with total assets of $8.4 trillion.

Foreign Banks in the United States

As of December 31, 2004, 211 foreign banks from 60 countries had established operations in the United States in the form of representative offices, branches, agencies, or banking subsidiaries. Foreign banks entering the U.S. market through branches and agencies have traditionally emphasized wholesale international commercial banking activities, such as interbank lending, trade finance and corporate lending, as well as money market and capital markets activities. Most of their funding is provided from the interbank market and wholesale deposits. This emphasis on wholesale activities is evident from the data presented in Table I at the end of this chapter, which shows that foreign banks' U.S. market share of bank business loans is almost twice their U.S. market share for total loans. However, some foreign banks have also established U.S. bank subsidiaries to offer retail banking products, including FDIC-insured deposits.

Foreign banks have also established or acquired significant nonbank financial institutions in the United States, including investment banks, insurance companies, investment management companies, mutual fund complexes, mortgage companies, finance companies and other financial service providers. In addition, they have been important investors in the U.S. venture capital and merchant banking markets. In fact, the amount of third-party assets held by foreign banks in nonbank financial institutions exceeds the amount of assets held in banking offices or subsidiaries. In the years 1995–2002, the

average year-to-year growth rate of foreign bank banking assets has been 4 percent, versus a 20 percent growth rate in the same period for nonbank financial assets. During this same 1995-2002 period, there was a marked shift in the respective share of total (bank and nonbank financial) assets owned by foreign banks from Europe and Asia. The share of total foreign bank assets held by banks from Europe increased from 51 percent to 81 percent, whereas the share of total foreign bank assets held by banks from Asia declined from 40 percent to 8 percent. In this same period, the share of banks from the Americas (predominantly Canada) increased from 8 percent to 10 percent. This growth in European share is attributable in significant part to growth in investment banking, investment management and related areas, including through several significant acquisitions.

Other Depository Institutions

In the United States, there are other types of more specialized deposit-taking institutions, including:

- Savings associations, which engage primarily in residential real estate lending and consumer lending and deposit-taking; and

- Credit unions, which principally provide a source of personal and consumer loans to individuals with a common employer or who belong to the same organization or who possess some other form of a "common bond."

Deposits in these institutions, like deposits in banks, are also insured by agencies of the Federal government— the Savings Association Insurance Fund ("SAIF") of the FDIC for savings associations and the National Credit Union Share Insurance Fund for credit unions. Competition and economic pressures have eroded the once clearly defined boundaries among deposit-taking institutions. Propelled by these forces, depository institutions, either directly or through affiliates, have expanded their traditional credit, depository and other nonblank financial service activities. These developments have produced significant changes in Federal and state laws to permit a greater degree of homogeneity in the financial services offered by nominally different depository institutions. For example, Federal savings associations can now engage in trust, credit card and limited commercial lending activities.

Although banks and savings associations continue in their traditional role as financial intermediaries, the ways in which they carry out that role have become increasingly complex. Under continuing pressure to operate profitably, the industry has adopted innovative approaches to carrying out the basic process of gathering and lending funds:

- Techniques for managing assets and liabilities that allow institutions to manage financial risks and maximize income have continued to evolve;

- Income, traditionally derived from the excess of interest collected from borrowers over interest paid to depositors, has become increasingly dependent on fees and other income streams from specialized transactions and services;

- Technological advances have accommodated increasingly complex transactions, such as the sale of securities backed by cash flows from other financial assets; and

- Regulatory policy has alternately fostered or restricted innovation as, for example, institutions look for new transactions to accommodate changes in the amount of funds they must keep in reserve or to achieve the levels of capital that they must maintain in relation to their assets.

Management of complex assets and liabilities, searches for additional sources of fee income, reactions to technological advances, responses to changes in law and regulation, and competition for deposits have all added to the risks and complexities of the business of banking in the United States.

Non-Depository Financial Institutions

Besides the blurring of distinctions among depository institutions, significant growth is occurring in the activities of non-depository financial services companies. These companies include securities firms, mutual funds, insurance companies, consumer finance, leasing and mortgage companies, and lending and finance subsidiaries of major industrial companies. Many financial products or services offered by these non-depository businesses are indistinguishable from and compete directly with the products and services offered by depository financial institutions. As discussed below, banks and other types of non-depository financial firms now may affiliate through a financial holding company.

Because they do not accept deposits insured by a Federal government agency, non-depository financial services companies are largely free of the complex web of regulation that applies to banks, savings associations and credit unions. Typically, such non-depository companies, which are chartered solely at the state level, are not subject to the same types of examination, reserve and capital requirements, or community reinvestment obligations and geographic restrictions that affect insured deposit-taking institutions. However, such non-depository financial services companies are often subject to some form of state licensing or oversight, with the focus generally on consumer protection.

Bank Regulation in the United States

All U.S. depository institutions, including banks, are subject to a high degree of government regulation, the principal features of which include:

Licensing and Approval

Each depository institution must obtain a license or banking charter from a Federal or state regulatory authority. Depository institutions chartered in the United States are generally required to have Federal deposit insurance, which requires a separate application. Additional approvals or notifications to regulatory authorities are required to open deposit-taking branch offices and to acquire or merge with other depository institutions. Regulatory approvals or notifications are sometimes required to establish subsidiaries or to engage in new activities.

Limited Powers

A depository institution may engage only in the deposit-taking, lending, exchange or other financial activities expressly authorized by statute, regulation or interpretation or in activities considered incidental to its banking business. U.S. depository institutions may not, for example, engage or invest in industrial or commercial activities such as mining, manufacturing, agriculture and merchandising.

Supervisory Oversight

Through off-site supervision and regular on-site examinations, Federal and/or state regulators closely monitor the operations of each depository institution to evaluate both its financial soundness and its compliance with applicable statutes and regulations. These regulatory authorities possess extensive supervisory powers and may order the correction of any deficiencies or illegalities, impose civil monetary penalties, remove directors or officers and close a severely troubled or failing U.S. institution.

Deposit Insurance

Federal and state-chartered depository institutions must generally obtain deposit insurance from a Federal government agency. In a U.S. bank, each depositor's accounts are insured by the BIF up to a maximum of $100,000. The FDIC possesses examination and enforcement powers over all BIF-insured institutions and routinely exercises those powers at state-chartered banks that are not members of the Federal Reserve System.

Reserve Requirements

Congress created the Federal Reserve System as an independent central bank to govern U.S. monetary policy. It is a Federal system, composed of a central governmental agency—the Board in Washington, D.C.—and 12 regional Federal Reserve Banks. Each depository institution in the United States is subject to monetary policy reserve requirements imposed by the Fed, whereby reserves must equal a specified percentage of the institution's domestic deposits. Reserves are generally held either in vault cash (smaller institutions) or in non-interest bearing accounts with a Federal Reserve Bank or, on a pass-through basis, with another bank or other government instrumentality (for savings associations and credit unions). Depository institutions that maintain required reserves may meet liquidity needs from time to time by borrowing funds on a secured basis from the discount window at the Federal Reserve Banks.

Holding Companies and Nonbank Activities

In the United States, holding company regulation starts from the premise that, under Federal law, a company—including a foreign bank—may not obtain control of an FDIC-insured depository institution without obtaining Federal regulatory approval. Any such parent company must also limit its nonbank activities, whether conducted directly or indirectly through nonbank subsidiaries, to certain financial activities permitted by Federal law.

A foreign bank that owns a U.S. bank is, by definition, a bank holding company and subject to nonbanking restrictions on its U.S. activities. Federal law also requires that a foreign bank with a branch or agency office or commercial lending

company or Edge Act subsidiary in the United States be "treated" as a bank holding company, meaning its scope of U.S. nonbank activities must also conform to the limits imposed on bank holding companies. Foreign banks principally engaged in a banking business outside the United States—called Qualifying Foreign Banking Organizations—may, however, hold investments in foreign nonfinancial companies that, subject to certain requirements and limitations, engage in nonfinancial activities in the United States.

There are three types of regulated holding companies in the United States—bank holding companies, financial holding companies and savings and loan holding companies. With the exception of "grandfathered" unitary savings and loan holding companies, holding company regulation is generally intended to separate banking and commerce by preventing commercial firms from owning FDIC-insured depository institutions. However, commercial firms are permitted to own certain "limited purpose" depository institutions without being subjected to holding company regulation. Limited purpose institutions include credit card banks, state-chartered industrial banks meeting certain criteria and limited purpose trust companies.

Bank Holding Companies and Financial Holding Companies

To obtain control of a bank, a company must receive Fed approval to become a "bank holding company." With certain exceptions, a bank holding company may not, directly or indirectly, engage in any nonblank activities that are not considered to be "closely related to banking."

The Gramm-Leach-Bliley Act ("GLB Act")—*see discussion below*—froze the range of nonbanking activities permitted to this class of traditional bank holding companies to those activities authorized by regulation or order as of November 11, 1999.

The GLB Act created a new subset of bank holding companies called financial holding companies ("FHCs") that may engage in a much broader range of financial activities than bank holding companies, including insurance underwriting. Unlike bank holding companies, financial holding companies will also be able over time to expand the range of financial activities in which they may engage. Financial companies with a limited amount of commercial activities, i.e., not more than 15 percent of total revenues, can become FHCs but cannot expand such activities and must terminate them within certain prescribed time periods.

To become a financial holding company, a bank holding company must demonstrate in a filing with the Fed that its U.S. depository institution subsidiaries are "well capitalized" and "well managed" and have satisfactory community reinvestment ratings. These depository institution subsidiaries must continue to receive these ratings at each subsequent examination; failing to do so jeopardizes the ability of the parent holding company to continue engaging in the expanded financial activities permitted to a financial holding company.

A foreign bank that controls a U.S. bank subsidiary, but has no branches or agencies, can elect to become a financial holding company if its U.S. depository institution subsidiaries meet the criteria described above. A foreign bank that has a branch or agency in the United States—but no U.S. depository institution subsidiary—may also be "treated" as a financial holding company in order to expand the range of its financial services in the United States. To do so, the foreign bank, in making its election, must demonstrate that the foreign bank itself meets "well capitalized" and "well managed" criteria, which the Fed believes to be "comparable" to those required of U.S. bank subsidiaries of U.S. financial holding companies. If a foreign bank controls a U.S. bank and has branches or agencies, its depository institution subsidiaries must meet "well capitalized," "well managed" and community reinvestment criteria and the foreign bank itself must meet comparable "well capitalized" and "well managed" criteria.

Savings and Loans Holding Companies

Savings and loan holding companies ("S&L holding companies") are either "unitary" or "multiple." A unitary S&L holding company controls only one savings association. Prior to the enactment of the GLB Act, any type of company, including a commercial enterprise, could become a unitary S&L holding company. The GLB Act limits unitary S&L holding companies to engaging in the same types of financial activities as financial holding companies and multiple S&L holding companies. Companies that became unitary S&L holding companies, or had applied to become so, before May 4, 1999, are exempted (or "grandfathered") from these restrictions. Thus, commercial firms that are grandfathered unitary S&L holding companies can continue to engage in nonfinancial activities without restriction. However, except in connection with corporate reorganizations, these grandfather rights cannot be transferred to another commercial company.

Multiple S&L holding companies own or control more than one savings association and can engage in "closely related to banking" activities permitted to bank holding companies and certain other enumerated financial activities. If a company controls both a bank and a savings association, it is regulated either as a bank holding company or financial holding company, but not as an S&L holding company.

Geographic Restrictions

Banks and Bank Holding Companies

Each state regulates the establishment and location of bank branches within its borders. Most states permit their banks to branch on a statewide basis; however, a few states prohibit or limit the establishment of new branches in certain locations, such as in small towns or cities where community banks are headquartered.

Under the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the "Interstate Act"), a bank holding company may acquire a bank subsidiary in any state, and merge that bank with a bank subsidiary in another state, thus creating an interstate branch network. Such interstate acquisitions and mergers are subject to state aging requirements on a bank charter (not to exceed five years) and national and statewide "caps" on the amount of deposits that can be held by any banking organization and its affiliates resulting from the acquisition and merger. The national cap in the Interstate Act is 10 percent of the total amount of deposits at insured depository institutions in the United States. The Interstate Act also permits a bank to establish in another state a *de novo* branch (*i.e.*, a newly established branch that does not result from the merger of existing offices), but only if the host state affirmatively "opts in" by enacting legislation permitting such *de novo* branches of banks headquartered in other states. (Under U.S. interstate banking rules, a bank's home state is the state where it is headquartered; any other state is considered a host state for interstate branching purposes.) Although a number of states have enacted such *de novo* branching legislation, most of these states will only allow *de novo* branching on a reciprocal basis.

The Interstate Act also allows bank subsidiaries of a bank holding company to establish certain agency arrangements among themselves that allow them to function more like a branch system. Nonbank financial subsidiaries of a bank holding company, such as mortgage companies, securities brokerage firms and consumer finance companies, are not subject to interstate banking restrictions and may operate nationwide.

Savings Associations

Subject to meeting certain requirements keyed to mortgage lending activities, Federal savings associations are not subject to any Federal interstate branching restrictions. State statutes also sometimes permit savings associations to establish branch offices in more than one state, subject to prior approval by the supervisory agency.

Securities Activities

The Glass-Steagall Act prevents the conduct of commercial and investment banking activities within the same corporate entity. Commercial banks may not underwrite or deal in corporate debt or equity securities, and investment banks may not accept deposits from the public. However, commercial banks and investment banks may be affiliated in several different ways.

Under the GLB Act, a financial holding company may own both a commercial bank and an investment bank (broker-dealer) in the United States. An investment bank—domestic or foreign—can become a financial holding company by acquiring control of a U.S. commercial bank. A foreign bank with a U.S. subsidiary bank and/or a branch or agency that qualifies to be treated as a financial holding company may also conduct both commercial and investment banking activities in the United States.

U.S. commercial banks—including a U.S. bank subsidiary of a foreign bank—may also own investment banks as so-called "financial subsidiaries," which are subject to a number of supervisory restrictions, e.g., a bank has to deduct its investment in a financial subsidiary engaged in securities, insurance or other nonbank financial activities as principal from its capital accounts.

Even if a bank holding company or foreign bank does not elect to become a financial holding company, it may have a U.S. securities subsidiary that does not "engage principally" in corporate underwriting and dealing activities that U.S. banks cannot engage in directly. As currently interpreted, this means that the subsidiary cannot derive more than 25 percent of its gross revenues from investment banking activities that a bank could not do directly.

The GLB Act repealed Sections 20 and 32 of the Glass-Steagall Act (aimed at prohibiting affiliations and interlocks between commercial and investment banks). Nevertheless, if a bank holding company or foreign bank does not elect to become or be treated as a financial holding company, its U.S. securities subsidiaries must continue to operate under gross revenue and certain other limitations originally imposed by the Fed under Section 20. Although the Fed may modify such limitations, it has not yet done so. This differing treatment highlights a key distinction between a financial holding company and bank holding company: an investment banking subsidiary of a financial holding company is not limited by restrictions previously imposed under Section 20, whereas a Section 20 securities subsidiary of a bank holding company remains subject to these restrictions.

Venture Capital and Merchant Banking Activities

Investing in the equity of nonfinancial companies and lending to private equity-financed companies are important sources of earnings and business relationships at a number of U.S. and non-U.S. banking organizations. Financial holding companies, bank holding companies and commercial banks are able to make equity investments under several statutory and regulatory authorities.

Under the portfolio investment provisions of the Bank Holding Company Act ("BHC Act"), bank holding companies may invest in up to 5 percent of the outstanding voting shares of any one company and up to 25 percent of the total equity of any one company, with no aggregate limits on the total dollar amount of such equity investments in all companies. Banking organizations can make equity investments through Small Business Investment Companies ("SBICs"), which can be a subsidiary of a commercial bank or bank holding company. A bank's aggregate investment in the stock of SBICs is limited to 5 percent of its capital and surplus. In the case of bank holding companies, the aggregate investment is limited to 5 percent of the holding company's proportionate interest in the capital and surplus of its subsidiary banks.

Under the Fed's Regulation K, U.S. banking organizations may make portfolio investments in foreign commercial and industrial companies that in the aggregate do not exceed 25 percent of the Tier 1 capital of the bank holding company.

More recently, under the GLB Act, financial holding companies may engage in a broad range of merchant banking activities under regulations issued jointly by the Fed and U.S. Department of Treasury. Permissible merchant banking activities are defined to include "investments in any amount of the shares, assets or ownership interests of any type of non-financial company."

Federal and State Regulation

The choice of a Federal or state charter or license has created a parallel, or dual, system of bank licensing and regulation in the United States. As of December 31, 2004, 1,906 U.S. commercial banks with $5.6 trillion of assets were chartered and primarily supervised by the Federal government. These banks are called "national banks." The State governments chartered and supervised another 5,723 commercial banks with $2.8 trillion of assets as of December 31, 2004. Forty-five percent of all commercial banks in the United States have $100 million or less in assets, reflecting the loyalty of customers to local banks.

Most commercial banks, whether national or state, are owned by bank holding companies. Bank holding companies control over 95 percent of all FDIC-insured commercial bank assets.

Three Federal banking agencies currently have regulatory and supervisory authority over commercial banks. The OCC, a bureau of the Treasury Department, charters, regulates, examines and supervises national banks. National banks tend to be larger banks, as while they comprise 25 percent of all commercial banks; they hold 66.5 percent of all assets in U.S. commercial banks. The OCC also regulates and supervises 50 Federal branches (including four insured branches) of foreign banks with $103 billion of assets (as of March 31, 2005). The FDIC insures bank deposits and is the primary Federal regulator, supervisor and examining agency for 4,805 state-chartered banks with $1.5 trillion of assets that are not members of the Federal Reserve System (as of December 31, 2004). The FDIC also regulates, supervises and examines 8 insured state branches of foreign banks with $7.7 billion of assets (as of March 31, 2005).

The Fed, as the nation's central bank, regulates bank reserves, provides discount window liquidity and lender of last resort facilities to U.S. banking institutions and operates and regulates much of the payments system. The Fed serves as the Federal supervisor, regulator and examining agency for 919 state-chartered banks that are members of the Federal Reserve System and have $1.3 trillion in assets. The Fed has direct regulatory and supervisory authority over bank and financial holding companies, Edge Act and Agreement (international banking) corporations and the international operations

of national and state member banks. Most importantly for foreign banks, the Fed has regulatory and supervisory authority over all foreign banks operating in the United States and is the primary Federal regulator, supervisor and examiner of 214 state-licensed uninsured branches and agencies of foreign banks with assets of $1.1 trillion (as of March 31, 2005).

State Banking Departments, which are usually headed by a Commissioner, Superintendent or Director appointed by the Governor of the state, charter, regulate, supervise and examine all 5,723 State-chartered banks. The State Banking Departments also license, regulate, supervise and examine 357 state-licensed branches, agencies and representative offices of foreign banks (as of March 31, 2005) with assets of $1.1 trillion. Some State Banking Departments are independent and others are Divisions of other State Executive Departments or Agencies. Sometimes states, in addition to Banking Departments or Divisions, have Banking Boards, often with nonbank members that perform advisory and/or policy-making functions. State Banking Departments also usually have some regulatory or supervisory jurisdiction over nonbank financial institutions, such as mortgage and finance companies and money-transmitters, which operate under State corporate charters.

State and Federal regulation of commercial banks often overlaps. For example, a state-chartered nonmember bank owned by a bank holding company is subject to: (i) regulation by a state bank regulator; (ii) Federal regulation by the FDIC, which insures its deposits; and (iii) Federal regulation by the Fed, which establishes and administers reserve requirements and regulates its parent bank holding company. Federally chartered national banks are governed by Federal banking laws but are subject to state laws in certain areas, such as branching and the exercise of fiduciary powers. National banks are also subject to state commercial, employment and other laws that are not part of the Federal bank regulatory scheme.

The Foreign Bank Supervision Enhancement Act of 1991 ("FBSEA") consolidated Federal regulation of foreign banks in the Fed, though Federal branches and agencies remain primarily regulated by the OCC, and insured state branches remain primarily regulated by the FDIC. There is also extensive state regulation of foreign banks, with bank regulators in New York, California, Illinois and Florida being the most prominent, because of the extensive scope of foreign bank operations in these states.

Following is a summary of the basic allocation of U.S. regulatory responsibilities between Federal and state bank regulators in the United States.

Type of Banking Office or Subsidiary	Supervisor and Regulator
National banks	OCC
State banks	
Members	Fed/state
Non-members	FDIC/state
Bank holding companies	Fed/some states
Financial holding companies	Fed/some states
Edge Act corporations	Fed
Agreement corporations	Fed/state
Commercial lending company	Fed/state
Foreign bank representative offices	Fed/state
Foreign bank branches and agencies	
State licensed	Fed/FDIC (insured)/state
Federally licensed	OCC/Fed

The International Banking Act of 1978

National Treatment

The complex dual system of state and Federal regulation applicable to domestic banks is the model for the establishment and regulation of U.S. offices of foreign banks. A foreign bank wishing to establish a U.S. branch, agency, subsidiary bank or international banking corporation may seek authority to do so under either state law or Federal law. This Federal/state option is consistent with the U.S. policy of according foreign banks "national treatment," which gives foreign banks the same powers and applies the same limitations to them as are given and applied to domestic banks. The policy of national treatment underpins the International Banking Act of 1978 ("IBA"). However, national treatment does not mean identical treatment, especially for branches and agencies of foreign banks, where U.S. law, in some cases, has been adapted to reflect their different noncorporate form of organization.

Geographic, Nonbank Activity and Other Restrictions

In passing the IBA, Congress attempted to eliminate various disparities in national treatment by authorizing the OCC (the same Federal banking agency that charters and supervises national banks) to license Federal branches and agencies of foreign banks. The IBA also permitted foreign banks to establish and acquire Edge Act international banking corporations. Foreign banks wishing to accept retail deposits at their Federal or state branches were allowed the option of obtaining Federal deposit insurance. However, uninsured Federal and state branches were specifically prohibited from engaging in retail deposit-taking activity.

While gaining some access to the deposit insurance system, foreign banks, under the IBA, lost certain previous advantages in competing with domestic banks through branches or agencies. Congress required each foreign bank doing a deposit-taking banking business in more than one state to choose a home state and to confine any future branches accepting domestic deposits or future U.S. bank subsidiaries to that home state. Foreign banks were generally permitted to retain their existing deposit-taking offices in more than one state under a grandfather clause.

Consistent with the policy of national treatment, the IBA limited the nonbanking powers of foreign banks with branches, agencies or commercial lending company subsidiaries in the United States to those of bank holding companies, and imposed Fed reserve requirements on branches and agencies. The Fed was also given the role of overall supervisor of a foreign bank's banking operations in the United States, though it was directed to rely mainly on existing OCC, FDIC or state examinations in this area.

The Foreign Bank Supervision Enhancement Act of 1991

Congress in 1991 strengthened the oversight authority of the Fed over foreign banks operating in the United States by enacting FBSEA. FBSEA requires the Fed to approve the establishment by a foreign bank of any representative office, branch or agency in the United States or the acquisition or control of any commercial lending company (a company that makes commercial loans and maintains credit balances).

In evaluating applications, the Fed must consider whether the applicant foreign bank is engaged in the banking business abroad and is subject to comprehensive, consolidated supervision or regulation in its home country. The Fed must also determine whether the applicant foreign bank has furnished sufficient information for a decision on the application, and whether the applicant will continue to furnish information about its activities that will be sufficient to allow the Fed to evaluate compliance with Federal regulatory requirements.

FBSEA required that each branch, agency and commercial lending company subsidiary of a foreign bank be examined on an annual basis by a Federal or state regulator— the Fed, OCC, FDIC or state banking agency. FBSEA also authorized the Fed to examine all U.S. branches, agencies, representative offices and commercial lending company operations of foreign banks. The Fed, in consultation with the other Federal and state regulators, coordinates the agencies' examination efforts and seeks to ensure that a branch or agency will not be subject to more than one safety and soundness examination during an annual period. As will be discussed in Chapter 4, state and Federal regulators have adopted Supervisory Coordination Agreements to streamline and coordinate further the examination process for the multistate state-licensed branches and agencies of foreign banks.

Finally, FBSEA prohibits any branch of a foreign bank from applying for Federal deposit insurance. The few branches of foreign banks that had obtained FDIC insurance before FBSEA were allowed to maintain that insurance (12 insured branches

remain under this authority). A foreign bank that wishes to accept insured deposits may do so now only by acquiring a separately chartered U.S. bank or savings association subsidiary.

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

The Interstate Act provided foreign banks with national treatment in interstate banking and branching by allowing foreign banks to acquire U.S. bank subsidiaries in more than one state on the same basis as U.S. bank holding companies. The Interstate Act also gave foreign banks and their U.S. bank subsidiaries the same rights as U.S. banks (described above) to establish *de novo* branches outside their home state and to establish interstate branches through mergers with banks in other States. Under the Interstate Act, the states cannot enact interstate banking or branching legislation that discriminates between U.S. and foreign banks, i.e., the states can give neither U.S. nor foreign banks preferential treatment.

Because foreign banks operate in the United States through a variety of forms of organization, the rules under the Interstate Act for foreign banks differ somewhat by the form of organization being established outside a foreign bank's home state. Federal interstate rules do not apply to representative offices, agencies or limited branches, i.e., branches that can accept only internationally related deposits. Such offices, however, remain subject to any applicable state restrictions on entry.

The Interstate Act required amendments to FDIC and OCC regulations that allow uninsured branches of foreign banks to accept certain types of initial deposits of less than $100,000 without being considered as engaged in impermissible retail deposit-taking activities. The Interstate Act also provided that offshore shell branches of foreign banks managed or controlled by U.S. branches and agencies may only manage the same types of activities permissible for foreign branches and subsidiaries of U.S. banks.

GAO Report on Role of Foreign Banks in U.S. Market

During congressional consideration of the Interstate Act, the Chairman of the Senate Banking Committee requested the U.S. General Accounting Office ("GAO") to review U.S. banking statutes and regulations and evaluate whether they give foreign banks operating in the United States a significant competitive advantage over U.S. banks. In its report, the GAO concluded that U.S. statutes and regulations do not appear to create significant competitive advantages for U.S. branches and agencies of foreign banks. The GAO found that branches and agencies operate largely in wholesale markets, have virtually no presence in retail banking and appear to be net suppliers of funds to the U.S. economy.

The Economic Growth and Regulatory Paperwork Reduction Act of 1996

In the Economic Growth and Regulatory Paperwork Reduction Act of 1996 ("1996 Act"), Congress established a much more streamlined, less intrusive regulatory framework for geographic and product expansion for banking organizations found to be "well capitalized" and "well managed." This preferred regulatory treatment reflects a focus on risk-based regulation and supervision in the United States, so that well-run institutions feel a lighter hand of direct regulation and supervision. The 1996 Act also clarified that foreign bank branches and agencies would not be subject to examination fees by the Fed, unless the Fed charged similar fees for state member banks. The Fed has not imposed examination fees on member banks or foreign banks, as the Fed's operations are funded through its open-market operations and other central bank activities. The 1996 Act thus reinforced the principle of national treatment toward foreign banks.

The Gramm-Leach-Bliley Act of 1999

The enactment of the GLB Act followed more than a decade of debate on financial modernization legislation. The GLB Act codifies, expands and rationalizes the substantial erosion of the barriers between the banking, securities, mutual fund and insurance industries that had already occurred through years of regulatory interpretation and court decisions.

The centerpiece of the GLB Act is its authorization of financial holding companies that may engage in a full range of financial activities, including banking, securities, insurance, mutual fund, merchant banking and other activities. The Fed may expand the list of financial activities permitted to financial holding companies, but only with the concurrence of the Secretary of the Treasury. A financial holding company is essentially a bank holding company with special privileges in terms of scope of business and lighter regulation. To access and maintain those privileges, a financial holding company must elect financial holding company status and ensure that its U.S. depository institution subsidiaries are and remain "well capitalized" and "well managed" and compliant with Community Reinvestment Act ("CRA") requirements.

Foreign banks may also become financial holding companies and thus conduct a full range of what may be considered typical "universal" banking activities in the United States. The election/qualification process for foreign banks differs

somewhat depending on the nature of their banking operations in the United States. This process is described above under the topic Bank and Financial Holding Companies and in more detail in Chapter 5.

As of August 15, 2005, over 650 companies had elected to become financial holding companies. The list includes virtually all of the largest U.S. money-center and regional banking organizations but also includes a number of smaller U.S. holding companies. Approximately 35 foreign-based companies have become financial holding companies as of this same date, including all of the major Canadian banks and many of the major European banks. The GLB Act also allows national banks and state banks, the latter if also consistent with state law, to establish "financial subsidiaries" that may engage in any of the new powers the GLB Act confers on a financial holding company, except for insurance underwriting, real estate development, and issuing annuities on which the beneficiary's income is tax deferred. The Secretary of the Treasury may expand the list of financial activities permitted to a national bank's financial subsidiary, but only with the Fed's concurrence.

Other provisions of the GLB Act address:

Functional Regulation. The Fed is the "umbrella" regulator for a financial holding company with the responsibility to supervise the company's overall risk management and activities that might harm a bank subsidiary. But other regulators—such the SEC and State insurance commissioners—continue to exercise their normal oversight of financial holding company activities falling within their respective jurisdictions.

Bank Securities Activities. As part of functional regulation, banks (and U.S. branches and agencies of foreign banks) have to "push out" certain securities activities that they now conduct directly. They must locate these activities in a broker-dealer or an investment adviser regulated by the SEC. Banks, however, received a new power under the GLB Act to underwrite municipal revenue bonds.

Insurance Regulation. The GLB Act preserves regulation of the business of insurance by the various states, but preempts state laws that would prevent or hamper affiliations between banks and insurance companies.

Commercial Ownership. The GLB Act (with limited exceptions) not only continues the prohibition against a commercial firm acquiring or affiliating with a bank, but also ends the prior authority for a commercial firm to acquire a savings association. Commercial ownership of savings associations that existed or were applied for on May 4, 1999, may continue but may not be transferred.

Consumer Privacy. The GLB Act requires all financial firms (whether or not affiliated with a bank) to adopt and adhere to consumer privacy policies, to disclose those policies and to permit customers to opt out of sharing nonpublic, personal information with unaffiliated third parties.

The USA PATRIOT Act of 2001

The USA PATRIOT Act (Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001) was enacted shortly after the September 11, 2001, tragedy and contains strong measures to prevent, detect and prosecute terrorism and international money laundering. Title III of the Act is the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001. It includes numerous provisions for fighting international money laundering and blocking terrorist access to the U.S. financial system. The Act is far-reaching in scope, covering a broad range of financial activities and institutions.

The provisions affecting banking organizations are generally set forth as amendments to the Bank Secrecy Act ("BSA"), which, contrary to its name, promotes transparency by requiring financial institutions in the United States to keep records and file reports about certain cash transactions. The PATRIOT Act, which generally applies to FDIC-insured depository institutions as well as to the U.S. branches and agencies of foreign banks prohibits certain correspondent relationships and requires certain additional due diligence and recordkeeping practices. Some requirements took effect without the issuance of regulations. Other provisions are implemented through regulations promulgated by the U.S. Department of the Treasury, in consultation with the Fed and the other Federal financial institution regulators.

The principal provisions of the PATRIOT Act will be discussed in Chapter 6, which covers Anti-Money Laundering Compliance.

The Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 ("SARBOX") established new standards for corporate accountability as well as penalties for corporate wrongdoing. The legislation contains 11 titles, ranging from additional responsibilities for audit committees to tougher criminal penalties for white-collar crimes such as securities fraud.

Following is a summary of some of the major provisions of SARBOX:

PCAOB. Establishes an independent, nongovernmental board—the Public Company Accounting Oversight Board ("PCAOB")—to oversee the audits of public companies and to protect the interests of investors and further public confidence in independent audit reports. Requires public accounting firms to register with the PCAOB and take certain other actions in order to perform audits of public companies.

Auditor Independence. Sets forth required actions by registered public accounting firms ("external auditors"), audit committees and companies to strengthen auditor independence. Determines certain services to be unlawful if performed by the external auditor.

Corporate Responsibility. Requires audit committees to be independent and undertake specified oversight responsibilities. Requires CEOs and CFOs to certify quarterly and annual reports to the SEC, including making representations about the effectiveness of specified controls. Provides rules of conduct for companies and their officers regarding pension blackout periods and certain other matters. Requires the SEC to issue rules requiring attorneys in certain roles to report violations of securities laws to a company's CEO or chief legal counsel and, if no action is taken, to the audit committee.

Enhanced Financial Disclosures. Requires companies to provide enhanced disclosures, including a report on the effectiveness of internal controls and procedures for financial reporting (along with external auditor attestation of that report) and disclosures covering off-balance sheet transactions and *pro forma* financial information. Requires disclosures regarding a code of ethics for senior financial officers and reporting of certain waivers. Requires accelerated disclosures by management, directors and principal stockholders concerning certain transactions involving company securities.

Analyst Conflicts of Interest. Requires the SEC to adopt rules to address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances.

SEC Resources and Authority. Gives the SEC and Federal courts more authority to censure and impose certain prohibitions on persons and entities.

Corporate and Criminal Fraud Accountability. Provides tougher criminal penalties for altering documents, defrauding shareholders and certain other forms of obstruction of justice and securities fraud. Makes debts non-dischargeable if incurred in violation of securities fraud laws. Protects employees of companies who provide evidence of fraud.

White-Collar Crime Penalty Enhancements. Provides that any person who attempts to commit white-collar crimes shall be treated under the law as if the person had committed the crime. Enhances penalties and sentencing guidelines for certain white-collar crimes such as mail and wire fraud. Requires CEOs and CFOs to certify in their periodic reports to the SEC that their financial statements fully comply with the requirements of the Securities Exchange Act of 1934 (the "Exchange Act"), and imposes penalties for certifying a misleading or fraudulent report.

Corporate Fraud and Accountability. Provides additional authority to regulatory bodies and courts to take various actions, including fines or imprisonment, with regard to tampering with records, impeding official proceedings, taking extraordinary payments, retaliating against corporate whistleblowers and certain other matters involving corporate fraud.

Table I

Selected Assets and Liabilities ($ billions) and Market Share of U.S. Offices and Banking Subsidiaries of Foreign Banks as of March 31, 2005 (Source: Federal Reserve Board)

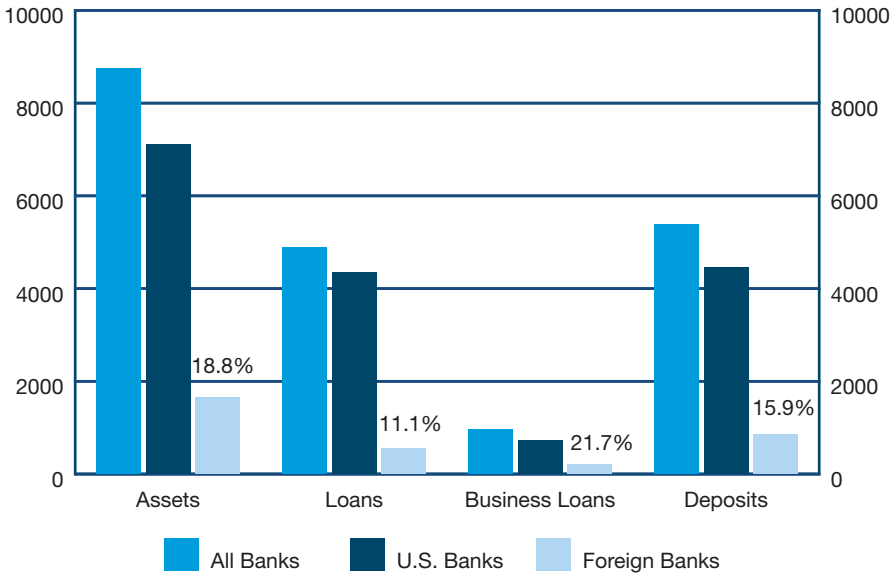
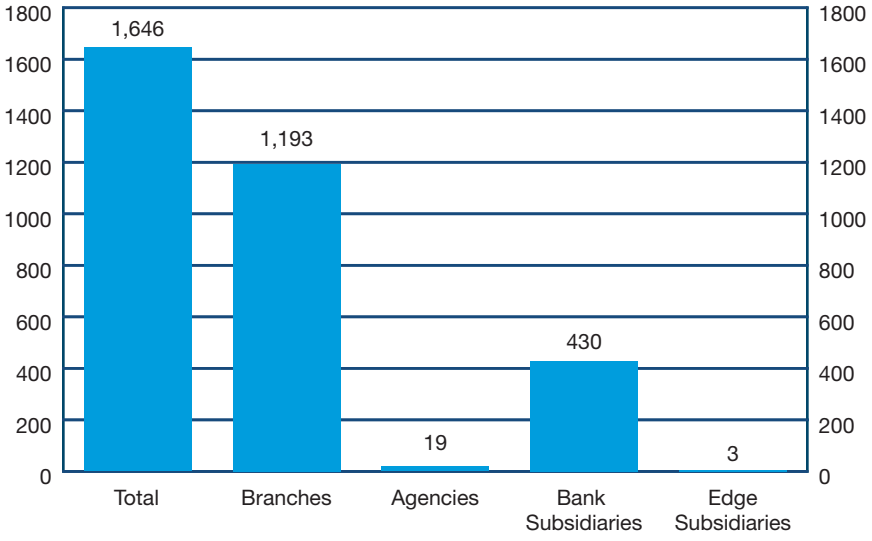


Table II

Assets of Foreign Banks in the United States by Type of Banking Office or Subsidiary ($ billions) as of March 31, 2005 (Source: Federal Reserve Board)



Chapter 2

Types of Foreign Bank Offices and Subsidiaries in the United States

Regulatory Guide
for Foreign Banks in
the United States*

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Chapter 2
Types of Foreign Bank Offices and Subsidiaries in the United States

Overview of Types of Organization

There are six principal types of organization through which foreign banks can engage in varying degrees of banking activities or business in the United States: representative offices, agencies, branches, banks, Edge Act and Agreement international banking corporations and commercial lending companies. Foreign banks that only have a representative office or offices in the United States are not subject to any restrictions on their U.S. nonbank activities. Foreign banks maintaining an agency or branch in the United States or that have a commercial lending company, Edge Act or Agreement corporation or bank subsidiary are subject to the nonbanking prohibitions of the BHC Act on their U.S. operations.

The characteristics of each form of banking organization are discussed below and nonbanking activities are reviewed in Chapter 5. Table III at the end of this chapter shows the number of each type of office or subsidiary as of March 31, 2005.

Representative Offices

A representative office may be established by a foreign bank in any state whose law permits such offices. The establishment of a representative office is subject to prior approval by the Fed and, in most cases, by the relevant state authority. The definition of "representative office" in the IBA was amended by the GLB Act to include a separate subsidiary—previously, only offices of the parent foreign bank were covered. This amendment was primarily intended to cover a situation where a subsidiary was established to act as a representative office without obtaining the necessary regulatory approval.

In amending its Regulation K in 2001, the Fed determined that it would not attempt to define when a subsidiary of a foreign bank may be considered to be a representative office, especially since there did not appear to be any current significant issues. Instead, the Fed issued general guidance focusing on whether a subsidiary is holding itself out to the public as a representative of a foreign bank and thus must seek regulatory approval. A subsidiary would not generally be considered a representative office if it merely makes customer referrals or cross markets the foreign bank's services in a manner that would be permissible for a nonbank affiliate of a U.S. bank.

The Fed also indicated in its 2001 release on Regulation K that it was seeking views on whether a money-transmitter subsidiary of a foreign bank should be prohibited from engaging in representative functions or employing individuals who act as bank representatives. Money-transmitters, which often are subject to state regulation or oversight, are nonbank companies that for a fee will send funds outside the United States. Often, the funds are first transmitted to an affiliated foreign bank for the benefit of the recipient. A foreign bank is not entitled to use a money-transmitter to engage in U.S. deposit taking. The Fed expressed concern that customers could be confused as to whether they were making deposits in a foreign bank in the United States if a money-transmitter were combined with a representative office.

A representative office is the simplest form of organization for foreign banks to establish, but also is the most restricted in activities. A representative office may only engage in representational and administrative functions on behalf of a foreign bank. A representative office may not conduct banking activities. In particular, a representative office may not make any business decision on behalf of the foreign bank.

In practical terms, a representative office is a marketing office that serves as a liaison between the head office of the foreign bank and its customers and correspondent banks in the United States. Persons designated as U.S. representatives may visit or receive visits at their offices from customers of the parent bank and from parent bank officials who may be traveling in the United States. U.S. representatives may also visit or receive visits from officials of correspondent banks and corporations in the United States seeking information about the parent bank or its home country. By maintaining contact with its parent's correspondent banks, the representative office can expedite and resolve operating problems arising from transactions entered into between the correspondent banks and the head office.

Representative offices often solicit business for the account of the head office, provide information and research on various matters in which the head office may be interested, investigate and prepare loan applications, perform back-office functions, serve as a regional administrative office and provide other services. A representative office cannot finally commit the head office or any related institutions to any banking transactions, including loan transactions, the purchase and sale of funds, notes or bills of exchange, or the acceptance of deposits. However, as a matter of Federal law under Regulation K, a representative office may make credit decisions if: (i) the foreign bank operates one or more branches or agencies in the United States; (ii) the loans approved at the representative office are made by a U.S. branch or agency of a foreign bank; and (iii) the loan proceeds are not disbursed at the representative office. A representative office also may not conduct any banking activities specifically prohibited by relevant state law.

Because of its limited powers, a representative office is subject to minimum regulation by the state banking authorities. Each state that permits representative offices to exist has its own licensing procedures and determines what types of activities are permissible. As a result, a foreign bank must review the law of each state where it plans to establish a representative office to determine applicable licensing and other requirements. The Fed, besides having to approve representative offices, may examine representative offices and terminate representative offices operating in violation of applicable legal restrictions.

The low cost of formation and regulation make a representative office a frequent choice for a foreign bank's initial entry into the United States. Foreign banks can also establish representative offices in more than one state. These offices can be an excellent vehicle for promoting business opportunities nationwide. As of March 31, 2005, foreign banks had 135 representative offices in 14 States and the District of Columbia. Thirty states and the District of Columbia authorize the establishment of representative offices by foreign banks.

Branches

Generally

A branch, unlike a subsidiary bank, is not a separate legal entity under U.S. law; rather, it is a legal and operational extension of its parent foreign bank. A branch may conduct a full range of banking activities, including trading and investment activities, accepting wholesale and foreign deposits, granting credit and acting as a fiduciary. However, with the exception of a few grandfathered insured branches, a branch may not engage in retail deposit-taking activities. With Fed approval, a foreign bank may establish a branch under either a Federal or state license, but only in a state whose laws do not prohibit such branches. Although over 25 states specifically permit branches of foreign banks, four states account for most branch assets and activity: New York, California, Florida and Illinois.

A branch is less costly to establish than a separately chartered subsidiary bank because a separate capital investment is not required (though capital equivalency deposits or asset pledges may be required to cover potential liquidation costs), and the legal and accounting costs of maintaining a separate corporation can be avoided. In addition, a branch may make larger loans than a subsidiary bank because its lending limits are based on the capital of its parent bank. These advantages, and the ability of a branch to engage in a full range of wholesale commercial banking activities, have made branches the preferred form of organization. As of March 31, 2005, there were 228 branches of foreign banks in ten states and the District of Columbia accounting for over 80 percent of total foreign bank banking assets in the United States. Thirty states and the District of Columbia authorize the establishment of branches by foreign banks.

U.S. law limits the kinds of deposits that can be accepted by uninsured foreign bank branches. An uninsured branch may accept initial deposits greater than $100,000 (considered wholesale deposits) from anyone. If the initial deposit is less than $100,000, then the deposits may only be received from certain categories of wholesale or foreign customers or for transmission abroad. Branches are also permitted to receive a *de minimis* amount of initial deposits under $100,000. *See further discussion in Chapter 4.*

The FDIC does not insure the deposits that can be accepted by branches of foreign banks. Since the enactment of FBSEA in 1991, a foreign bank seeking to accept retail deposits (initial deposits under $100,000) may only do so by establishing a U.S. subsidiary bank (or savings association) whose deposits are insured by the FDIC. Before FBSEA, a small number of foreign bank branches had obtained FDIC insurance under the provisions of the IBA and thus were permitted to accept retail deposits. These branches ("insured branches"), which currently are 12 in number, are grandfathered, *i.e.*, they may continue to receive insured retail deposits.

In addition, under the IBA, Congress authorized a category of limited branches that may not accept domestic deposits but may accept uninsured internationally related deposits that can be accepted by Edge Act corporations. *See discussion later in this Chapter.* Because limited branches do not accept domestic deposits, they are not subject to interstate branching restrictions. As of March 31, 2005, there were 29 limited branches of foreign banks with $18.9 billion in assets, slightly more than 2 percent of assets at all U.S. branches.

Federal Branches

A Federal branch is subject to licensing, regulation, examination and supervision by the OCC. Under FBSEA, the Fed must also approve the establishment of a Federal branch. A Federal branch may not accept insured deposits. Except for the taking of retail deposits, an uninsured Federal branch has the same powers and privileges and is subject to the same duties and limitations as a national bank in the same location, except that:

- A Federal branch is not required to become a member of the Federal Reserve System;
- Limitations based on the amount of a Federal branch's capital refer to the dollar equivalent capital of its parent bank; and
- A Federal branch may not obtain Federal deposit insurance. (The four Federal branches that obtained Federal deposit insurance before December 19, 1991, may continue to operate as insured branches.)

A Federal branch may conduct a general banking business, including making loans, receiving non-retail deposits, borrowing money, accepting drafts and bills of exchange and acting as a trustee or other fiduciary (the latter authority requires separate OCC approval).

The OCC also may license a limited Federal branch that operates under an agreement with the Fed to accept only those internationally related deposits that are permissible for an Edge Act corporation. Except for this restriction, a limited Federal branch can exercise the full range of powers available to any Federal branch. A limited Federal branch is not subject to Federal interstate branching limitations and may be established outside a foreign bank's designated home state, but only if it is expressly permitted by the state in which the branch will be operated.

State Branches

The state banking regulator of the state in which the branch will be located approves and licenses a state branch. Under FBSEA, the Fed must also approve the establishment of a state branch. Except for taking retail deposits, a state-licensed uninsured branch generally has the same powers as a state bank in such state.

State branches are not eligible for Federal deposit insurance. However, 8 insured state branches established before December 19, 1991, may continue to accept insured deposits. States may also authorize limited branches that only accept deposits permissible for an Edge Act corporation and that are not subject to Federal interstate branching restrictions.

A state-licensed branch may not engage in any activity that is not permissible for a Federal branch unless:

- The Fed has determined that the activity is consistent with sound banking practice; and
- For an insured branch, the FDIC has determined that the activity would pose no significant risk to the insurance fund.

Some states impose reciprocity requirements on foreign banks seeking a state-licensed agency or branch. Reciprocity usually means that the laws of the foreign bank's home country must permit state or national banks headquartered in the state to conduct banking operations in the foreign bank's home country that are substantially similar to those permitted foreign banks in the state. Federally licensed branches and agencies are not subject to state reciprocity requirements.

Agencies

Generally

An agency, like a branch, is a legal and operational extension of its parent foreign bank and not a separately capitalized U.S. corporation. An agency primarily makes commercial and corporate loans and finances international transactions. An agency does not have general deposit-taking authority, though it may receive credit balances, as described below, related to its operations.

Agencies, like branches, may be established under either state or Federal law, but only in a state whose laws do not prohibit agencies of foreign banks. As with branches, agencies may only be established with prior OCC or state approval and Fed approval. As of March 31, 2005, there were 44 state-licensed agencies of foreign banks in six states with assets of $19.8 billion. Twenty-six states and the District of Columbia authorize the establishment of agencies by foreign banks.

Federal and State-Licensed Agencies

A Federal agency has the same powers as a Federal branch, except that an agency may not accept deposits and may not exercise trust powers. A Federal agency may engage in a broad range of banking powers, including:

- Making loans;
- Buying, selling and collecting bills of exchange;
- Issuing letters of credit;
- Paying and collecting activities for the parent foreign bank; and
- Paying, selling or issuing checks, drafts, traveler's checks, money orders and similar instruments.

State-licensed agencies have powers similar to those of Federal agencies, with some variation from state to state. New York, for example, authorizes state-licensed agencies to exercise fiduciary powers. Before the IBA, when no Federal licensing authority existed for agencies and branches, a foreign bank that was prohibited under state law from obtaining a state branch license because of reciprocity requirements often sought a state agency license. Because agencies do not accept domestic deposits, they are not subject to Federal interstate branching restrictions. Accordingly, they may be established in states where establishment of a branch may not be possible under interstate branching rules.

Deposit-Taking Restrictions

Agencies are distinguished from branches by their lack of a general power to accept deposits. However, agencies may maintain credit balances. A credit balance is a deposit-like obligation that is generated by the exercise of other lawful banking powers. A credit balance has these characteristics:

- It serves a specific purpose;
- It is not solicited from the general public;
- It is not used to pay routine operating expenses in the United States;
- It is withdrawn within a reasonable period of time after the specific purpose for its placement has been accomplished; and
- It must generally be drawn upon in a manner reasonable in relation to the size and nature of the account.

States often permit agencies to accept limited types of deposits. New York and California, for example, authorize state-licensed agencies to accept deposits from non-U.S. citizens who are nonresidents. New York also authorizes state-licensed agencies to issue large-denomination obligations, including certificates of deposit, in amounts of $100,000 or more to corporations, partnerships and unincorporated associations. (However, the Fed views these latter deposit-taking agencies as branches for the purposes of the interstate branching restrictions.) In contrast, Federal agencies cannot accept any type of deposits under Federal law. Perhaps for this reason, the states license all of the current agencies in the United States.

The OCC has proposed legislation to the U.S. Congress that would permit Federal agencies to accept deposits from non-U.S. citizens who are nonresidents, thus making Federal agencies more competitive with state agencies. This proposal is included in much more extensive regulatory relief legislation being considered by the Congress.

Subsidiary Banks

A subsidiary U.S. bank is a separately capitalized legal entity chartered in the United States, the shares of which are owned or controlled by the parent foreign bank. The subsidiary may be either a national bank—Federally chartered under the National Bank Act by the OCC—or a state bank, chartered under state banking law by the state bank regulator in the state in which the bank is located. As of March 31, 2005, there were 67 bank subsidiaries of foreign banks in 17 states with total assets of $431.9 billion. Four of these bank subsidiaries with assets in excess of $35 billion controlled, in the aggregate, 64 percent of all assets at U.S. bank subsidiaries of foreign banks.

National bank subsidiaries can be located in any State and the District of Columbia. Thirty states and the District of Columbia provide specifically for foreign bank ownership of state-chartered banks. Bank subsidiaries of foreign banks in the United States have the same banking powers and are subject to the same legal or regulatory restrictions and limitations and reporting or other requirements as other domestic banks. They may engage in the same banking activities as other domestic banks, perform trust functions, accept all types of deposits and obtain deposit insurance from the FDIC.

A board of directors composed primarily of U.S. citizens and residents must govern the U.S. subsidiary bank of a foreign bank. In the case of a national bank subsidiary of a foreign bank, less than a majority of the board of directors may be foreign citizens. Although a majority of a national bank's board of directors must reside in the area in which the bank is located, the OCC may waive this requirement. State law citizenship and residency requirements for bank directors may vary.

Because a subsidiary bank is a separate legal entity, it must have its own capital structure, separate from that of the parent bank. The subsidiary's own capital accounts will be used to determine compliance with various regulatory requirements dependent on capital, such as minimum capital adequacy requirements, and the limitations on the loans it may make to a single borrower or group of related borrowers. In practice, the subsidiary bank may comply with those lending limits by selling or participating portions of any large credit to the parent bank or to other banks.

A subsidiary bank may be established either by obtaining a new charter or by acquiring the shares of an existing bank. In every case involving the establishment or acquisition of a U.S. subsidiary bank (defined as a 25 percent or greater investment in a class of a bank's voting shares), the foreign bank parent must seek the approval of the Fed under the BHC Act. The parent bank, and any other upstream parent companies of the proposed U.S. subsidiary bank, will become a bank holding company within the meaning of the BHC Act, a statute that limits the nonbanking activities of the parent bank (or other parent institutions in the chain of ownership) in the United States. Like U.S. bank holding companies, a parent foreign bank can elect to become a financial holding company to engage in a broader range of financial activities in the United States *(see discussion in Chapter 5)*.

If a foreign bank seeks to charter a new *de novo* bank, it must also obtain approval from the OCC for a national bank charter or from a state authority for a state charter. All subsidiary banks of a foreign bank must also be insured by the FDIC, which must separately approve insurance for any *de novo* bank.

If a foreign bank is not already a bank holding company and does not have a branch, agency or commercial lending company subsidiary in the United States, then it may acquire less than 25 percent of any class of the voting shares of a U.S. bank or bank holding company without having to apply to become a bank holding company. However, in making any such investment, it may not exercise control over the U.S. bank or bank holding company by itself or by acting in concert with others. If the investment by the foreign bank is for more than 10 percent, but less than 25 percent, of any class of the voting shares of a publicly held U.S. bank or bank holding company, the foreign bank will generally be required by U.S. law to file a prior Change-in-Bank-Control Act Notice with the bank's primary Federal regulator (or the Fed in the case of a bank holding company), which may disapprove such acquisition on prudential or other grounds.

In addition, under the Interstate Act, if a foreign bank with a branch, agency or commercial lending company subsidiary in the United States wants to acquire more than 5 percent of the voting shares of a U.S. bank or bank holding company, it must obtain prior Fed approval to do so, just as if it were a bank holding company.

Edge Act and Agreement Corporations

A U.S. or foreign bank may organize or acquire a separate subsidiary to engage in international banking activities specified in the Edge Act (the Act is named after a U.S. Senator) and its implementing Fed regulations. This subsidiary may be an Edge Act corporation, chartered under Federal law by the Fed, or an Agreement corporation, that is chartered under State law and formally agrees with the Fed to limit its activities to those permitted to an Edge Act corporation. An Edge Act corporation and its branches may be established in any state, regardless of where its parent bank's home state is located.

The IBA amended U.S. law to permit foreign banks and their affiliates to establish Edge Act corporations, subject to prior approval by the Fed. The powers and limitations of an Edge Act corporation are similar to those of a wholesale bank, with the additional restriction that its transactions and activities must have a foreign or international connection. A small number of foreign banks have established Edge Act corporations. As of March 31, 2005, three Edge Act corporation subsidiaries of foreign banks held about $4.2 billion in U.S. assets. These three subsidiaries are located in Miami, Florida.

Commercial Lending Companies

A commercial lending company is a specialized non-depository lending institution authorized under state law. Currently, these types of corporations are located only in New York. A foreign bank may acquire a commercial lending company after receiving approval of both the Superintendent of the New York State Banking Department ("NY Banking Department") and the Fed. The state and Federal standards for approval are similar to those for branch and agency approvals. These institutions, called Article XII Investment Companies in New York, may engage in borrowing and lending activities and many other banking powers and may maintain credit balances, but may not accept deposits. For many years, NY Banking Department policy, in general, has been that foreign banks are allowed to establish Article XII investment companies only if there are no other practicable means of entering the New York market.

International Banking Facilities

An international banking facility ("IBF") is a set of accounts segregated on the books and records of a depository institution. The IBF may include only international time deposits and international loans, as well as the income and expense accounts relating to those international loans and deposits. U.S. banks, Edge Act and Agreement corporations and U.S. branches and agencies of foreign banks may establish IBFs. The institution establishing the IBF may accept deposits in the IBF only from foreign residents, other IBFs and other offices of the institution establishing the IBF. Both the deposits and extensions of credit may be used only to support customers' operations outside the United States.

An IBF is the banking equivalent of a free trade zone. An institution booking deposits in an IBF may maintain them free of U.S. reserve requirements and deposit insurance premiums. An IBF thus has a lower cost of funds than an insured bank providing identical services. An IBF is intended to provide U.S. banks with competitive funding opportunities in international markets without having to establish a shell branch. However, foreign bank branches and agencies, in fact, account for a majority of IBF operations in the United States since IBFs can serve as useful vehicles to conduct dollar operations in third countries. The establishment of an IBF does not authorize activities that are otherwise prohibited for the establishing institution. For example, the IBF of an agency cannot accept U.S. deposits if its establishing agency may not accept U.S. deposits.

Other Depository Institution Entry and Expansion Vehicles for Foreign Banks

While the vast majority of foreign banks do business in the United States through one or more of the six types of organizations described above, foreign banks do have the ability to establish or acquire other types of U.S. depository financial institutions, including savings associations, industrial loan companies (in certain states), credit card banks and limited purpose trust companies.

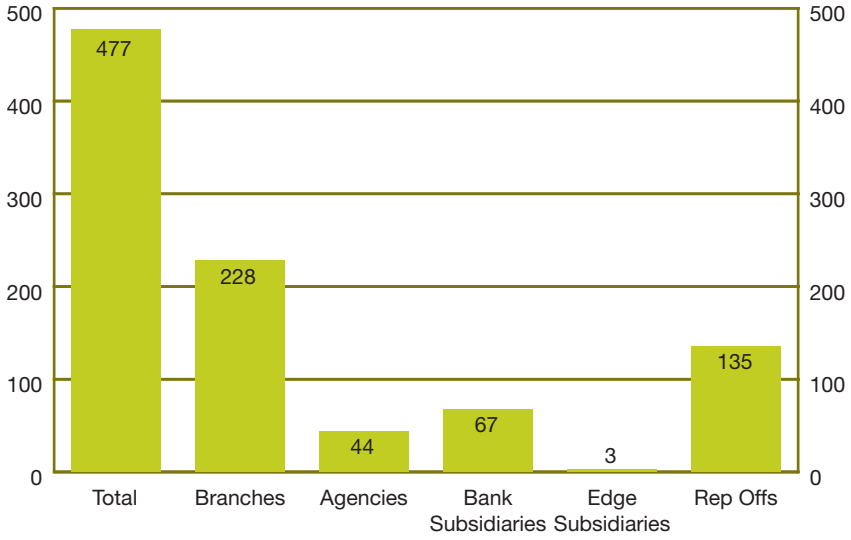
Deposits in savings associations are FDIC-insured. Savings associations are required to focus on lending and investing in the residential mortgage market. Savings associations may engage in other consumer banking activities, but may engage in only very limited commercial lending activities. Savings associations are chartered at the Federal level by the Office of Thrift Supervision ("OTS"), a bureau of the Treasury Department, or at the state level by state banking agencies. Unless it were already a bank holding company, any foreign bank establishing or acquiring a savings association would need the prior approval of the OTS to become an S&L holding company, which would limit its other financial activities in the United States to those permitted FHCs.

While a few states permit FDIC-insured industrial loan companies ("ILCs"), most are located in the state of Utah, where the charter has become attractive to a large number of U.S. nonbank institutions, because ownership of an ILC does not subject the parent institution to any Federal or state regulation at the holding company level. This would be true as well for a foreign bank that owned an ILC but did not also have a branch or agency or commercial lending company, Edge or Agreement corporation or bank subsidiary in the United States. ILCs can generally engage in the same activities as state banks but are restricted in their ability to accept demand deposits.

Credit card banks are limited to engaging in the issuance of credit cards and related operations, and limited purpose trust companies engage solely in trust and related fiduciary activities. These "monoline" entities, though operating with a bank charter, are not considered banks under the BHC Act. Thus, if a company owns a credit card bank or limited purpose trust company, the Fed does not regulate it as a bank holding company. This would be true as well for a foreign bank that owned a credit card bank or limited purpose trust company but did not also have a branch or agency or commercial lending company, Edge or Agreement corporation or bank subsidiary in the United States. A number of U.S. investment banks and mutual fund complexes have limited purpose trust companies, which they use to provide fiduciary services to their customers.

Table III

Number and Type of Foreign Bank Offices or Banking Subsidiaries in the United States as of March 31, 2005 (Source: Federal Reserve Board)



Chapter 3

The Licensing, Chartering or Approval Process

Regulatory Guide
for Foreign Banks in
the United States*

2005–2006 edition

Chapter 3
The Licensing, Chartering or Approval Process

Representative Offices

A foreign bank seeking to establish a representative office in a particular state must find authority to do so under state law. State law generally controls licensing procedures and permissible activities for a representative office. Although states typically require an application to open a representative office, it is usually less extensive than an application for a branch or agency.

Under Federal law, a foreign bank must receive the prior approval of the Fed to open a representative office, which includes a U.S. subsidiary engaged in representative office activities. Notwithstanding any activities that may be permitted under state law, Federal law prohibits a representative office from engaging in a banking business and taking deposits or making loans.

In evaluating a representative office application, the Fed does not have to make a determination that the parent foreign bank is subject to comprehensive supervision or regulation on a consolidated basis (a "CCS" determination). Instead, the Fed must "take into account" home country supervision of the parent bank. Under its Regulation K, the standard regarding supervision by the foreign bank's home country supervisor is met in the case of a representative office application if the Fed makes a finding that the bank is subject to a supervisory framework that is consistent with the activities of the proposed office, taking into account the nature of the activities proposed and the bank's operating record.

In addition to home country supervision, the Fed, in acting on an application filed on its form FR K-2, will take into account standards that apply to branch and agency applications *(see discussion later in this Chapter)* and other standards in Regulation K, including:

- The consent of the home country supervisor;
- The foreign bank's financial and managerial resources;
- Whether the foreign bank's home country supervisor shares information with other supervisory authorities;
- Whether the foreign bank has provided the Fed with adequate assurances of access to information on the operations of the bank and its affiliates necessary to determine compliance with U.S. law; and
- Whether the foreign bank has adopted and implemented procedures to combat money laundering and whether the home country is participating in efforts to combat money laundering.

The Fed has indicated that it will consider the latter anti-money laundering standard in all applications.

To reduce regulatory burdens associated with the establishment of representative offices, the Fed's Regulation K allows a foreign bank that has a branch or agency or a commercial lending company or bank subsidiary in the United States to establish representative offices without the need for any prior approval or notification if: (i) the Fed has previously determined the foreign bank meets the CCS standard; (ii) the office will be a regional administrative office; or (iii) the office will engage solely in limited administrative (*e.g.*, back-office) functions that are clearly defined and performed in connection

with U.S. banking activities of the foreign bank and do not involve contact or liaison with customers or potential customers beyond incidental contact.

A foreign bank may also establish a representative office subject only to 45-day prior notice procedures if: (i) the Fed has not made a CCS determination but the foreign bank has a branch or agency or a commercial lending company or bank subsidiary in the United States; (ii) the Fed has made a CCS determination in connection with a branch or agency application by the foreign bank; or (iii) the Fed has approved an application by the foreign bank to establish a representative office.

The Fed, for appropriate supervisory reasons, can suspend either of these streamlined procedures for approval of representative offices for a particular foreign bank.

Branches and Agencies

Generally

To establish either a branch or an agency in the United States, a foreign bank must apply for and obtain the prior approval of the Fed and the approval of either the OCC or a state bank regulator, depending on whether the foreign bank wants a Federal or state license. Applications to U.S. supervisory authorities typically require the following documents or information:

- Formal documents, such as:

– certified copies of the applicant's articles of incorporation and by-laws;

– an approval (or statement of no objection) from the home country supervisor;

– a corporate resolution authorizing the application; and

– necessary legal opinions.

- Information about the parent foreign bank, including:

– the most recent quarterly and historical financial statements;

– information concerning the applicant's ownership and management; and

– an organization chart and description of its existing offices and affiliates.

- Information about the proposed branch or agency, including:

– its business plan;

– its expected competition; and

– its projected income, expenses and balance sheet.

Federally-licensed branches and agencies

A foreign bank may establish a Federal branch or agency in a state where state law does not prohibit all foreign banks from establishing a branch or agency. In addition, in the case of a *de novo* Federal branch being established outside a foreign bank's home state, host state law must affirmatively permit both U.S. and foreign banks to establish such interstate *de novo* branch. A foreign bank may establish a Federal branch or agency only after receiving Fed and OCC approval.

To establish a Federal branch or agency, a foreign bank must file an application with the OCC, together with a filing fee, currently $10,000 for an initial Federal branch or agency. The full application becomes public information, unless the applicant requests that specified portions of the application remain confidential because of competitive, privacy or other pertinent reasons. If a foreign bank wishes to exercise trust powers at a Federal branch (such powers are not available at a Federal agency), it must submit a separate fiduciary application to do so, accompanied by a standard "fiduciary powers" filing fee of $1,600.

The application process typically involves three stages: (i) prefiling discussions; (ii) filing, processing and deciding the application; and (iii) opening the Federal branch or agency. In December 1999, the OCC published a Corporate Manual covering *Entry/Expansionary Activities/Other Changes and Activities for Federal Branches and Agencies*, which describes this process in some detail.

Under the IBA and FBSEA, the OCC must consider the following factors in deciding whether to approve applications by foreign banks to operate a Federal branch or agency in the United States:

- The financial and managerial resources and future prospects of the applicant foreign bank and the Federal branch or agency;
- Whether the foreign bank has furnished the OCC with adequate information to assess the application and has provided the OCC with adequate assurances that information will be made available to determine and enforce compliance with the IBA and other applicable Federal banking laws;
- Whether the foreign bank and its U.S. affiliates are in compliance with U.S. law, including interstate branching requirements;
- The convenience and needs of the community to be served and the effects of the proposed branch or agency on competition in the domestic and foreign commerce of the United States;
- Controls directed to the detection of money laundering;
- Whether the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor; and
- Whether the home country supervisor has consented to the proposed establishment of the Federal branch or agency.

In addition, no approval from the OCC can be effective for a foreign bank applicant until it has also received approval from the Fed. *See discussion later in this Chapter*. If a foreign bank has received Fed and OCC approval, the OCC will give the bank preliminary approval to establish the Federal branch or agency according to the plan in the application. The Federal branch or agency must commence business within 18 months from the date of the preliminary approval. The OCC will not generally grant extensions.

At least two weeks before the Federal branch or agency is scheduled to open, the OCC will conduct a review to verify that the foreign bank has met all requirements for commencing the business of banking in the United States. If the bank has met the requirements for opening, the OCC will grant a license. If the examination uncovers numerous exceptions or significant deviations from the originally approved proposal, the opening may be delayed or the original preliminary approval may be revoked.

In December of 2003, the OCC published a final rule to streamline and simplify regulations that apply to federal branches and agencies of foreign banks. The changes were intended to further conform the treatment of federal branches and agencies to that of national banks consistent with the national treatment principles of the IBA The final rule streamlined regulatory processes in several ways, including the following:

- It eliminated the requirement to file an application with the OCC when a foreign bank pares back its U.S. activities by converting a federal branch into a limited federal branch or a federal agency.
- It eliminated the need for foreign banks to apply for a new license when expanding U.S. activities and establishing certain additional federal branches or agencies after the opening of the initial U.S. office. Approval requirements may still apply for these expanded activities, but establishing certain additional federal offices will not require applying for a new license from the OCC.
- It permitted a well-capitalized and well-managed federal branch to make certain non-controlling equity investments in an enterprise in the same manner as a national bank.
- It expanded the list of notices and applications that are eligible for expedited processing.

State-Licensed Branches and Agencies

A State-licensed branch or agency of a foreign bank may be established in any state permitting such form of organization. In the case of a *de novo* branch being established outside a foreign bank's home state, host state law must allow both U.S. and foreign banks to establish such *de novo* branch.

The parent bank must submit an application to the state bank regulatory agency. The information and representations required in this application vary to some extent from state to state. In general, the state bank regulator will require information sufficient to show that the parent foreign bank is reputable, financially sound and subject to comprehensive, consolidated supervision and the branch or agency will be operated in a safe and sound manner, will be "well managed" and will serve the convenience and needs of its community. A foreign bank may establish a state branch or agency only after receiving both state approval and Fed approval under FBSEA.

A brief overview of the approval requirements for the states of New York, California, Illinois and Florida follows:

New York

To establish a branch or agency, a foreign bank must apply to the Superintendent of the New York State Banking Department. The application requirements are contained in the Banking Department's Supervisory Procedure FB 101 and Form FB-101.

By statute, to approve a branch or agency application, the New York Superintendent must find that (i) establishment of a branch or agency will promote the public advantage and convenience, and (ii) character, responsibility and general fitness of the foreign bank and its principal shareholders and management will be such as to command confidence and warrant belief that the foreign bank's business will be honestly and efficiently conducted according to the intent and purpose of New York State Banking Law.

The Superintendent must consider a number of general standards in making the preceding determinations, including standards similar to those considered by the OCC for Federal branches and agencies and by the Fed under FBSEA. New York charges an application fee of $2,000 for an initial branch or agency.

California

To open a branch or agency in California, a foreign bank must file an application with the California Commissioner of Financial Institutions. Department regulations require that a foreign bank submit to the Department a copy of its application to the Fed for a branch or agency, and submit as well copies of all amendments to its Fed application.

In deciding whether to approve a branch or agency application, the California Commissioner applies safety and soundness licensing standards similar to those considered by the OCC for Federal branches and agencies and by the Fed under FBSEA. However, in the case of an application for a branch, the California Commissioner must also consider reciprocity, that is, whether the foreign nation where the foreign bank is domiciled permits California banks to establish and maintain in such foreign nation substantially equivalent offices or wholly owned bank subsidiaries.

The application fee for establishment of an initial state-licensed foreign bank branch office in California is $2,000, and the fee for establishment of an initial state-licensed foreign bank agency office is $1,500.

Illinois

Illinois law does not distinguish between branches and agencies. Illinois law allows a foreign bank to establish a Foreign Banking Office ("Illinois FBO"), which has the same rights and privileges as a state bank. For purposes of Federal law and Fed application requirements, an Illinois FBO is a branch of a foreign bank. A foreign bank applying for a branch must use the Application for a Certificate of Authority to Operate a Foreign Banking Office published by the Office of Banks and Real Estate.

A foreign bank must submit its application to open an Illinois FBO to the Commissioner of Banks and Real Estate. The Illinois Commissioner will approve a license upon finding that the standards for chartering an Illinois bank are satisfied and that the applicant is able to demonstrate that its home country permits an Illinois bank or a national bank headquartered in Illinois to conduct a general banking business or to own a bank organized under the laws of that country. Applicants also must submit a complete and detailed statement of its financial condition and the actual value of its assets, which must be at least $1,000,000 in excess of its liabilities as of a date within 120 days prior to the date of such application. The application fee for an initial Illinois FBO is $8,000.

Florida

Under Florida law and regulation, to open an international agency or branch, a foreign bank must apply to the Office of Financial Regulation—Division of Financial Institutions. Application requirements are set forth in Chapter 663 of Florida's laws and in the Office of Financial Regulation's Application Form OFR-U-20. As part of the application submission process, copies must be sent to the Fed. .

The Deputy Director of the Office of Financial Regulation may not approve an agency or branch application unless he or she determines that certain statutory safety and soundness and related requirements have been met. These requirements are similar in content to those applied by other state regulators, the OCC and the Fed. These requirements include that the applicant must satisfy the following:

- Hold an unrestricted license to receive deposits from the general public, as authorized for that international banking corporation, in the foreign country under the laws of which it is organized and chartered.
- Have been authorized by the foreign country's bank regulatory authority to establish the proposed international bank office.
- Be adequately supervised by the central bank or bank regulatory agency in the foreign country in which it is organized and chartered.

In addition, the applicant must submit detailed financial information on its parent company.

As in the case of California and Illinois, the Florida Comptroller must also consider reciprocity—whether a Florida bank may establish similar facilities in the foreign bank's home country. However, in evaluating reciprocity, the Florida Comptroller must also consider whether the applicable federal regulatory agency could issue a comparable license to the foreign bank. As noted previously, there is no reciprocity requirement for Federal branches or agencies. Florida's application fee is $10,000 for an international agency or branch.

Federal Reserve Standards for Approval

To establish a branch or agency in the United States, a foreign bank must obtain two approvals: one from the Fed and one from the appropriate licensing authority—the OCC for Federal branches and agencies or the State regulator for state branches or agencies. An application with the Fed to open a branch or agency is prescribed by its Form FR K-2. The FR K-2 comprises a set of applications and notifications for foreign banks seeking to open a branch, agency, or commercial lending company or representative office in the United States. The applications and notifications collect information on the operations, structure, and ownership of the applicant or notificant; the proposed office; the financial condition of the applicant or notificant; home country supervision; and the anti-money-laundering laws and regulations of the applicant or notificant's home country.

Pursuant to the requirements of FBSEA, the Fed may not approve the establishment of a branch or agency unless it determines the following:

- The foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by the appropriate authorities in its home country *(see further discussion of the CCS determination in Chapter 4)*;
- The foreign bank (and any parent foreign bank) engages directly in the business of banking outside the United States; and
- The foreign bank has furnished the Fed the information it needs to adequately consider the application.

The Fed has discretion to approve the establishment of a branch or agency by a foreign bank even if the application record may be insufficient to support a CCS determination. However, in that case, the Fed must find that the home country supervisor is "actively working to establish arrangements for the consolidated supervision" of the bank and all other factors are consistent with approval. In deciding whether to use this discretionary authority, the Fed has indicated that this authority should be viewed as a "limited exception" to the generally required CCS determination. The Fed has exercised this discretionary authority on a few occasions.

The Fed may also take into account additional standards, including the following:

- The financial and managerial resources of the foreign bank, including its internal methods of monitoring its worldwide operations and compliance with law;

- Whether the foreign bank has given the Fed adequate assurances that it will make available to the Fed such information on its operations and activities and those of its affiliates as the Fed deems necessary to determine and enforce compliance with U.S. law;

- Whether the bank and its affiliates are in compliance with all applicable U.S. laws;

- Whether the foreign bank's home country supervisor shares material supervisory information with other regulatory authorities;

- Whether the foreign bank has received approval from its home country authorities to establish the branch or agency; and

- Whether the foreign bank has implemented procedures to combat money laundering and whether its home country has in place a legal regime to combat laundering or is participating in multilateral efforts to do so.

The Fed has indicated that it will consider the anti-money laundering standard in all applications.

In deciding whether to approve an application, the Fed may not make the size of the foreign bank the sole determinant factor, and may take into account community needs and the foreign bank's history and related size in its home country. In order to make its decision, the Fed requires information about the bank, its financial and managerial resources, its business plan and its home country system of supervision. A great deal of the information required will be included in the Federal or state licensing application.

As discussed in Chapter 4, for a number of foreign banks, a major issue in obtaining Fed approval of a branch or agency application has been the requirement that the Fed determine the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis in its home country. To make this CCS determination, the Fed requests a substantial amount of information concerning home country supervision and, on some occasions, its staff has even visited with home country authorities. The process is especially burdensome for the first application from a bank in a particular foreign country. Once the Fed has made an affirmative determination concerning a bank from Country X, subsequent applications from other banks in Country X must only show that they are supervised by home country regulators on substantially the same terms and conditions as the bank for which a CCS determination was made.

When the Fed is unable to make an affirmative determination on the CCS test, or exercise its rather limited discretion not to apply the test, the application is usually withdrawn or returned. If there is substantial doubt whether a foreign bank can meet the CCS standard, the foreign bank may first wish to apply for a representative office, because a CCS determination is not a requirement for the establishment of a representative office. *See discussion above under Representative Offices*.

If a foreign bank does not believe that it can obtain a representative office because of its current home country supervision or if such office would not be consistent with U.S. market objectives, a foreign bank may wish to consider entering the U.S. market through a U.S. nonbank entity, such as a finance company or investment advisory or management company. Although establishment of a nonbank financial subsidiary by a foreign bank with no U.S. branch or agency or bank, Edge Act corporation or commercial lending company subsidiary would not require prior Fed approval, registration or other action may be required in certain cases by SEC or state authorities. Although not legally required, consultation with Fed staff and state banking agency staff is strongly recommended to ensure the U.S. nonbanking operation will not be viewed as engaging in banking or representative office activities requiring Fed or state approval.

In the past, a foreign bank seeking to establish an initial branch or agency could expect that it would take one year or longer to receive Fed approval; with the time period less if the Fed had already made an affirmative CCS determination involving a similar bank from the foreign bank's home country. To promote a more streamlined application process, the 1996 Act generally requires the Fed to act on foreign bank applications within 180 days of receipt, with the Fed having discretion to extend this period once for an additional 180 days. Applicants may also waive time periods for Fed actions on such applications, especially when such additional time is needed to ensure an approval or one without potentially onerous terms or conditions.

Under the Fed's Regulation K, a foreign bank that has received a CCS determination may establish additional branches, limited branches and agencies pursuant to a 45-day prior notice procedure. The Fed can also waive this 45-day period if immediate action is required by the circumstances presented. This expedited procedure does not apply to interstate branches, which still require a prior application. The Fed can suspend this streamlined process for approval of branches or agencies for a foreign bank if, for example, the composite examination rating of a foreign bank's U.S. branches and agencies was not satisfactory.

Subsidiary Banks

Acquiring a subsidiary U.S. bank requires a foreign bank to apply to the Fed to become a bank holding company, a complex undertaking that is only briefly described in this Guide. For a foreign bank, the Fed must also determine that the foreign bank is subject to comprehensive, consolidated supervision in its home country, which, as noted above in the case of branches and agencies, can increase processing time for approval.

A New Bank

A foreign bank or other company may organize a new bank in the United States, under either a state or a Federal charter. This new bank is organized in the same manner as any other new bank with domestic ownership, except that it may usually have a greater number of non-U.S. directors than other U.S. banks. Upon opening for business, it will possess the same powers as any other domestic bank.

If the application is for a new national bank, five or more individuals must submit an application for the new bank to the OCC. If the application is for a state-chartered bank, it must be submitted to the state bank regulator. States also require an application to be submitted by an organizing group of individuals, generally a minimum of five.

Whether for a state or national bank, the application must contain a business plan and substantial financial and biographical information about the organizers, the proposed directors, the proposed management and any major stockholders. The business plan must contain detailed financial information and explanatory material showing the new bank's proposed services and geographic market. Usually, the business plan must show that the bank has a realistic way to make a profit within three years based upon reasonable economic assumptions. Regulators will also want to know how the subsidiary bank fits into the foreign bank's overall strategic objectives for the U.S. market.

After the bank regulator investigates and grants preliminary approval, the U.S. bank subsidiary may file its organization certificate, articles of association and by-laws. The regulator's approval of these documents will authorize the applicants to exercise certain corporate powers in the name of the new bank. The new bank may lease or build premises, collect subscriptions for its stock and undertake the other arrangements necessary to begin business. When the organizers complete these steps to the satisfaction of the chartering authority, the supervisor will issue a charter authorizing the new bank to commence the business of banking.

Between the time the organizers apply to charter a new bank and the bank's actual opening, the organizers must submit a separate application to the FDIC, which will insure the new bank's deposits. The FDIC will conduct its own review of the proposed bank and its organizers, reviewing many of the same factors considered by the proposed bank's primary supervisor. The FDIC's decision will be based upon an evaluation of the application against seven statutory considerations, which emphasize safety and soundness, convenience and needs of the community and protection of the deposit insurance fund.

The bank may begin to conduct business with the public only after it has the approval of the chartering authority (state bank regulator or OCC) and the insuring authority (FDIC), and its parent foreign bank has received approval from the Fed to become a bank holding company.

An Existing Bank or Bank Holding Company

A number of foreign banks have entered the U.S. market by acquiring existing U.S. banks or bank holding companies, rather than by chartering a new bank. As of March 31, 2005, foreign banks owned 67 U.S. banks with total assets of $432 billion.

The first steps toward such an acquisition are private. The proposed acquiring company identifies the potential target bank or bank holding company, investigates its business and financial condition and negotiates the proposed purchase with the target's management and directors. These actions will require substantial professional assistance. Because of the strict limits of the U.S. securities and banking laws, neither the proposed institution to be acquired nor any of its directors, officers

or employees should acquire any securities of the target bank or target holding company during this period of investigation and negotiation without first having consulted U.S. legal counsel.

Both the directors and shareholders of a target bank or bank holding company must approve the acquisition by a foreign bank. If, as is likely, the bank or bank holding company is publicly held, *i.e.*, ownership is widely dispersed, then the shareholders of the U.S. bank or bank holding company must receive a disclosure document describing the proposed transaction and providing financial and business information about both the target bank or bank holding company and the proposed foreign bank purchaser. The SEC must approve this disclosure document before it is submitted to the target's shareholders. The acquisition will also require the approval of bank regulatory agencies. The Fed is responsible for Federal regulatory approval of all U.S. bank and bank holding company acquisitions by foreign banks. Depending on state law and the bank's charter, approval also may be required from a state bank regulator.

Bank Holding Company Approval and Financial Holding Company Election

Acquisition of any U.S. bank, either existing or newly chartered, or any bank holding company will require the prior approval of the Fed as provided in the BHC Act. The BHC Act prohibits any company (including a foreign bank) from acquiring 25 percent or more of any class of a bank's or bank holding company's voting securities or otherwise controlling a bank or bank holding company without the Fed's prior approval. Any foreign bank that already has a branch, agency, subsidiary commercial lending company or subsidiary bank in the United States is subject to a lower limit: it needs the Fed's prior approval under the BHC Act to acquire more than 5 percent of any class of voting shares of a U.S. bank or bank holding company.

Obtaining the Fed's approval to acquire a bank or bank holding company requires a formal application, calling for detailed information about the applicant's finances, business, management and system of home country supervision. The application requirements for a foreign bank to become a bank holding company are set forth in the Fed's Form FR-Y1f. After it receives the application, the Fed will publish notice of the application to solicit public comments or objections. In making its decision, the Fed must consider certain competitive factors and the management and financial resources (including capital) of both the proposed acquirer and the target bank or bank holding company.

In addition, the PATRIOT Act amended the BHC Act and the Federal Deposit Insurance Act ("FDI Act") to require that, with respect to any application submitted under the applicable provisions of those laws, the Fed and the other Federal banking regulators must also take into consideration the effectiveness of an applicant's anti-money laundering activities, including in overseas branches.

In the case of a foreign bank acquirer, the Fed must deny an application if:

- The foreign bank is not subject to comprehensive supervision on a consolidated basis in its home country; or
- The applicant fails to provide adequate assurances that it will provide sufficient information to the Fed about it and its affiliates.

The Fed's decision to approve or deny an application may be challenged in a U.S. Court of Appeals and set aside if the court finds the decision to be arbitrary, unsupported by substantial evidence or otherwise unlawful.

If, in connection with an application to acquire a U.S. bank or bank holding company, a foreign bank wishes to become or be treated as a financial holding company—and thus be able to engage in a broader range of financial activities in the United States—it may elect to do so, but only if it satisfies certain eligibility criteria.

To be a financial holding company, the foreign bank must demonstrate that its U.S. bank subsidiaries are "well capitalized" and "well managed" and have satisfactory CRA ratings. The CRA requirement does not apply to a bank acquired within the past 12 months, if it has adopted a satisfactory plan for achieving a satisfactory rating. If the foreign bank also has branch or agency offices in the United States, the parent foreign bank itself must demonstrate that it is "well capitalized" and "well managed" on a comparable basis to a U.S. bank subsidiary of a financial holding company. *See further discussion of achieving financial holding company status in Chapter 5*.

Edge Act and Agreement Corporations

A foreign bank may invest up to 10 percent (or with Fed approval up to 20 percent) of its capital and surplus in an Edge Act international banking corporation. The corporation must have minimum capital of $2.5 million and it must be chartered with Fed approval.

Attachment C to the Fed's Form FR K-1 sets forth the information that a foreign bank must provide to acquire a controlling interest in an Edge Act corporation. While the application form is less extensive than would be required for acquisition of a bank, it nevertheless requires information about the foreign bank, how it is supervised and its business plans for the Edge Act corporation.

In acting on an application to establish an Edge Act corporation, the Fed will consider the financial condition of the applicant, the general character of its management, the convenience and needs of the community to be served with respect to international banking and financing services, and the effects of the proposal on competition.

In acting on an application by a foreign institution that is not otherwise subject to the IBA or BHC Act, the Fed additionally may impose any conditions it believes to be necessary to prevent undue concentration of resources, decreased or unfair competition, conflicts of interest or unsound banking practices in the United States.

A foreign bank may also be able to establish a state-chartered international banking corporation to engage in the same types of activities as an Edge Act corporation. In such case, the foreign bank will need the Fed's prior approval and the state corporation will enter into an "Agreement" with the Fed to limit its activities to those permissible for an Edge Act corporation and to be regulated and supervised by the Fed, as well as state authorities.

Commercial Lending Companies

"Commercial lending companies" generally refers to investment companies organized under Article XII of New York State Banking Law.

Application and related forms to establish an Article XII Investment Company may be obtained from the NY Banking Department. Before the application process begins, the foreign bank must meet with representatives of the NY Banking Department to discuss the proposal. The required information and standards for approval are similar to those required for establishing a branch or agency or organizing a New York State-chartered bank. As noted previously, it has been the policy of the NY Banking Department for several years to consider foreign bank applications to establish an Article XII Investment Company only when other entry alternatives are not available to the foreign bank.

In addition to receiving NY Banking Department approval to establish or acquire an Article XII Investment Company, a foreign bank would also have to receive the prior approval of the Fed. The procedures and standards for such approval are the same as for the establishment of a branch or agency discussed above. In essence, the IBA treats an Article XII Investment Company as the functional equivalent of a foreign bank agency for regulatory purposes.

Table IV at the end of this Chapter provides a summary of the regulatory approvals required for establishment of representative offices, branches and agencies and U.S. banking subsidiaries.

Name and Background Checks

In connection with the processing of applications by foreign banks to establish banking offices or subsidiaries in the United States, the Fed will conduct name and background checks on a foreign bank and certain principals and affiliates of the bank with other U.S. federal agencies, such as the Federal Bureau of Investigation, and with Interpol. Individuals who are to serve as organizers, senior executive officers, directors or principal shareholders of FDIC-insured banks are generally required to complete and submit to the approving agency an Interagency Biographical and Financial Report, which requires biographical, and in some cases, personal financial information. U.S. representatives of foreign banks, the managers in charge of a U.S. branch or agency and the CEO of the parent foreign bank are also usually required to submit a biographical report to the licensing Federal or state agency, the content of which may vary somewhat in the case of state banking departments. The information provided on such forms is treated as highly confidential personal information and is not publicly disclosed.

Federal and state banking agencies view the name and background check process as important for proposed domestic or foreign owners of U.S. banks, because it may provide them with information relevant to a number of the financial,

managerial and other standards which they are required to consider in governing law or regulation. While the Fed has sought to reduce the burden of name checks in applications, especially when checks have been done in connection with other recently approved applications, the Fed remains of the view that in certain cases full background checks must be completed before it may take action on an application.

International Banking Facilities

No application or approval is required to establish an IBF. An institution that wants to establish an IBF is required only to notify the Federal Reserve Bank in its district at least 14 days before the first reserve computation period during which it intends to accept IBF deposits. An institution may establish one international banking facility for each reporting entity that submits to the Fed a separate Report of Transaction Accounts, Other Deposits and Vault Cash (Federal Reserve Form FR 2900).

Institutions eligible to establish IBFs are: U.S. depository institutions, Edge Act and Agreement corporations and U.S. branches and agencies of foreign banks. The establishing institution must agree to abide by the conditions established by the Fed for conducting an IBF business. The notification must include a Statement of Intent that the institution will comply with the rules concerning IBFs, including the restrictions on sources and uses of funds and record-keeping and accounting requirements.

An institution establishing an IBF must:

- Maintain segregated accounting for its IBF within the office in which the IBF is located;
- Periodically report its IBF assets and liabilities as required by the Fed; and
- Comply with any requirements established by the Fed for IBFs.

Failure to comply with the Fed's restrictions on the type of business IBFs may engage in could result in the imposition of reserve requirements on deposits booked in the IBF or revocation of the authority of the establishing entity to maintain an IBF.

The Fed has adopted technical rules that govern the nature of IBF transactions and the funds they generate. These rules restrict fund-raising transactions to those with the establishing institution, banking offices outside the U.S. and non-U.S. resident sources. Such funds may generally only be used to extend credit to the institution establishing the IBF, banking offices outside the U.S. and other non-U.S. residents or entities.

Table IV
Summary of Required Regulatory Approvals for Foreign Banks

	Federal Reserve Board	Comptroller of The Currency	Federal Deposit Insurance Corporation	State Banking Supervisor
Rep office	Approval required	No	No	Approval usually required; depends on State law
Agency	Approval required	Approval required if Federal agency	No	Approval required if state agency
Branch	Approval required	Approval required if Federal branch	No	Approval required if state branch
NY Investment XII Company (commercial lending company)	Approval required	No	No	Approval required under Article XII of New York State Banking Law
Edge Act or Agreement corporation	Approval required	No	No	Approval may be required for state- chartered Agreement corporation
Bank	Approval required	Approval required if forming *de novo* national bank	Insured status of *de novo* bank is subject to FDIC approval	Approval required if forming *de novo* state bank; approval may also be required under state bank holding company laws

Chapter 4

Prudential Framework for Banking Supervision, Regulation and Examination

Regulatory Guide for Foreign Banks in the United States*

2005–2006 edition

Chapter 4
Prudential Framework for Banking Supervision, Regulation and Examination

As described in Chapter 1, the U.S. government policy toward foreign banks doing business in the United States is one of national treatment. The ways in which this policy is determined and applied by U.S. regulatory agencies are, however, influenced by a number of structural, legal and competitive factors. In particular, special supervisory and other regimes have been developed for branches and agencies of foreign banks because they are not incorporated under U.S. law, do not have separate capital accounts and cannot be FDIC-insured (with a few grandfathered exceptions). Nonetheless, to the greatest extent possible, such regimes seek to apply U.S. risk-based and related supervisory principles. Taking into account structural differences, branches and agencies are regulated and supervised similarly to U.S. banks as discussed in this and other Chapters of the Guide.

Significance of Home Country Supervision and Capital Requirements

Determination of Comprehensive, Consolidated Supervision

As discussed in Chapter 3, the Fed must find that a foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor (make a "CCS determination"), in order to approve any application by a foreign bank for a branch, agency, commercial lending company subsidiary or bank subsidiary.

The CCS standard, which was adopted as part of FBSEA in 1991, reinforced a movement in other countries and international organizations to recognize the importance of the supervision of internationally active banks by home country authorities on a comprehensive, consolidated basis and to enhance supervision of such banks and their affiliates.

In applying the CCS test, the Fed takes into account a number of factors in determining whether the test is satisfied. These factors include the extent to which a foreign bank's home country supervisor:

- Ensures that the foreign bank has adequate procedures for monitoring and controlling its activities worldwide;
- Obtains information on the condition of the foreign bank and its subsidiaries and offices outside the home country through regular reports of examination, audit or otherwise;
- Obtains information on the dealings and relationships between the foreign bank and its affiliates, both foreign and domestic;
- Receives from the foreign bank financial reports that are consolidated on a worldwide basis, or comparable information that permits analysis of the foreign bank's financial condition on a worldwide, consolidated basis; and
- Evaluates prudential standards, such as capital adequacy and risk asset exposure, on a worldwide basis.

As also discussed in Chapter 3, the Fed has discretionary authority to approve a branch or agency application without having to make a CCS determination. The Fed has made limited use of such authority.

The Fed has determined that banks from the following countries are subject to comprehensive regulation or supervision on a consolidated basis.

Argentina	Australia	Belgium	Canada	Chile
Colombia*	Egypt*	Finland	France	Germany
Greece	Hong Kong	Ireland	Israel	Italy
Japan	Korea	Mexico	Norway	The Netherlands
Peru*	People's Republic of China*	Portugal	Spain	Switzerland
Taiwan	Turkey	United Kingdom		

*Banks from these countries were approved by the Fed using the "discretionary" CCS determination of the 1996 Act, on the basis that the appropriate authorities in the home country are actively working to establish arrangements for the consolidated supervision of the bank.

Capital Adequacy of Foreign Banks

In considering any application by a foreign bank to establish a branch or agency or acquire a U.S. bank subsidiary, the Fed requires the foreign bank's capital ratio to be equivalent, but not identical, to the minimum ratio required of a U.S. bank. Currently, the Fed requires an applicant from a country adhering to the Basel Accord to demonstrate that it meets the agreed minimum standard of 8 percent risk-based capital as applied in its home country.

The Fed requires a detailed submission showing the components of Tier 1 and Tier 2 capital and an explanation of differences from U.S. accounting standards. Applicants from countries not adhering to the Basel Accord are required to provide: (i) information regarding the capital standards applied by the home country supervisor; (ii) information sufficient to evaluate the bank's capital position, adjusted as appropriate for accounting and structural differences with U.S. standards; and (iii) to the extent possible, information comparable to that required by the Basel Accord. The capital minimums are a starting point for the Fed. It may require additional capital to support any perceived higher risk in an applicant's proposed activities.

U.S. Well-Capitalized and Well-Managed Standards Applied to Parent Foreign Banks

U.S. laws and regulations create a three-tiered regulatory approach toward expansion by U.S. banking organizations and, by extension, foreign banks doing business in the United States. Banking organizations that are "well capitalized" and "well managed" are able to expand into new types of financial activities and make acquisitions either without prior regulatory approvals or under expedited procedures. Banking organizations that meet minimum capital and supervisory requirements may expand into a narrower list of financial activities and make acquisitions under prior approval or notification procedures. Banking organizations that do not meet minimum capital guidelines or supervisory expectations will find most opportunities for strategic expansion hampered or even foreclosed.

The GLB Act reinforced this tiered approach and significantly widened the gulf in treatment between holding companies whose U.S. bank subsidiaries are "well capitalized" and "well managed" and those whose bank subsidiaries are not. To become and remain a financial holding company, a bank holding company must demonstrate that its U.S. depository institution subsidiaries are "well capitalized" and "well managed." This requirement is a continuing one, meaning financial holding company status can be lost if any depository institution subsidiary falls below these levels and a remedial plan is not adopted and approved. As will be discussed in more detail later in this Chapter, financial holding company status provides three major benefits to holding companies:

- The ability to engage in or acquire institutions engaged in a broad range of financial activities, including investment and merchant banking, life and casualty insurance and a full range of mutual fund activities;
- The ability to expand into this broader range of financial activities under after-the-fact notice procedures; and
- Umbrella supervision by the Fed, which restricts the Fed's ability to supervise functionally regulated subsidiaries, such as broker-dealer and investment company subsidiaries.

To be considered "well capitalized," a U.S. bank subsidiary must have an overall risk-based capital ratio of at least 10 percent and a Tier 1 risk-based capital ratio of at least 6 percent. It must also have a Tier 1 leverage ratio (Tier 1 capital divided by total assets) of 5 percent. To be "well managed," a U.S. bank subsidiary must have received satisfactory examination ratings and not be subject to any outstanding enforcement action.

If a foreign bank has a U.S. bank subsidiary and wishes to elect financial holding company status, it must, like any other bank holding company, demonstrate that its bank subsidiary is "well capitalized" and "well managed" under the criteria noted above. However, most foreign banks do business in the United States through branches or agencies. If a foreign bank operates a U.S. branch or agency, it is treated like a bank holding company and may, like U.S. bank holding companies, also elect to be treated as a financial holding company.

To be treated as a financial holding company, a foreign bank with branches, agencies or commercial lending company operations in the United States must establish that it is "well capitalized" and "well managed" in accordance with standards "comparable" to those required of U.S. bank subsidiaries of financial holding companies. If a foreign bank also controls another foreign bank with branches, agencies or commercial lending operations in the United States, such foreign bank subsidiary must also meet the same "well capitalized" and "well managed" tests. If a foreign bank has branches or agencies and a U.S. bank subsidiary, the foreign bank must be "well capitalized" and "well managed" and its U.S. bank subsidiaries must also be "well capitalized" and "well managed."

A foreign bank may meet the "well capitalized" test in either of two ways. The first method is applicable to foreign banks whose home country supervisors have adopted risk-based capital standards consistent with the Basel Accord. Under this method, the foreign bank's Tier 1 and total risk-based capital ratios, as calculated under its home country standard, must be at least 6 percent for Tier 1 capital to total risk-based assets and 10 percent for total capital to total risk-based assets. In interim rules under the GLB Act, the Fed had also required foreign banks to meet a minimum U.S. leverage ratio standard imposed on U.S. banks. However, the Fed eliminated the leverage ratio from the test in its final rules implementing the GLB Act because home country supervisors of most foreign banks do not require banks to meet or manage toward a leverage ratio. The Fed will still consider a foreign bank's leverage ratio as one factor in evaluating the "comparability" of the foreign bank's capital and management to that of a U.S. bank.

A second method applies to foreign banks whose home country supervisors have not adopted the Basel Accord standards and to any other foreign banking organizations that otherwise do not meet the standards set out under the first method. Any such institution may be considered "well capitalized" only by obtaining from the Fed a prior determination that its capital is otherwise comparable to the capital that would be required of a U.S. bank.

In order for a foreign bank to qualify as "well managed," the foreign bank must have received at least a satisfactory rating for its U.S. branches, agencies and commercial lending company subsidiaries on a composite basis. *See discussion of supervisory ratings later in this Chapter*. In its interim rule, the Fed had required that each direct banking office of a foreign bank must have received a satisfactory rating for the foreign bank to be considered well managed. However, taking into account comments on its interim rule, the Fed determined that it would be more comparable to a U.S. bank for the Fed to evaluate a foreign bank for financial folding company purposes on the basis of a consolidated rating of all of its direct U.S. banking operations. In addition, the home country supervisor of the foreign bank must consent to the foreign bank expanding its activities in the United States to include the broader financial activities permissible for a financial holding company.

In determining whether a foreign bank is "well capitalized" and "well managed," the Fed also takes into account other factors, such as the foreign bank's composition of capital, its Tier I capital to total assets leverage ratio, its accounting standards, its long-term debt ratings, its reliance on government support to meet capital requirements, the foreign bank's anti-money laundering procedures, whether the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis and other factors that may affect the analysis of capital and management. The Fed will consult with the home country supervisor for the foreign bank as appropriate. A foreign bank that is not subject to comprehensive supervision or regulation on a consolidated basis may not be considered "well capitalized" and "well managed" unless the foreign country has made significant progress toward CCS and the foreign bank is in strong financial condition, *e.g.*, by having capital levels that exceed the well-capitalized minimums.

Any foreign bank contemplating election of financial holding company status should review the standards carefully and consult early on with Fed staff.

Even if a foreign bank does not elect to become a financial holding company, if it is deemed "well capitalized" and "well managed" under the Fed's Regulation Y governing bank holding companies, it may engage in activities closely related to banking (as of November 11, 1999) under expedited notification/approval procedures. The "well capitalized" and "well managed" requirements for expedited treatment are similar to those applied to foreign banks electing to become financial holding companies, although somewhat less discretionary in nature.

Requirements Applicable to Branches or Agencies

Capital Equivalency (Asset Pledge) Requirements

Federal Branches and Agencies

Under U.S. law, Federal branches and agencies of a foreign bank must maintain a Capital Equivalency Deposit ("CED") equal to 5 percent of their liabilities, excluding accrued expenses and liabilities owed to offices, branches, agencies and subsidiaries of the parent foreign bank. The CED must be maintained in trust accounts at other banks. The funds in those accounts, which are intended to serve as a cushion against losses, cannot be withdrawn without permission from the OCC. Every Federal branch or agency must maintain a CED of at least $1 million, even if the CED is more than 5 percent of its liabilities.

The OCC, as part of its effort to streamline its regulation of federal branches and agencies, adopted a number of rule changes in late 2003, including with respect to the CED. The new rules allow a foreign bank with federal branches or agencies in more than one state to consolidate its required CEDs into one account and clarify which U.S. banks are eligible to hold these consolidated deposits. It also establishes in regulation the OCC's current policy of excluding liabilities of an international banking facility when calculating the amount of a federal branch's CED. The OCC has also recommended to Congress that it be provided with more discretionary authority to set the CED. Currently, U.S. law requires the CED to be equal to 5 percent of third-party liabilities. The OCC has recommended that it be permitted to set the CED at a level necessary to protect depositors consistent with safety and soundness, so long as the amount would not be less than the amount required for a state branch or agency in the state where the Federal branch or agency is located. Alternatively, the OCC has proposed to Congress that, after consultation with the FFIEC, it be allowed to set the CED on a risk-based institution-by-institution basis.

State Branches and Agencies

State law determines the capital equivalency or asset pledge deposit required for a state-licensed branch or agency. These requirements vary from state to state.

- New York. In December of 2002, New York amended its asset pledge requirements to significantly reduce both the amount of pledge required by most branches and agencies and the administrative burden of calculating and maintaining the required pledge. The pledge requirement for branches and agencies in New York is 1 percent of third-party liabilities (reduced from 5 percent of third-party liabilities excluding IBFs). The NY Banking Department may require higher amounts for supervisory reasons. The calculation of liabilities subject to pledge was changed from a daily actual to a monthly average based upon the office's Call Report *(see discussion in Chapter 7 of branch and agency reporting requirements)*. The minimum pledge is $2 million and the maximum pledge is capped at $400 million for well-rated foreign banks. Generally, well rated foreign banks are well capitalized and well managed. All foreign banks can use additional AAA-rated assets for up to one-half of the required pledge amount. The pledge of obligations issued or guaranteed by entities from the foreign bank's home country is no longer allowed. Haircuts are placed on all assets pledged, based on the Fed's discount window valuation list. The New York State Superintendent of Banks has indicated a willingness to consider further modifications to reduce burdens in this area.

- California. Under California rules, a state-licensed branch of a foreign bank must deposit with an approved California State or national bank eligible assets equal to the greater of (i) $2 million or (ii) 5 percent of its adjusted liabilities. Eligible assets include certain liquid and high-quality obligations. Adjusted liabilities exclude accrued expenses, amounts due other offices of the bank, amounts due majority-owned subsidiaries of the bank and IBF liabilities. A foreign bank with one or more California-licensed agencies must maintain a deposit of $1 million. California law requires only one deposit to cover all state-licensed agencies.

- Illinois. Illinois law provides that an asset pledge need only be maintained at the discretion of the Commissioner. If required by the Commissioner, an Illinois FBO (which is equivalent to a branch) must maintain the greater of $100,000 or 5 percent of total foreign banking office liabilities as an asset pledge consisting of certain liquid and high-quality assets

with an Illinois State or national bank or the Federal Reserve Bank of Chicago. Total liabilities include acceptances but exclude accrued expenses and amounts due to other offices and affiliates of the foreign bank.

- Florida. A Florida international bank agency or international branch must maintain a capital equivalency account in an approved Florida State or national bank or a Federal Reserve Bank consisting of dollar deposits or permissible investment securities. The account must be equal to the greater of $4 million or 7 percent of the agency or branch's total liabilities, less accrued expenses and amounts due affiliates, branches, agencies or entities. The agency or branch must calculate its capital equivalency requirement on a monthly basis.

Asset Maintenance Requirements

Federal and state regulators (in most cases) also are authorized to impose asset maintenance requirements on branches and agencies. The general purpose of such requirements is to ensure that a branch or agency maintains eligible assets in excess of third-party liabilities for protecting creditors and for the benefit of the public. Eligibility is defined to include assets for which there is a reasonable expectation of liquidation on a timely basis. Amounts due from the head office or other non-U.S. offices or affiliates are generally not eligible. Imposition of asset maintenance effectively precludes a branch or agency from being a net provider of funds to its parent bank's non-U.S. operations.

Asset maintenance is typically imposed in cases where there is a perceived weakness in the financial condition of the parent bank, or when home country developments may adversely affect U.S. branches or agencies. As discussed below under the U.S. Supervisory and Examination Regime for the U.S. Operations of Foreign Banks, a fair or worse SOSA rating may result in some degree of asset maintenance for a U.S. branch or agency. Overall, relatively few foreign banks are subject to asset maintenance requirements at any point in time. Nonetheless, Federal and state regulators view asset maintenance requirements as an important instrument that permits considerable flexibility in addressing supervisory concerns associated with particular situations.

Restrictions on Retail Deposit-Taking

Except for 12 insured branches, a foreign bank branch may not generally engage in "retail deposit-taking," defined as accepting initial deposits of less than $100,000 from U.S. sources. However, FDIC regulations (and OCC regulations for uninsured Federal branches) allow foreign bank branches to receive certain types of initial deposits under $100,000, without being considered to be engaged in prohibited retail deposit-taking activities. Specifically, an uninsured branch may receive initial deposits in an amount less than $100,000 from:

- Individuals who are not citizens or residents of the United States at the time of the deposit;
- Individuals who are residents but not citizens of the United States and who are employed by a foreign or recognized international organization;
- Persons who have received credit or other non-deposit banking services within the last 12 months or who have entered into a written agreement to use such services within the next 12 months;
- Foreign businesses, large U.S. businesses and persons from whom an Edge Act corporation may accept deposits;
- U.S. and foreign governmental units, including political subdivisions and agencies and recognized international organizations; and
- Persons who are depositing funds in connection with the issuance of a financial instrument by the branch for the transmission of funds, including by any electronic means.

An uninsured branch may also accept a *de minimis* amount of deposits from any depositor, defined as an amount that does not exceed on an average daily basis 1 percent of the average of the branch's deposits for the last 30 days of the most recent calendar quarter, excluding deposits in the branch from other offices or affiliates of the foreign bank. The branch also may not actively solicit deposits from the public.

FDIC Insured Branches

As of March 31, 2003, 10 foreign banks had 12 insured branches. A grandfathered foreign bank branch with FDIC insurance can accept retail deposits. It pays risk-based deposit insurance premiums and must pledge assets equal to 5 percent

of the average liabilities of the branch for the last 30 days of the most recent calendar quarter, excluding amounts due to other offices, agencies, branches or wholly owned subsidiaries of the parent foreign bank. This pledge requires a deposit of assets, surety bonds, or both, with the FDIC. The value of the pledged assets must be computed on the lesser of the principal amount or market value of the assets at the time of the original pledge and thereafter as of the last day of each calendar quarter.

The FDIC may require a foreign bank with an insured branch to pledge additional assets or to compute its pledge on a daily basis when the FDIC determines that the condition of the foreign bank or insured branch is such that the pledged assets may not adequately protect the FDIC fund. As an asset maintenance requirement, an insured branch of a foreign bank must also 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 insured branch's liabilities.

Loan Loss Reserves

The Fed and OCC do not require branches and agencies to maintain specific loan loss reserves for Federal supervisory purposes. However, the regulators expect branches and agencies to have an effective loan review system and adequate procedures for identifying losses in their loan portfolios. A much more in-depth discussion of this issue is provided in PricewaterhouseCoopers' *A Guide to Understanding the Allowance for Loan Losses of Banks—for U.S. Domestic Banks and U.S. Branches and Agencies of Foreign Banking Organizations*. The 2002 (fourth) edition of this Guide is available from the RAS office in Washington, D.C.

Prudential Restrictions

As a general rule, under the U.S. policy of national treatment, U.S. branches and agencies of foreign banks operate under similar prudential restrictions that apply to U.S. banks, except where application is inappropriate when dealing with unincorporated branch or agency offices. For example, U.S. branches and agencies are not subject to capital adequacy requirements applicable to U.S. banks, though the parent foreign bank's capital adequacy is considered in several contexts described previously, e.g., with respect to financial holding company status. While U.S. branches and agencies must comply with the same lending limits to customers as U.S. banks, the limits are calculated on the basis of the capital of the parent foreign bank.

Although U.S. branches and agencies of foreign banks are not generally subject to restrictions or limitations on loans to affiliates that apply to U.S. banks, the Fed's Regulation W does apply such limitations to transactions between a U.S. branch or agency and U.S. affiliates engaged in expanded financial activities authorized for financial holding companies by the Fed under the GLB Act. These affiliates include U.S. broker-dealers, life and casualty insurance companies, merchant banking investments and insurance company investments. *Regulation W is reviewed in more detail later in Chapter 5 under Areas of Regulatory or Supervisory Focus*.

Offshore Shell Branches Managed from the United States

Many foreign banks, like U.S. banks, maintain offshore branches in the Cayman Islands or other jurisdictions for tax and other advantages. Most of these offices are simply shell operations consisting of a separate set of books managed by personnel from the foreign bank's U.S. branch or agency. As discussed in Chapter 7, U.S. branches or agencies that manage or control offshore shell branches must submit a supplement to their quarterly condition report on these offshore offices.

Fed and OCC regulations prohibit a U.S. branch or agency of a foreign bank from managing any type of activity at an offshore shell branch "managed or controlled" by a U.S. office that a U.S. bank could not manage at its foreign branches or foreign subsidiaries. The regulations use the same criteria as the form FFIEC 002S *(see discussion in Chapter 7)*. In determining whether an offshore branch is "managed or controlled" by a U.S. branch or agency. The standard focuses on whether a majority of the responsibility for business decisions or recordkeeping rests with the U.S. branch or agency.

The regulations also provide that in applying the restrictions on "types" of activities applicable to U.S. banks, the various procedural or quantitative requirements imposed on U.S. banks' overseas activities are not applicable. In this regard, U.S. banks, through Edge Act corporation subsidiaries or bank holding company affiliates, are generally permitted to manage a wider range of types of activities outside the United States than permitted domestically. Foreign branches of U.S. banks also have somewhat broader powers than domestic offices.

Closure of Offices

The OCC may close a Federal branch or agency of a foreign bank that violates the IBA, becomes insolvent or upon appointment of a conservator for the home office. FBSEA authorizes the Fed to close a state branch or agency of a foreign bank upon determining that:

- The foreign bank or any of its affiliates have violated U.S. law or engaged in an unsafe or unsound banking practice in the United States; or

- The foreign bank parent is not subject to comprehensive supervision on a consolidated basis in its home country.

The Fed has adopted a regulation indicating that a lack of comprehensive, consolidated supervision in a foreign bank's home country would not be *per se* grounds for closure of a foreign bank's U.S. banking operations, absent other very compelling adverse factors concerning a particular foreign bank—such as continued violations of U.S. law and regulation or a continued failure to remedy unsafe and unsound practices at U.S. offices. State bank regulators also may close state branches or agencies for reasons such as insolvency of the parent or for compelling prudential or supervisory concerns.

Requirements Applicable to U.S. Bank Subsidiaries

Capital Adequacy Requirements

A separately chartered U.S. subsidiary bank—whether state or Federal—owned by a foreign bank must comply with U.S. bank capital requirements. The FDIC, the OCC and the Fed each have adopted the risk-based capital standards developed by the Basel Committee on Banking Supervision: minimum total risk-based capital of 8 percent and minimum Tier 1 risk-based capital of 4 percent. U.S. regulators also impose a leverage ratio, requiring each U.S. bank to have a Tier 1 capital ratio of 3 percent or more of its total assets (without risk weighting). Most banks are required to meet a leverage ratio of 4 percent or higher. A U.S. bank subsidiary whose trading activity equaled 10 percent or more of its total assets or $1 billion or more would also be subject to U.S. market-risk capital requirements based on the framework adopted by the Basel Committee.

Federal Deposit Insurance

U.S. bank subsidiaries of foreign banks, like other U.S. banks, must obtain Federal deposit insurance. Acquiring an insured bank (or thrift) subsidiary is the sole means for a foreign bank to gain access to the FDIC-insured retail deposit market. Federal deposit insurance protects each depositor up to $100,000 of his or her deposit accounts in a single bank. Premiums for this insurance are assessed against each bank on a risk-weighted basis, with the most troubled banks paying higher premiums—up to $.27 per $100 of deposits. Over 90 percent of U.S. banks pay no premiums because they are "well capitalized" and "well managed" and the BIF currently meets its statutorily mandated reserve ratio of 1.25 percent of insured deposits. The FDIC has indicated that unless insured deposit growth slows significantly in the near term, there is a high probability that the BIF will fall below its statutorily mandated target of 1.25 percent by the end of this year or early next year. If the BIF falls below that level, it may cause the FDIC to impose premiums on insured institutions.

At the request of the FDIC, the Congress has for several years been considering legislation to reform the Federal deposit insurance system. Legislation was introduced in the U.S. Senate in July of 2005 to merge the deposit insurance funds and modernize the deposit insurance system. In the view of the FDIC, the increased likelihood of premiums in future years that will be assessed without regard to past assessments or risk underscores the need for Congress to consider deposit insurance reform legislation to ensure a fairer and more effective risk-related system than under current law.

Community Reinvestment Act

The Community Reinvestment Act ("CRA") is a U.S. law intended to encourage insured U.S. depository institutions to help meet the credit needs of their entire communities, including low- and moderate income neighborhoods. The CRA neither prohibits any activity nor attempts to allocate credit or encourage unsound lending practices.

CRA requirements apply to insured bank subsidiaries of foreign banks and to insured branches. These insured institutions must adopt and review annually a CRA statement and must maintain certain public files pertaining to their CRA performance. An insured institution's CRA performance is rated by the appropriate Federal banking agency as "Outstanding," "Satisfactory," "Needs to Improve" or "Substantial Noncompliance." A less than satisfactory rating effectively precludes favorable agency consideration of branching or merger applications by an insured institution and bank acquisitions by the bank's parent bank holding company.

In addition, a bank holding company cannot elect to become a financial holding company if its FDIC-insured subsidiaries do not have satisfactory CRA ratings. Should an FDIC-insured subsidiary of a financial holding company not achieve a satisfactory rating, the financial holding company may not engage in any new activities or acquire any firm engaged in activities not permitted bank holding companies. This restriction continues until each FDIC-insured subsidiary has achieved a satisfactory CRA rating.

Prompt Corrective Action

A U.S. bank subsidiary and an insured branch of a foreign bank are also subject to Prompt Corrective Action provisions of U.S. banking law, which impose escalating restrictions on a bank's operations and activities as its capital decreases below certain threshold levels. Once capital of a U.S. bank subsidiary decreases below a defined critical level, the bank can be taken over and closed by U.S. authorities. In the case of insured branches, declines in asset pledge and asset maintenance requirements are used in lieu of capital to trigger corrective action.

Prudential Restrictions

U.S. statutes and regulations impose a number of prudential restrictions on U.S. banks, including U.S. bank subsidiaries of foreign banks. Such restrictions include lending limits and limits on loans to affiliates, on loans to insiders, and on the payment of bank dividends, among other provisions. *See discussion later in this Chapter*. Affiliate transaction restrictions contained in Sections 23A and 23B of the Federal Reserve Act limit the scope of permissible business transactions between U.S. chartered banks and their affiliates. The Fed has issued Regulation W which comprehensively interprets the restrictions, limitations and requirements of Sections 23A and 23B. Transactions between a U.S. bank subsidiary of a foreign bank and its foreign bank parent, its branches or agencies and any subsidiaries or affiliates of its foreign bank parent are subject to Regulation W.

Under Regulation W and Section 23A, a U.S. bank's covered transactions (a defined term) with a single affiliate may not exceed 10 percent of the U.S. bank's capital and surplus, and the aggregate amount of covered transactions by a bank with all affiliates may not exceed 20 percent of the U.S. bank's capital and surplus. Credit transactions within these limits must be secured by collateral valued at between 100 percent and 130 percent of the amount of the transaction, depending upon the type of collateral. Examples of covered (and thus regulated) transactions include bank loans and extensions of credit to affiliates, bank purchases of assets from affiliates and a bank's purchase (or acceptance as collateral) of securities issued by affiliates. Other kinds of transactions, such as contracts for goods and services and sales of assets by a bank, are regulated to a lesser extent under Section 23B and Regulation W. These transactions must be on terms no less favorable to the bank than would be available from unrelated third parties.

Certain relationships or transactions are exempt from affiliate transaction limitations. For example, there is a "sister bank" exemption for transactions between banks owned 80 percent or more by the same bank holding company. Credit extended by a bank to an affiliate that is fully secured by U.S. government securities or segregated deposit accounts and a bank's purchase of assets from an affiliate at a readily identifiable and publicly available market quotation are exempt from affiliate transaction limitations. Under Regulation W, U.S. banks must adopt policies and procedures designed to monitor, manage and control credit exposures arising from derivatives transactions with affiliates and intraday credit extensions to affiliates. *Regulation W is reviewed in more detail in Chapter 5*. PwC has also issued a *Guide to Regulation W of the Federal Reserve Board* that is available from our website, www.pwc.com.

Special amount and capital limitations and corporate approval procedures also apply to loans by a U.S. bank to "insiders," which include directors, officers, principal shareholders and their related interests. National and state member banks are also subject to restrictions on the payment of dividends in excess of net profits.

Prudential Restrictions on Edge Act Corporations

An Edge Act corporation must be fully secured for all eligible acceptances, *i.e.*, acceptances eligible for discount at the Federal Reserve Banks, outstanding in excess of twice its Tier 1 capital. All eligible acceptances for any one person in excess of 10 percent of an Edge Act corporation's capital must also be fully secured. These aggregate and per customer limitations do not apply if the excess amount represents the international shipment of goods and the Edge Act corporation is fully covered by reimbursement obligations guaranteed by banks or by participation agreements with other banks.

An Edge Act corporation that accepts deposits is subject to customer lending limits with some exceptions, *e.g.*, credits guaranteed by the U.S. Export-Import Bank. An Edge Act corporation must also be capitalized in relation to the scope and character of its activities. For an Edge Act corporation that accepts deposits, its minimum ratio of qualifying total capital to

risk-weighted assets may not be less than 10 percent, of which at least half must be Tier 1 capital. In addition, there is no limit on the amount of subordinated debt that can be included in Tier 2 capital.

The U.S. Supervisory and Examination Regime for the U.S. Operations of Foreign Banks

Risk-focused examination and supervision

The Fed, OCC, FDIC, New York Superintendent of Banks and other state regulators employ a risk-focused examination and supervisory program for foreign bank operations in the United States called the "FBO Supervision Program." This program focuses on an organization's principal risks and its internal systems and processes for managing and controlling these risks.

Examinations and Ratings of Foreign Banking Organizations

U.S. law requires an annual safety and soundness examination of U.S. branches and agencies of foreign banks with total assets greater than $250 million. Branches and agencies with total assets of $250 million or less and that meet certain prudential criteria may be examined once in an 18-month period. Regulators use a three-tiered rating system for foreign banking organizations' operations in the United States.

The Individual and Combined ROCA Rating for Branches or Agencies

Each branch or agency of a foreign bank receives a ROCA rating assessing its Risk management, Operational controls, Compliance, and Asset quality. The Federal or state regulator conducting the examination of a particular branch or agency assigns the ROCA rating. Each of the four ROCA components is rated on a scale of 1 to 5, with 1 and 2 being satisfactory. The branch is then assigned a composite ROCA rating, which is also on a scale of 1 to 5, with ratings of 1 and 2 meriting only normal supervision for the branch or agency. *See Table V.* Examiners disclose composite and component ROCA ratings only to the branch or agency and other U.S. supervisors. The ratings are otherwise confidential.

U.S. bank supervisors also assign a "combined" ROCA rating for all of a foreign bank's U.S. branches, agencies and commercial lending company subsidiaries. This assessment of risk management, operational controls, compliance and asset quality for all branches, agencies and commercial lending company subsidiaries will in turn be factored into the overall Combined U.S. Operations rating assigned the foreign bank (see following discussion). As noted previously, this combined ROCA rating is also important to maintaining the "well managed" status of a foreign bank that elects to be treated as a financial holding company.

Table V
ROCA Rating

1	Strong branch in every respect. Normal supervisory attention required.
2	Modest weaknesses correctable by management. Normal supervisory attention required.
3	Weaknesses in risk management, operational controls and compliance or numerous asset quality problems that, in combination with condition of parent or other factors, cause supervisory concern. In addition, branch or head office management may not be taking the necessary corrective action. Closer supervisory attention required. Special audit procedures are required when both the "Operational controls" component and the composite rating are 3 or worse. *See discussion on bank audit requirements in Chapter 7*.
4	Marginal condition due to serious weaknesses, reflected in the assessments of individual components. Serious problems exist that have not been satisfactorily resolved by branch and/or head office management. Close supervisory attention and definitive plan for corrective action required.
5	Unsatisfactory condition due to a high level of severe weaknesses or unsafe or unsound conditions. Urgent restructuring of operations required by branch and head office management.

The Combined Rating of U.S. Operations

An important supervisory component of the FBO Supervision Program is the integration of individual examination findings into an assessment of a foreign bank's entire U.S. operations—both bank and nonbank. Following an annual supervisory cycle, a Summary of Condition is prepared by the responsible Federal Reserve Bank or other U.S. bank supervisory agency. This Summary of Condition includes an assessment of all risk factors and (i) all elements of the ROCA rating system; (ii) the quality of risk management oversight employed by all levels of the foreign bank in the United States; and

(iii) the examinations of all entities of the foreign bank during the year. The Summary of Condition and rating of the foreign bank's Combined U.S. Operations represent important tools for U.S. supervisors in reaching decisions regarding the scope and frequency of future examinations and appropriate supervisory measures.

The Combined Rating of U.S. Operations is also on a scale of 1 to 5, with ratings of 1 and 2 meriting only normal supervision for the foreign bank's operations. *See Table VI*. Examiners communicate the Summary of Condition, the Combined Rating of U.S. Operations and the Combined ROCA rating in a letter to the Chief Executive Officer at the foreign bank's head office and to other U.S. supervisors. This information is also transmitted to the foreign bank's home country supervisor via a cover letter. The Combined rating is otherwise confidential.

Table VI
Combined Rating of U.S. Operations

1	Overall operations are fundamentally sound. Only normal supervisory attention is required.
2	Combined U.S. operations are basically sound, but have modest weaknesses that can be corrected by management. Only normal supervisory attention is required.
3	Overall U.S. operations are weak in any of the ROC factors of ROCA or have numerous asset quality problems and management may not be taking necessary corrective action. This rating may be assigned when any of the ROC factors of ROCA are individually viewed as unsatisfactory. Enhanced supervisory attention and concern.
4	Combined U.S. operations have a significant volume of serious weaknesses. Serious problems or unsafe or unsound banking practices or operations exist that have not been satisfactorily resolved by U.S. or head office management. These factors require close supervision and surveillance monitoring and a definitive plan for corrective action by head office management.
5	U.S. operations have so many severe weaknesses or unsafe or unsound conditions that they require urgent restructuring by head office management.

The SOSA Rating for the Parent Foreign Bank

A foreign bank receives a SOSA rating, which is a Strength of Support Assessment that addresses the overall financial viability of the foreign bank, as well as several external factors, such as the strength of its management oversight and the degree of supervision the bank receives from its home country supervisor. *See Table VII*. Factors considered in assigning the ranking include the foreign bank's financial condition, the system of home country supervision, the record of home country government support of the banking system or other sources of support, and any transfer risk concern. Also included are managerial factors that raise questions about the foreign bank's oversight of its U.S. operations, such as internal controls and compliance procedures at its U.S. operations, and current activities (*e.g.*, recent merger or reported control problems outside the United States) that may pose a potential risk to U.S. operations. The Fed, in consultation with the other bank regulatory agencies, assigns the SOSA rating.

The SOSA ranking is on a scale of 1 to 3, with 1 representing the lowest level of supervisory concern and 3 the highest. A summary of standards and criteria for these assessments follows:

Table VII
Strength of Support Assessments (SOSA)

1	Financial profile and outlook are consistent with a low risk that foreign bank will be unable to support its operations. Bank is viewed as investment grade or equivalent, capital ratios are at or above internationally accepted minima, and access to dollar funding is readily available. Home country has a good record of supporting and dealing with problem institutions and no transfer risk concern. A foreign bank whose profile might otherwise justify a 1 ranking may be assigned a 2 ranking if its system of home country supervision is lacking or significant transfer risks exist.
2	Current financial profile and outlook do not pose significant concerns, but more than normal review may be warranted based on such factors as lack of an investment grade rating, capital ratios at or below international minima, or other factors. Management and oversight of U.S. operations may be lacking in some respects but are not critically deficient. The home country has demonstrated an ability and willingness to support the foreign bank or similar financial institutions.

3 Significant financial or supervisory weaknesses are apparent. Ability to continue as a going concern may be due primarily to government support, ownership or other significant factors; however, resource or other constraints may place important limitations on such support. In the most extreme cases, a seriously deficient financial profile and/or poor operating practices, together with the absence of sufficient oversight or support, suggest the possibility that the foreign bank may be unable to honor its obligations in the near future or is otherwise considered to present a hazard to U.S. financial markets.

The SOSA ratings and supporting analyses are for U.S. supervisory use only. The evaluations are kept strictly confidential by each of the agencies, in part to ensure that exchanges of supervisory information do not violate state or Federal regulations. The U.S. bank supervisory agencies disclose to each foreign bank, and its home country supervisor, its SOSA ranking and a summary of the key points supporting the ranking. In support of this policy, the Fed has stated, "sharing SOSA ratings should strengthen communications with bank management, as well as enhance information sharing, collaboration and communication between the host (U.S.) and home country authorities in the supervision of multinational banking organizations."

An important source of information on U.S. supervisory policies toward foreign bank branches and agencies is the Fed's *Examination Manual for U.S. Branches and Agencies of Foreign Banks* that was prepared under the direction of Fed and Federal Reserve Bank supervisory staff with substantial contributions from the NY Banking Department, the OCC, FDIC and other state supervisors. The Manual explains the rating and examination system for foreign banks and sets forth examination objectives, procedures, internal control questionnaires and audit guidelines for implementing the system. The Manual can be purchased from the Fed's Publications Department (202.452.3245), and is available on the Fed's website.

Relationships with Offshore or Other Offices

If a U.S. branch or agency of a foreign bank functionally manages or performs activities but books the related asset at an offshore shell branch or other office, Fed examiners will evaluate the functions or activities performed by the branch or agency on behalf of the offshore or other office under the ROC factors of the ROCA rating system. However, the examiner will not evaluate the assets booked at the offshore or other branch, because the "Asset" factor of ROCA applies only to assets on the books of the branch or agency being examined.

When a U.S. branch or agency performs duties on behalf of another office of a foreign bank, such as in the offshore booking example above, the branch or agency should have in place written policies and procedures that clearly delineate the oversight, operational and control responsibilities of the U.S. branch or agency for the interoffice transactions. The foreign bank's head office should be aware of, and in agreement with, this delineation of responsibilities.

Coordination of State and Federal Examinations

Through the efforts of the International Working Group of the Conference of State Bank Supervisors ("CSBS"), two agreements have been entered into by U.S. bank regulators to create a more streamlined system for the supervision of the multistate operations of foreign banks that operate under state license or charter.

The Nationwide Foreign Banking Organization Supervision and Examination Coordination Agreement ("State Coordination Agreement") was made among the state banking departments. Under the Agreement, all foreign banks with multistate operations are subject to a supervision and examination process directed by a State Coordinator. The State Coordinator acts as the single point of contact for coordination of the supervision and examination of the state-licensed and chartered operations of the foreign bank. However, each state supervisor remains primarily responsible for supervising the state-licensed or chartered foreign bank operations in its own state, and for informing the State Coordinator of any information received from the foreign bank or a locally licensed office.

The state supervisors designate a Primary Contact Person for each foreign bank with multistate operations for which they act as the State Coordinator. These individuals jointly coordinate the supervisory and examination responsibilities of their respective agencies with other state and Federal bank supervisory agencies. The designated Primary Contact Persons from the State Coordinator and the Responsible Federal Reserve Bank *(see below)* are responsible, in coordination with the other state supervisors and other participating Federal bank supervisory agencies, for the development of a written comprehensive supervisory plan that is tailored to the foreign bank's structure and risk profile in the United States. State bank supervisors share information, and the coordinating state facilitates any joint enforcement actions by state banking departments.

A second agreement, the Nationwide State/Federal Foreign Banking Organization Supervision and Examination Coordination Agreement ("State/Federal Agreement"), was entered into by State banking departments and the Fed and FDIC. It requires designation of a particular Federal Reserve Bank as the "Responsible Federal Reserve Bank" for all examination and supervisory purposes for a particular foreign bank operating in more than one Federal Reserve District, and requires the designation of a specific FDIC Regional Office to coordinate all of that agency's activities with regard to a particular foreign bank with an insured branch.

Examinations and Ratings of U.S. Bank Subsidiaries

A U.S. bank subsidiary of a foreign bank, like any other U.S. bank, is subject to a full-scope safety and soundness examination by the appropriate Federal or state regulatory authority every 12 or 18 months (depending on the size and condition of the bank). The OCC examines national banks. State banking authorities examine state banks, which are also examined by the Fed, if they are member banks, or the FDIC, if they are non-member banks. The state authorities and the Fed and FDIC generally conduct alternate or joint examinations so that a bank is subject to only one safety and soundness examination per year. Federal or state examiners assign the bank a CAMELS rating. The CAMELS rating assesses the adequacy of a U.S. bank subsidiary's Capital, Asset quality, Management, Earnings, Liquidity and Sensitivity to market risk. Examiners rate each element on a 1 to 5 score. A composite rating of 1 to 5 is then provided to the bank.

Banks that receive composite CAMELS ratings of 1 or 2 receive only normal supervisory attention. In assigning both component and composite ratings, the supervisory agencies put special emphasis on the ability of the bank's management to identify, measure, monitor and control the risks of the bank's operations. The ability of management to respond to changing circumstances, to address risks arising from changing business conditions or the initiation of new activities or products are also important factors used by the agencies in evaluating a bank's overall risk profile and the level of supervisory attention warranted. The composite and component CAMELS ratings are disclosed to the bank and other supervisors, but may not be publicly disclosed.

Specialty Examinations

The supervisory agencies also conduct specialty examinations of U.S. bank subsidiaries and U.S. branches and agencies, depending upon whether the subsidiary or institution engages in certain activities. For example, specialty examinations include such areas as Anti-Money Laundering Compliance, Compliance with consumer banking laws and regulations, Community Reinvestment, Government Security Dealers, Municipal Security Dealers, Transfer Agent and Trust activities.

Representative Office Examinations

The Fed's approach toward examinations of representative offices depends upon two factors: (i) whether the foreign bank has a banking presence in the United States; and (ii) the scope of activities performed by the representative office. A representative office that engages in loan production or trading-related functions and which was established by a foreign bank with a banking presence, *e.g.*, has a U.S. branch, agency, or bank or commercial lending company subsidiary, will be subject to examination under the ROC factors of ROCA, with an accompanying examination report. If the office's functions are limited to more traditional marketing or related functions, it will be subject only to a brief compliance-oriented review, with no examination report required.

A representative office established by a foreign bank that has no U.S. banking presence would be subject to a ROC-type review described above, if it has a large number of employees or is known to engage in a wide range of activities. Otherwise, it would only be subject to a brief compliance-oriented review. Representative offices may also be examined by state banking agencies, which examination generally focuses on compliance with state law activity limitations.

Examinations of Edge Act Corporation, Agreement Corporation and Commercial Lending Company Subsidiaries

Edge Act corporation subsidiaries are subject to a separate Fed examination at least once a year. Agreement corporations are subject to Fed examination at such time as may be fixed by the Fed. An Edge or Agreement corporation must make available to Fed examiners information sufficient to assess its condition and operations and the condition and activities of any organization whose shares it holds. Article XII New York Investment Company (commercial lending company) subsidiaries are subject to annual examinations by the New York Banking Department.

Holding Company Regulation

Capital Adequacy Requirements U.S. Bank and Financial Holding Companies

U.S. bank holding companies are subject to the same risk-based and leverage capital requirements imposed on U.S. banks, but may include more and different types of perpetual preferred stock in Tier 1 capital. In situations where a foreign bank owns a U.S. bank indirectly through one or more intermediate U.S. bank holding companies, the Fed has had a long-standing practice of applying its U.S. bank holding company capital adequacy standards to the top-tier U.S. bank holding company owned by the foreign bank. The Fed has stated, however, that it will not generally require any intermediate U.S. bank holding company to meet U.S. bank holding company capital adequacy standards if the parent foreign bank is a financial holding company that the Fed has determined to be well capitalized and well managed. Essentially, in the case of a foreign bank FHC, since the Fed has already determined that the parent foreign bank meets U.S. bank standards for being well capitalized, there is no reason to impose a bank holding company capital requirement on a U.S. bank holding company that may own the U.S. bank subsidiary. However, the Fed has reserved the right to require an intermediate U.S. bank holding company to maintain higher capital levels where such levels are appropriate to ensure its U.S. activities are operated in a safe and sound manner.

Supervision of Bank and Financial Holding Companies and their Nonbank Subsidiaries

Bank holding companies are subject to annual inspections by the Fed. The Fed also periodically inspects a bank holding company's nonbank subsidiaries that are significant in size or that have a high-risk profile in order to assess their impact on the financial condition of the holding company and its bank subsidiaries. As with bank supervision, the Fed employs a risk-focused inspection program for bank holding companies and their subsidiaries. In this regard, given potentially rapid changes in risk profiles, the Fed's supervisory approach for Large Complex Banking Organizations ("LCBOs"), including large foreign banks with U.S. banking operations, has gravitated to a more continuous supervisory process, placing increased emphasis on an organization's internal systems and controls for managing risk.

Under the GLB Act, the Fed's supervisory oversight role for financial holding companies is that of an "umbrella supervisor" concentrating on a consolidated or group-wide analysis of an organization. The Fed, as umbrella supervisor, will assess the holding company on a consolidated or group-wide basis with the objective of ensuring that the holding company does not threaten the viability of its U.S. depository institution subsidiaries. The manner in which the Fed fulfills this role may differ depending on the mix of banking, securities and insurance activities of a financial holding company.

Depository institution subsidiaries of bank and financial holding companies are supervised by their appropriate primary bank or thrift supervisor (Federal and state). The GLB Act did not alter the role of the Fed, as holding company supervisor, vis-à-vis the primary supervisors of bank and thrift subsidiaries because the Fed has traditionally relied to the fullest extent possible on those supervisors.

U.S. nonbank (or non-thrift) subsidiaries of financial holding companies engaged in securities, commodities or insurance activities are supervised by their appropriate functional regulators. Such functionally regulated subsidiaries include (i) a broker, dealer, investment adviser and investment company registered with and regulated by the SEC (or, in the case of an investment adviser, registered with any state), (ii) an insurance company or insurance agent subject to supervision by a state insurance regulator, and (iii) a nonbank subsidiary engaged in Commodities Futures Trading Commission regulated activities.

Under the GLB Act, the Fed may require reports from or examine such "functionally regulated" subsidiaries of financial holding companies only in very limited circumstances, *e.g.*, the subsidiary is engaged in an activity that poses a material risk to an affiliated depository institution. The Fed has indicated that it will pursue a cooperative and coordinated supervisory approach with such functional regulators to avoid any duplicative supervision.

For a subsidiary of a financial holding company that is not supervised by a bank, thrift or functional regulator, the Fed will obtain information from the subsidiary, as appropriate and necessary, to assess the financial condition of the financial holding company as a whole. In addition, the Fed will conduct examinations of such subsidiaries, if necessary, to be informed as to the nature of the subsidiary's operations and financial condition, as well as the subsidiary's financial and operational risks that may pose a threat to the safety and soundness of any depository institution subsidiary of the financial holding company and the systems for monitoring and controlling such risks. Under the GLB Act, the Fed may not examine any subsidiary of a financial holding company that is an investment company registered with the SEC and that is not itself a bank holding company.

Confidentiality of Information in Examination and Inspection Reports

Documentation obtained from U.S. banks, U.S. operations of foreign banks and bank affiliates during the course of agency examinations or inspections, as well as examiner workpapers, memoranda and reports of examination or inspection, are considered by the banking agencies to be highly confidential supervisory and examination information. While the policies of the Federal bank regulatory agencies permit external auditors to have access to certain regulatory and examination reports and supervisory documents for depository institutions under audit, information contained in examination reports, inspection reports and supervisory discussions—including any summaries or quotations—is confidential supervisory information and may not be disclosed by institutions or their auditors to any party without the written permission of the appropriate Federal regulatory agency. Unauthorized disclosure of confidential supervisory information may subject the bank or auditor to civil and criminal actions and fines and other penalties.

Chapter 5

Areas of Regulatory or Supervisory Focus for U.S. Operations of Foreign Banks

Regulatory Guide
for Foreign Banks in
the United States*

2005–2006 edition

Chapter 5
Areas of Regulatory or Supervisory Focus for U.S. Operations of Foreign Banks

Banking Activities and Operations

Federal and State Lending Limits

A Federally chartered national bank may not extend credit to any one borrower in excess of 15 percent of the bank's capital. Capital for this purpose means total risk-based capital (defined under the Basel Accord as implemented in the United States), plus any portion of general loan loss reserves not included in Tier 2 capital. A national bank may extend credit to the same borrower in amounts up to an additional 10 percent of the bank's capital if such extensions of credit are fully secured by readily marketable collateral with a market value at least equal to the additional amount loaned. These lending limits apply not only to direct loans, but also to certain indirect credit obligations (such as an endorsement of commercial paper) and contingent obligations (such as standby letters of credit). The limits do not apply, however, to 10 specified kinds of self-liquidating, specially secured or government-guaranteed extensions of credit.

The same limitations apply to a Federal branch or agency of a foreign bank, but the percentage is measured against the parent foreign bank's capital. If a foreign bank has more than one Federal branch or agency, transactions of all its Federal branches and agencies must be aggregated to determine compliance with the lending limits.

The laws regulating state-chartered banks also establish limits on their lending. The state lending limits are similar to Federal lending limits, but with some variations. State branches and agencies of foreign banks generally must comply with state bank lending limits, again applied on the basis of parent foreign bank capital.

Aggregate Branch and Agency Lending Limit

A foreign bank's aggregate credit exposure to any one borrower (or related group of borrowers) at all of its U.S. branches and agencies, both Federal and state combined, may not exceed the national bank lending limit as applied to Federal branches and agencies. This means that a foreign bank must combine loans to the same borrower, or related group of borrowers, at all of its branches and agencies in the United States, which aggregate amount may not exceed 15 percent of the parent bank's capital, and an additional 10 percent of the parent bank's capital secured by readily marketable collateral. This aggregate limit does not include loans by a U.S. subsidiary bank, which are subject to that bank's separate lending limit.

Reserve Requirements

Every banking institution that accepts deposits, whether operating under Federal or state authority, must comply with the Fed's reserve requirement regulations. U.S. branches and agencies of foreign banks are required to maintain the same reserves as domestic banks. Institutions must maintain reserves exclusively in the following forms:

- Vault cash;
- Balances with a Federal Reserve Bank; or
- Pass-through accounts with correspondent banks.

The following reserve ratios currently apply to all depository institutions, Edge Act and Agreement corporations, and branches and agencies of foreign banks in the United States.

Deposit Category	Reserve Requirement
Net transaction accounts:	
• $0 to $7 million*	0 percent
• Over $7 million and up to $47.6 million*	3 percent
• Over $47.6 million	$ 1,218,000 plus 10 percent of amount over $47.6 million
Non-personal time deposits	0 percent
Eurocurrency liabilities	0 percent

* These lower reserve tranche amounts are adjusted each year.

These reserve requirements have some complex exceptions and additions. Many institutions also offer wholesale or retail cash management programs that sweep end-of-day balances in transaction accounts to other deposits or instruments not subject to reserve requirements. Deposits booked in IBFs or in foreign offices of U.S. or foreign banks are not subject to reserve requirements. U.S. branches and agencies of foreign banks have the option of maintaining reserves on a same state/same Federal Reserve District basis or of aggregating reserves on a nationwide basis with a single, pass-through correspondent bank.

Discount Window Access

Like other U.S. depository institutions, U.S. bank subsidiaries of foreign banks that maintain reserve requirements have access to the Fed's discount window. U.S. branches and agencies of foreign banks that are subject to reserve requirements also have access to the discount window in the same manner and to the same extent as U.S. depository institutions.

Beginning in January of 2003, the Fed made a number of significant changes to its discount window programs. Adjustment credit, which was extended at a below-market rate, has been replaced with a new type of discount window credit called "primary credit" that is broadly similar to credit programs offered by many other major central banks. The Fed has indicated that U.S. depository institutions with CAMELS ratings of 1, 2 or 3 that are adequately capitalized and foreign banks with SOSA rankings of 1 or 2 and a ROCA, Combined ROCA or Combined U.S. Operations rating of 1, 2 or 3 will be considered eligible for primary credit unless supplementary information indicates their condition is not generally sound.

Reserve Banks extend primary credit at a rate 100 basis points above the Federal funds rate, which eliminates any incentive for institutions to borrow for the purpose of exploiting the positive spread of money market rates over the discount rate. Reserve Banks establish the primary credit rate at least every two weeks, subject to review and determination by the Federal Reserve Board in Washington.

By employing an above-market rate and restricting eligibility to generally sound institutions, the primary credit program is intended to reduce the need for the Federal Reserve Banks to review the funding situations of borrowers and monitor the use of borrowed funds. This reduced administration is intended to make the discount window a more attractive funding source for depository institutions when money markets tighten. The Fed has suggested that by enhancing the availability of discount window credit, the primary credit program offers depository institutions an additional source of backup funds for managing short-term liquidity risks and thus can enhance the diversification of contingency funds. Accordingly, the Fed believes that examiners and supervisors should view the occasional use of primary credit as appropriate. To use the primary credit program, a depository institution should have the necessary collateral arrangements and documentation in place with the appropriate Reserve Bank (all borrowing from the Federal Reserve Banks must be secured).

There is also a secondary credit program that is available in appropriate circumstances to depository institutions that do not qualify for primary credit. The secondary credit rate is normally set by the Federal Reserve Banks at a level 50 basis points above the primary credit rate.

Daylight Overdraft Limits for Foreign Banks

The Fed has adopted a policy to reduce the risks that large-dollar payment systems present to the Federal Reserve Banks, to the banking system and to other sectors of the economy. An integral component of the Fed's policy is a program to control the usage of intraday Federal Reserve credit, which is commonly referred to as "daylight credit" or "daylight overdrafts." A daylight overdraft occurs when a depository institution's Federal Reserve Account is in a negative position during the business day.

To reduce the risks of daylight credit or daylight overdrafts, the Fed has adopted a Policy Statement on Payments System Risk ("PSR") establishing limits on the amount of Federal Reserve daylight credit that may be used by a depository institution during a single day or on average over a two-week period. The policy also permits Reserve Banks to protect themselves from the risk of loss by requiring collateral to cover daylight overdrafts in certain circumstances, or by restricting the use of Federal Reserve payment services by institutions that incur frequent, excessive overdrafts.

The Fed's PSR policy includes a schedule of fees to be assessed for institutions' use of Federal Reserve daylight credit to provide a financial incentive for institutions to control their use of intraday Federal Reserve credit and to recognize explicitly the risks inherent in the provision of intraday credit. The daylight overdraft measurement method, which incorporates a set of nearly real-time transaction posting rules, is intended to help institutions control their use of Federal Reserve intraday credit by providing greater certainty about how their payment activity affects their Federal Reserve account balance during the day.

Under the Federal Reserve's PSR program, each depository institution that maintains a Federal Reserve account is assigned or may establish a daylight overdraft "net debit cap," which is a ceiling on the daylight overdraft position that an institution can incur during a given interval. An institution's cap category and capital measure determine the size of its net debit cap. An institution that wishes to establish a net debit cap of "average" to "high" must perform a self-assessment of its own creditworthiness and operational and other factors. Each institution's board of directors must review the self-assessment and determine the appropriate cap category. Documentation of the self-assessment must be made available for review by bank examiners.

For U.S. branches and agencies of foreign banks, net debit caps on daylight overdrafts in Federal Reserve accounts are calculated by applying the cap multiples for each cap category to the foreign bank's U.S. capital equivalency measure. U.S. capital equivalency (in the context of daylight overdrafts) is equal to the following:

- 35 percent of (worldwide) capital for foreign banks that are FHCs;
- 25 percent of (worldwide) capital for foreign banks that are not FHCs and have a SOSA ranking of 1;
- 10 percent of (worldwide) capital for foreign banks that are not FHCs and are ranked a SOSA 2; or
- 5 percent of "net due to related depository institutions" for foreign banks that are not FHCs and are ranked a SOSA 3.

These capital measures represent a substantial increase from previous limits and were intended to address liquidity concerns of branches and agencies of foreign banks, which often demonstrated cap utilization levels well in excess of utilization levels of domestic banks. However, there is still some concern among foreign banks that they may be at a competitive disadvantage in clearing payments because the Fed only recognizes 35% of the capital of top foreign banks versus 100% for domestic banks. The Fed has also recognized that while net debit caps provide sufficient liquidity to most institutions, some depository institutions still experience liquidity pressures. The Fed may thus allow certain depository institutions with self-assessed net debit caps, including branches and agencies of foreign banks, to pledge collateral to their administrative Reserve Bank to secure daylight overdraft capacity in excess of their net debit caps, subject to Reserve Bank approval.

Secondary Market Credit Activities

U.S. and foreign banks often engage in significant secondary market credit activities such as loan syndications, loan sales and participations, credit derivatives and asset securitizations and also provide credit enhancements and liquidity facilities to support such transactions. The Federal banking agencies have indicated that banking institutions should explicitly incorporate the full range of risks of their secondary market credit activities into their overall risk management systems. In particular, regulators expect institutions to: (i) adequately identify, quantify and monitor these risks; (ii) clearly communicate the extent and depth of these risks to senior management and the Board of Directors and in regulatory reports; (iii) conduct

ongoing stress testing to identify potential losses and liquidity needs under adverse conditions; and (iv) establish internal standards for allowances or liabilities for losses, capital and contingency funding.

Although U.S. branches and agencies of foreign banks are expected to meet the above expectations, the banking agencies have indicated that appropriate adaptations may be necessary to reflect that: (i) such offices are an integral part of a foreign bank, which should manage its risks on a consolidated basis and recognize that there may be possible obstacles to cash movements among branches; and (ii) the foreign bank is subject to overall supervision by its home country authorities.

Complex Structured Finance Transactions

Federal banking regulators have expressed increased supervisory concern with banks' risk management practices in providing complex structured financial products to wholesale customers. Because certain customers may have used such products in the past to obscure financial statements and hamper sound analysis used by creditors and investors, or to engage in questionable and improper tax strategies, banks providing such services need to have in place sound risk management practices to deal with potentially significant credit, legal and reputational risks.

In May of 2004, the federal banking agencies and SEC sought public comment on a *Proposed Statement on Sound Practices Concerning the Complex Structured Finance Activities of Financial Institutions*. The Statement describes a number of internal controls and risk management procedures that the agencies believe are particularly useful in assisting financial institutions to ensure that their complex structured financial activities are conducted in accordance with applicable law and that institutions effectively manage the full range of risks associated with these activities, including legal and reputational risks. Financial institutions should consider the Statement in developing and evaluating the institution's risk controls for complex structured finance activities.

As a general matter, the Statement indicates that financial institutions offering complex structured finance transactions should maintain a comprehensive set of formal, firm-wide policies and procedures that provide for the identification, documentation, evaluation, and control of the full range of credit, market, operational, legal, and reputational risks that may be associated with these transactions. These policies and procedures should be designed to ensure that the financial institution consistently and appropriately manages its complex structured finance activities on both a per transaction and relationship basis, with all customers (including corporate entities, government entities, and individuals) and in all jurisdictions where the financial institution operates. The Statement indicates that the board of directors of a financial institution has ultimate responsibility for establishing the institution's risk tolerances for complex structured finance transactions and ensuring that a sufficiently strong risk control framework is in place to guide the actions of the financial institution's personnel. The board of directors and senior management also should send a strong message to others in the financial institution about the importance of integrity, compliance with the law, and overall good business ethics, which may be implemented through a Code of Professional Conduct.

As described further in the Statement, an institution's policies and procedures should define what constitutes a complex structured finance transaction and should, among other things:

- Define the process that financial institution personnel must follow to obtain approval for complex structured finance transactions;
- For institutions supervised by the Fed, the OCC, the OTS, and the FDIC the statement will represent supervisory guidance;
- Establish a control process for the approval of all "new" complex structured finance products;
- Ensure that the reputational and legal risks associated with a complex structured finance transaction, or series of transactions, are identified and evaluated in both the transaction and new product approval process and appropriately managed by the institution;
- Ensure that financial institution staff appropriately reviews and documents the customers' proposed accounting treatment of complex structured finance transactions, financial disclosures relating to the transactions, and business objectives for entering into the transactions;
- Provide for the generation, collection and retention of appropriate documentation relating to all complex structured finance transactions;

- Ensure that senior management and the board of directors of the institution receive appropriate and timely reports concerning the institution's complex structured finance activities;

- Provide for periodic independent reviews of the institution's complex structured finance activities to ensure that the institution's policies and controls are being implemented effectively and to identify potential compliance issues;

- Ensure effective internal audit coverage of the institution's complex structured finance activities; and

- Ensure that financial institution personnel receive appropriate training concerning the institution's policies and procedures governing its complex structured finance activities.

Affiliate Transactions and Regulation W

As discussed previously, Sections 23A and 23B of the Federal Reserve Act restrict transactions between U.S. depository institutions and their affiliates and thus primarily impact U.S. depository institution subsidiaries of a foreign bank. However, effective April 1, 2003, the Fed's Regulation W applies Sections 23A and 23B to transactions between U.S. branches and agencies of foreign banks and U.S. affiliates engaged in securities underwriting and dealing, merchant banking, insurance underwriting and insurance investment activities permissible under the GLB Act for financial holding companies ("GLB affiliates"). For purposes of the capital limitations in Section 23A, a U.S. branch or agency uses the capital of its parent foreign bank. The Fed may also in the future apply Sections 23A and 23B to transactions between a U.S. branch or agency and U.S. affiliates engaged in new activities authorized for financial holding companies under the GLB Act.

The Fed imposed these restrictions on U.S. branches and agencies on the basis of Section 114 of the GLB Act, which grants the Fed authority to impose prudential safeguards governing relationships or transactions between a U.S. branch or agency of a foreign bank and any U.S. affiliate thereof in order to avoid, among other consequences, "significant risk to the safety and soundness of depository institutions or any Federal deposit insurance fund or other adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest or unsound banking practices." In deciding to apply Regulation W to U.S. branches and agencies, the Fed expressed its concern that foreign banks might gain a competitive advantage over domestic banking organizations if Sections 23A and 23B were not applied to their U.S. branches and agencies in the case of affiliates engaged in expanded financial activities authorized under the GLB Act.

As required by the GLB Act, Regulation W also addresses the application of Sections 23A and 23B to derivatives and intraday credit transactions by requiring U.S. banks (and U.S. branches and agencies of foreign banks with respect to transactions with GLB affiliates) to have policies and procedures for monitoring, managing and controlling credit risks arising from derivatives and intraday credit transactions with affiliates. Of particular importance under Regulation W is the ability of banks to document that such transactions comply with the arm's length dealing standards of Section 23B, *i.e.*, that a bank's derivative transactions with affiliates are on the same basis, including credit standards, that would be done with an unaffiliated counterparty. The Fed and its staff have generally indicated that this arm's length standard will be strictly applied.

Although Regulation W does not generally apply Section 23A to bank derivatives transactions with affiliates, it does treat as a "covered transaction" for purposes of Section 23A, credit derivatives where a bank protects a nonaffiliate from default by an affiliate. In publishing Regulation W, the Fed indicated that it was seeking further public comment on how to treat as covered transactions under Section 23A other derivatives that are the functional equivalent of a loan to an affiliate or an asset purchase from an affiliate

Sarbanes-Oxley Corporate Governance Requirements and Foreign Companies

The SEC has recognized that aspects of SARBOX may pose special concerns for foreign market participants accessing the US capital markets. Congress was clear that SARBOX generally should make no distinction between domestic and foreign firms. The SEC has also realized, however, that the application of U.S. rules to foreign companies must be done in a reasonable, measured way, as has been its historical practice. One of the greatest challenges that the SEC has faced in implementing SARBOX has been to fulfill its congressional mandate, while also respecting foreign laws and regulatory schemes.

In April 2003, the SEC adopted a new rule directing the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the audit committee requirements mandated by SARBOX. All members of the audit committees of public companies must be independent directors and audit com-

mittees must be directly responsible for the appointment, compensation and oversight of the issuer's audit firm. Also, the committee must establish procedures for handling complaints regarding accounting and internal control matters of the issuer, including confidential methods for addressing concerns raised by employees.

Based on a consideration of various conflicting foreign legal requirements, the SEC's rule includes certain accommodations for foreign private issuers that take into account foreign corporate governance schemes, while preserving the intention of SARBOX to ensure that those responsible for overseeing a company's outside auditors are independent of management. These accommodations include:

- Allow nonmanagement employees to serve as audit committee members, consistent with "co-determination" and similar requirements in some countries;
- Allow shareholders to select or ratify the selection of auditors, also consistent with requirements in many foreign countries;
- Allow alternative structures such as statutory auditors or boards of auditors to perform auditor oversight functions where they are authorized by home country requirements, they are not elected by management of the issuer, and no executive officer of the issuer is a member; and
- Allow for foreign government and controlling shareholder representation on audit committees.

Information Technology and its Outsourcing

Bank examiners explicitly consider information technology when developing their risk assessments and supervisory plans. Safety and soundness examiners are coordinating with information technology specialists to determine the scope of supervisory activities in this area for individual institutions.

Examiners must assess the banking organization's critical systems, *i.e.*, those that support major business activities and the degree of reliance those systems have on information technology. While deficiencies appear to be most directly related to operational risk, information technology can also affect other business risks, *e.g.*, credit, market, liquidity, legal and reputational. Examiners thus view information technology elements in an integrated manner with the overall business risks of the organization or business activity. The five key information technology elements that have been identified by U.S. regulators are (i) management processes, (ii) architecture, (iii) integrity, (iv) security and (v) availability.

Financial institutions increasingly rely on services provided by other entities to support an array of technology related functions. To ensure the proper management of risks associated with such outsourcing, the agencies have adopted formal regulatory guidance on the type of risk management process U.S. banks and U.S. branches and agencies of foreign banks should follow in the selection and monitoring of third-party vendors. The guidance puts special emphasis on due diligence analysis in the selection of a provider, contract issues and oversight.

Information Security

The Fed and other Federal banking agencies have expressed heightened supervisory interest in information security at banking organizations in order to maintain a high degree of trust in the U.S. banking system. A guidance paper, developed by the FRBNY from its visits with a cross-section of 34 financial institutions, provides a basis for senior management of financial institutions to evaluate their own information security practices. Although the sound practices described in the paper are not regulations, they are nonetheless used by Federal bank examiners as best practice guidelines in evaluating information security measures. (The FRBNY study did not include a review of traditional security practices conducted in a mainframe data center environment.)

The paper presents a management overview of three major information security issues:

- Security of private local and wide area networks;
- Value transfer systems connected to private local and wide area networks; and
- Confidentiality of information transmitted over public networks without encryption.

Business Recovery Planning

In April of 2003, three federal regulatory agencies—the Fed, OCC and SEC—*issued an Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System*. In the Paper, the agencies identify broad industry consensus on three business continuity objectives that have special importance after September 11, 2001, for all financial firms:

- Rapid recovery and timely resumption of critical operations following a wide-scale disruption;
- Rapid recovery and timely resumption of critical operations following the loss or inaccessibility of staff in at least one major operating location; and
- A high level of confidence, through ongoing use or robust testing, that critical internal and external continuity arrangements are effective and compatible.

The events of September 11, 2001 underscored the fact that the financial system operates as a network of interrelated markets and participants. The ability of an individual participant to function can have wide-ranging effects beyond its immediate counterparties. Because of the interdependent nature of the U.S. financial markets, the agencies believe that all financial firms have a role in improving the overall resilience of the financial system. All financial firms are thus expected to review their business continuity plans and incorporate these three broad business continuity objectives to the fullest extent practicable.

The agencies indicated in the Paper that the resilience of the U.S. financial system in the event of a "wide-scale disruption" rests on the rapid "recovery" and "resumption" of the "clearing and settlement activities" that support "critical financial markets." Some organizations, namely "core clearing and settlement organizations" and "firms that play a significant role in critical financial markets," present a type of "systemic risk" to the U.S. financial system should they be unable to recover or, in some instances, resume clearing and settlement activities that support those markets. The Paper defines these terms and organizations. The agencies then identify four broad sound practices for these "core clearing and settlement organizations" and "firms that play significant roles in critical financial markets." The sound practices are:

- Identify clearing and settlement activities in support of critical financial markets;
- Determine appropriate recovery and resumption objectives for clearing and settlement activities in support of critical markets;
- Maintain sufficient geographically dispersed resources to meet recovery and resumption objectives; and
- Routinely use or test recovery and resumption arrangements.

The sound practices focus on the appropriate backup capacity necessary for recovery and resumption of clearance and settlement activities for material open transactions in wholesale financial markets. They do not address the recovery or resumption of trading operations or retail financial services.

In the Paper, the agencies are not recommending that firms move their primary offices, primary operating sites, or primary data centers out of metropolitan locations, and understand that there are important business and internal control reasons for financial firms to maintain processing sites near financial markets and their own headquarters. The agencies also recognize that achieving the sound practices could be a multiyear endeavor for some firms and that it is not necessary or appropriate to prescribe any specific technology solution or limit a firm's flexibility to implement the sound practices in a manner that reflects its own risk profile. The sound practices discussed in the Paper supplement the agencies' respective policies and other guidance on business continuity planning.

Consumer Protection Banking Laws and Regulations

Foreign banks that conduct consumer banking activities in the United States—whether through banking offices or subsidiaries—must also comply with a host of U.S. consumer protection laws and regulations applicable to such activities. A description of such laws and their implementing regulations—which are very complex and detailed—is beyond the scope of this Guide. Further information can be found on the websites of the Federal banking agencies.

Consumer Privacy

U.S. laws and regulations governing the privacy of consumer financial information impose three requirements established by the GLB Act:

- Financial institutions must provide initial notices to consumer "customers" about their privacy policies, describing the conditions under which they may disclose nonpublic personal information to nonaffiliated third parties and affiliates. These notices must be accurate, clear and conspicuous.

- Financial institutions must provide annual notices of their privacy policies to their current consumer customers. These notices must be accurate, clear and conspicuous.

- Financial institutions must provide a reasonable method for consumers to "opt out" of disclosures to nonaffiliated third parties. That is, consumers must be given a reasonable opportunity to "opt out" and a reasonable means to do so. Consumers may exercise their "opt-out" option at any time.

The regulations apply to financial institutions, including U.S. branches and agencies and bank subsidiaries of foreign banks, for which the Federal banking agencies have primary supervisory authority. For foreign bank branches and agencies, bank areas dealing with private banking or individual clients will be most impacted by these regulations, as the regulations do not apply to commercial customers.

The states have also been enacting consumer privacy requirements and financial institutions will also have to comply with applicable state laws that impose broader restrictions than the GLB Act.

The Federal banking agencies have also issued guidelines required by the GLB Act establishing standards for financial institutions relating to the administrative, technical and physical safeguards for customer records and information. The Guidelines require institutions—including U.S. branches and agencies of foreign banks—to establish an information security program to assess and control risks to customer information. Each institution may implement a program appropriate to its size and complexity and the nature and scope of its operations.

In December 2003, the President signed the Fair and Accurate Credit Transactions Act (the "FACT Act") into law. The FACT Act amends the Fair Credit Reporting Act ("FCRA") in numerous respects and also includes provisions to address identity theft, the accuracy of consumer reports, the duties of furnishers of information, the ability of consumers to opt out of receiving marketing solicitations from an organization when the solicitation is based on information provided to that organization by its affiliate, and the ability of creditors to obtain or use medical information in connection with determining credit eligibility. Proposed and final rules have been issued in a number of areas covered by the legislation.

Scope of Nonbanking Activities

Bank Holding Companies

No bank holding company may engage within the United States in any activities except those permitted by the BHC Act as "exempt" activities or as types of activities that the Fed has determined to be so closely related to banking as to be a proper incident thereto under Section 4(c)(8) of the BHC Act. Permitted exempt activities include certain servicing, portfolio investment and other activities, such as forming subsidiaries to hold foreclosed properties and bank premises.

A foreign bank controlling a separately chartered U.S. subsidiary bank is a bank holding company under the BHC Act and is subject to these restrictions on nonbanking activities within the United States. Any foreign bank that maintains a branch or agency, or commercial lending company or Edge Act or Agreement subsidiary in the United States (defined for this purpose as a "foreign banking organization or FBO") is similarly restricted in its nonbanking activities to those permissible for a U.S. bank holding company.

The GLB Act allows a bank holding company or FBO to engage in activities which the Fed, by order or regulation, had determined to be "closely related to banking" as of November 11, 1999. The Fed may not expand this list; however, it may modify or remove conditions or limitations that it has imposed on such permissible activities.

Financial Holding Companies

As previously discussed, the GLB Act also created a new subset of bank holding companies called financial holding companies that may engage in a much broader range of financial activities than bank holding companies, including insur-

ance underwriting and merchant banking activities. Pursuant to Fed regulations implementing the GLB Act, the following activities are permissible for a financial holding company:

Closely Related to Banking Activities. A permissible "closely related to banking" activity includes:

- Any activity that the Fed had determined by regulation prior to November 12, 1999, to be so closely related to banking as to be a proper incident thereto, subject to the terms and conditions imposed, unless modified by the Fed. In this connection, the Fed has proposed to change the conditions that govern the conduct of financial data processing activities previously found to be closely related to banking in order to permit all bank holding companies to conduct a greater amount of nonfinancial data processing in connection with the processing of financial data.

- Any activity that the Fed had determined by an order that was in effect on November 12, 1999, to be so closely related to banking as to be a proper incident thereto, subject to the terms and conditions contained in the authorizing orders. Examples of such activities include providing administrative and other services to mutual funds, acting as a certification authority for digital signatures, check cashing and wire transmission services and other activities.

Activities Permissible Outside the United States. Any activity that the Fed has determined by regulation in effect on November 11, 1999, to be usual in connection with the transaction of banking or other financial operations abroad, subject to any conditions imposed by the Fed's Regulation K. Historically, bank holding companies have been able to engage in a broader range of financial activities outside the United States. Most of these activities overlap with activities that are closely related to banking or with activities permissible under the GLB Act. However, this authority does permit financial holding companies to engage in certain additional activities, including providing management consulting services, operating a travel agency, and organizing, sponsoring and managing a mutual fund, subject to certain conditions.

Financial Activities. Any activity defined to be "financial in nature" under the GLB Act:

- Lending, exchanging, transferring, investing for others, or safeguarding money or securities;

- Underwriting, dealing and making markets in securities;

- Insuring, guaranteeing, or indemnifying against harm, loss, illness, disability or death, as principal or broker;

- Issuing or selling annuities;

- Providing financial or investment advisory services to individuals, businesses and mutual funds;

- Issuing or selling interests in pools of assets that a bank could own;

- Owning shares or assets acquired as part of underwriting or merchant banking activities; and

- Owning through an insurance company shares or assets acquired as an investment in the ordinary course of business.

New Activities. This authority also includes any other activities that the Fed and Treasury, through a consultative process, determine to be financial in nature. The Fed and Treasury have made use of this authority by authorizing financial holding companies to act as a "finder" by bringing together buyers and sellers of financial and nonfinancial products for transactions that the buyers and sellers themselves negotiate and consummate. This allows financial holding companies, among other things, to host an Internet marketplace consisting of links to the websites of third-party buyers and sellers. The Fed and Treasury have also proposed to permit financial holding companies to act as real estate brokers and managers. This proposal, which was made on March 2, 2001, is strongly opposed by the U.S. real estate brokerage industry and is currently dormant.

Complementary Activities. Under the GLB Act, a financial holding company may also engage in any nonfinancial activity that the Fed determines to be "complementary to a financial activity." The Fed interprets this to mean that the activity must in some way complement or enhance a financial activity or there must be a relationship or connection between the complementary activity and a financial activity.

To become a financial holding company, a bank holding company must demonstrate in an elective filing with the Fed that its U.S. banking subsidiaries are "well capitalized" and "well managed" and have satisfactory CRA ratings. These bank subsidiary requirements must be maintained to preserve the advantages of financial holding company status.

A foreign bank that is a bank holding company can elect to become a financial holding company if its bank subsidiary(ies) meets the criteria described above. However, if a foreign bank has a branch or agency in the United States and wishes to be "treated" as a financial holding company, it must demonstrate that the foreign bank itself meets certain "well capitalized" and "well managed" criteria that the Fed believes to be "comparable" to those required of U.S. bank subsidiaries of U.S. bank holding companies. *(See earlier discussion in this Chapter.)* If a foreign bank both controls a U.S. bank and has branches or agencies, it must meet both sets of criteria to become a financial holding company, *i.e.*, its bank subsidiaries must meet "well capitalized," "well managed" and CRA criteria, and the foreign bank itself must meet comparable "well capitalized" and "well managed" criteria.

Securities Activities

Holding Companies

The Glass-Steagall Act restricted ownership affiliations between banks and securities firms. However, through regulatory interpretations and guidance under the BHC Act, the Fed, during the late 1980s and 1990s, had permitted banks to become affiliated through parent bank holding companies with securities firms earning not more than 25 percent of their gross revenues from underwriting and dealing in ineligible securities, i.e., securities that a bank could not underwrite or deal in directly. These securities firms are called "Section 20" companies since they are not "principally engaged" in securities activities prohibited to member banks and thus complied with Section 20 of the Glass-Steagall Act.

The GLB Act repealed Sections 20 and 32 of the Glass-Steagall Act, which had restricted bank affiliations with securities firms through affiliation and interlock prohibitions. Securities firms owned by financial holding companies (or foreign banking organizations treated as financial holding companies) benefit fully from this repeal and are not subject to any Section 20 revenue limitations on the types of securities activities they may conduct. However, to date, the Fed has chosen not to remove its Section 20 revenue limitations on securities firms owned by bank holding companies (or foreign banking organizations treated as bank holding companies).

There are two types of Section 20 subsidiaries permitted by the Fed under the BHC Act. Tier 1 subsidiaries may not derive more than 25 percent of their gross revenues from underwriting and dealing in any of four types of ineligible securities: municipal revenue bonds, commercial paper, mortgage-backed securities, and securities backed by credit cards or other consumer receivables. Tier 2 subsidiaries may not derive more than 25 percent of their gross revenues from dealing in and underwriting all types of ineligible securities, including corporate debt and equity securities.

Section 20 subsidiaries operate under eight operating conditions that have been established by the Fed to prevent unsafe or unsound practices involving affiliated banks, to avoid conflicts of interest and to prevent unfair competition. The operating conditions cover eight areas: (i) capital requirements; (ii) internal controls; (iii) management interlock restrictions; (iv) customer disclosures; (v) credit for clearing purposes; (vi) funding of securities purchases from securities affiliates; (vii) reporting requirements; and (viii) the application of Federal affiliate transaction limitations to certain covered transactions between a U.S. branch or agency of a foreign bank and a U.S. securities affiliate. Securities firm subsidiaries of financial holding companies are subject only to two of these operating conditions—intraday credit for clearing purposes and the application of Federal affiliate transaction limitations to branches and agencies, which is now part of Regulation W.

Banks and GLB Act Push-Out Requirements

The GLB Act left in place Section 16 of the Glass-Steagall Act, which prevents member banks from engaging in "ineligible" securities activities—generally, underwriting and dealing in corporate debt and equity securities. However, it did amend Section 16 to permit member banks to underwrite and deal in municipal revenue bonds. U.S. branches and agencies of foreign banks are also subject to such restrictions through Federal or state licensing laws or by interpretations of the Fed.

The GLB Act permits U.S. banks to establish financial subsidiaries that may engage in activities not permitted the bank itself, including underwriting and dealing in all types of securities. Under rules of the OCC, FRB and FDIC implementing such authority for national and state banks, a bank must meet a number of requirements and conditions to establish such a financial subsidiary. For example, the bank must be "well capitalized" and "well managed" and have satisfactory CRA ratings, as must each of its depository institution affiliates. Aggregate limitations apply to a bank's total investment in financial subsidiaries. The bank must also deduct the financial subsidiary's capital and assets from the bank's reported consolidated

assets and regulatory capital, and the bank must observe affiliate transaction restrictions and requirements in dealing with financial subsidiaries, which latter restrictions are now part of Regulation W.

U.S. banks engaged in eligible securities activities, *i.e.*, securities brokerage and underwriting and dealing in government securities, also have to comply with the "push-out" provisions of the GLB Act. Historically, banks have been exempt from the definitions of "broker" and "dealer" in the securities laws and thus were not regulated by the SEC in the conduct of these activities permissible for banks. The GLB Act amended the definitions of the terms "broker" and "dealer" in the Exchange Act so that banks would no longer be automatically exempt from coverage as "banks." Instead, the revised definitions exempt certain types of securities and trust activities conducted by banks from the "broker" or "dealer" definitions. Activities that do not meet the test for exemption must be transferred, *i.e.*, "pushed out," to a SEC regulated broker-dealer. In the case of foreign banks, the "push-out" provisions apply not only to their separately incorporated U.S. bank subsidiaries, but also to their U.S. branches and agencies.

Under the GLB Act, the revised definitions of "broker" and "dealer" in the 1934 Act became effective May 12, 2001. On May 11, 2001, the SEC issued interim final rules to define certain terms used in, and grant additional exemptions from the amended definitions of "broker" and "dealer." These interim SEC rules implementing the push-out provisions proved highly controversial, generating objections both from the banking industry and bank regulators. As a result of this controversy, the SEC decided to provide a temporary exemption for banks from the definitions of "dealer" and "broker" to provide the SEC with more time to engage in a constructive dialogue with banks and their regulators and further refine its implementing regulations.

On February 13, 2003, the SEC issued its final rules on the scope of the bank exemption from the definition of "dealer" under the GLB Act, with a compliance date of September 30, 2003. The rules amended definitions in the asset-backed transactions exception from the definition of dealer, permitted both legs of a riskless principal transaction to count as a single transaction for purposes of the 500 transaction *de minimis* exemption, and added exemptions for bank custodial securities lending and noncustodial securities lending activity with "qualified investors."

The SEC has yet to complete the much more difficult task of defining terms under the "broker" exceptions for banks. There is more bank activity on the broker side than the dealer side and there are more exceptions to consider. The SEC issued a proposed new Regulation B in 2004 that built on the 2001 interim rules and encouraged further dialogue with the banking community on these proposals. The SEC has extended the compliance date for new Regulation B until September 30, 2006 so that it can continue to consider the public comments it has received on these issues.

The GLB Act also amended the Investment Advisers Act of 1940 to require a bank to register as an investment adviser with the SEC if the bank acts as an investment adviser to a registered investment company (mutual fund). If the bank gives advice through a separately identifiable department or division, e.g., a trust department, then that department or division may register.

Anti-Tying Prohibitions and Restrictions

Section 106 of the Bank Holding Company Act Amendments of 1970 provides that U.S. banks may not engage in certain prohibited "tying" arrangements wherein a bank is, by law, presumed to use its economic power to coerce a customer into purchasing or providing a nonbank service from or to the bank or any of its affiliates. Under the IBA, U.S. branches and agencies and commercial lending company subsidiaries of foreign banks are subject to these prohibitions to the same extent as U.S. banks.

The anti-tying prohibitions generally prohibit banks from extending credit, leasing or selling property, furnishing services or varying prices on the condition that the customer:

- Obtain an additional product or service from or provide an additional product or service to the same bank or its affiliates; or

- Not obtain an additional product or service from competitors of the bank or its affiliates.

There are important exceptions to these prohibitions which permit a bank to extend credit, lease or sell personal property, furnish services or vary prices on the condition that the customer obtain a "traditional bank product" is a loan, discount, deposit or trust service. There is also a "foreign safe harbor" for bank transactions with a customer organized and principally engaged in business outside the United States. In addition, it should be noted that the law does not prohibit a bank's

cross-marketing or cross-selling of products or services, where a customer is informed that other products or services are available from the bank or its affiliates.

Recently, the National Association of Securities Dealers ("NASD"), the self-regulatory organization for broker-dealers in the United States, expressed concern that the practice of tying bank credit to investment banking is "increasingly widespread." The NASD suggested that such tying typically arises in three contexts: (i) bridge loans in which a loan is intended to be repaid out of the proceeds of a securities offering; (ii) backup credit facilities that support a company's commercial paper; and (iii) syndicated loans. Generally, it has been alleged by some competitors that banks are pricing commercial credit below market rates to obtain investment banking business for their affiliates.

In correspondence responding to congressional inquiries in 2002, the Fed and OCC stated that they had not found that banks are engaging in prohibited tying activities to gain market share in investment banking. However, the Fed and OCC have indicated that they are conducting joint targeted tying reviews at several large banking organizations and will take any corrective actions that are appropriate as a result of these reviews and any other findings made through the supervisory process. The Fed has requested public comment on an official interpretation of the anti-tying restrictions and related supervisory guidance.

Merchant Banking Activities

As discussed briefly in Chapter 1, bank holding companies have been able to make limited venture capital investments under portfolio investment rules and through Small Business Investment Companies. The GLB Act allows financial holding companies and foreign banks treated as financial holding companies to make a much broader range of investments through its grant of authority to engage in merchant banking activities.

Under regulations jointly adopted by the Fed and Treasury, a FHC need not obtain the Fed's approval or provide notice before it begins making merchant banking investments or acquiring a company that makes such investments. However, whether it engages in such investment activity directly or indirectly, an FHC must provide the Fed a 30-day after-the-fact notice. Following are highlights of the regulations:

FHCs Eligible to Make Merchant Banking Investments. To qualify to make merchant banking investments, a FHC must have an affiliate registered under the Exchange Act that is either a broker-dealer or municipal securities dealer, including a separately identifiable department of a bank that is a registered municipal securities dealer.

Bona Fide Requirement. The regulations require that merchant banking investments be made as part of a bona fide underwriting, merchant banking or investment activity. This requirement is intended to prevent a FHC from using its merchant banking authority to engage indirectly in impermissible nonfinancial activities.

Direct and Indirect Investment. The regulations permit FHCs to make investments directly or through any subsidiary other than a depository institution, a subsidiary of a depository institution or U.S. branches or agencies of foreign banks.

Private Equity Funds. FHCs may also make merchant banking investments in and through private equity funds. An FHC may either control and manage a private equity fund or be a passive investor in the fund. If a fund is controlled by an FHC, the fund must comply with the record-keeping and reporting requirements of the rule, and the portfolio investments it owns or controls are subject to the regulations' cross-marketing and affiliate transaction limitations and prohibitions. The regulations provide more flexibility for investments made by FHCs in private equity funds that meet certain qualifications.

Portfolio Company. The regulations define a "portfolio company" as any company or entity that is engaged in an activity impermissible for FHCs or houses merchant banking-related shares, assets or ownership interests held, owned or controlled by an FHC, including through a private equity fund. Generally, a FHC is prohibited from routinely managing or operating a portfolio company other than as may be required to obtain a reasonable return on the resale or disposition of an investment.

Investment Holding Periods. The GLB Act dictates that shares, assets and ownership interests may be held only for a period of time that enables the sale or disposition of the interest on a reasonable basis consistent with the financial viability of the merchant banking activity. The Fed and Treasury have adopted a 10-year limit, which they believe is consistent with industry practice. Interests in a private equity fund can be held up to 15 years.

Risk Management. FHCs are required to adopt policies, procedures and systems reasonably designed to manage the risks associated with making merchant banking investments.

Cross-Marketing Prohibitions. U.S. depository subsidiaries of FHCs, including U.S. branches and agencies of foreign banks, are prohibited from marketing or offering, or allowing to be marketed or offered, any product or service of any portfolio company in which its parent FHC owns or controls more than 5 percent of any class of voting shares.

Affiliate Transaction Restrictions. When an FHC owns or controls more than 15 percent of the total equity of a portfolio company, the company must be treated as an affiliate for purposes of applying prohibitions, restrictions and requirements under Sections 23A and 23B of the Federal Reserve Act and Regulation W *(discussed earlier in the Chapter)*. These restrictions apply to transactions between a U.S. depository institution subsidiary of a FHC and U.S. branches and agencies of a foreign bank FHC and the portfolio company.

Capital Treatment. U.S. bank regulators have adopted capital requirements that apply to equity investments made by U.S. banks and their U.S. bank or financial holding company parents in nonfinancial companies under various legal authorities, including merchant banking authority, bank holding company portfolio investment authority, Edge Act corporation portfolio investment authority outside the United States, and investments held through SBICs. These capital requirements do not apply to U.S. branches and agencies of foreign banks since they are not subject to U.S. bank capital adequacy requirements. However, a foreign bank FHC conducting merchant banking activities in the United States would have to comply with home country capital rules for the treatment of equity investments.

Equity investments covered by the capital rules are subject to a series of marginal Tier 1 capital charges with the size of the charge increasing as the organization's level of concentration in equity investments increases. The highest marginal charge specified requires a 25 percent deduction from Tier 1 capital for covered investments that aggregate more than 25 percent of an organization's Tier 1 capital. Equity investments held through SBICs are exempt from the new charges to the extent such investments, in the aggregate, do not exceed 15 percent of the banking organization's Tier 1 capital.

Qualifying Foreign Banking Organization ("QFBO") Activities and Investments

QFBO Activities and Investments

QFBO status is important to foreign banks because it limits Fed jurisdiction over nonbanking and nonfinancial activities of a foreign bank's affiliates in the United States and abroad. Congress established special rules for QFBOs to prevent U.S. nonbanking restrictions from being applied extraterritorially or causing undue conflict with home country policies that permit foreign banks to invest in or be affiliated with commercial or industrial enterprises that are also likely to establish operations in the United States.

Pursuant to these special exemptions, a QFBO may engage in activities of any kind outside the United States and engage directly in activities in the United States that are incidental to activities outside the United States. A QFBO may also own or control voting shares of any company that is not engaged, directly or indirectly, in any activities in the United States other than those "incidental" to the international or foreign business of such company.

A QFBO may also own or control voting shares of any foreign company that is engaged directly or indirectly in activities in the United States, other than those incidental to its international or foreign business, subject to the following conditions:

- More than 50 percent of the company's consolidated assets and revenues must be derived from outside the United States; and

- The company may not own or control or underwrite or distribute more than 5 percent of the voting shares of any company engaged in underwriting, dealing or distributing securities in the United States.

If the foreign company is also a subsidiary of the QFBO, defined as 25 percent ownership or control of any class of voting shares, the foreign company's activities in the United States must be conducted subject to the following additional limitations:

- The foreign company's activities in the United States must be the same kind of activities or related to the activities engaged in directly or indirectly by the foreign company outside the United States; and

- The foreign company may only engage in banking, securities, insurance or other financial activities to the same extent permitted U.S. bank holding companies.

A QFBO that believes other foreign-based activities or investments should be exempt from U.S. nonbanking restrictions may apply to the Fed for a special exemption. The Fed has frequently used this individual exemptive authority to permit foreign banks to make acquisitions abroad of companies that have U.S. subsidiaries engaged in impermissible U.S. activities, subject to commitments to divest or conform the impermissible activities in the United States within a short period of time or to apply for retention under U.S. law. In this way, U.S. regulation does not unduly interfere with essentially foreign acquisitions.

Qualification as a QFBO

To qualify as a QFBO, a foreign bank, and its ultimate parent, if any, must demonstrate: (i) that more than half of its worldwide business is banking; and (ii) more than half of its worldwide banking business is conducted outside of the United States. For purposes of the exemption, foreign activities qualify as banking business, only if they are conducted in the foreign bank ownership chain, *i.e.*, by the foreign bank or a subsidiary of the foreign bank. Activities by a parent holding company are not considered to be in the foreign bank ownership chain.

In cases where foreign banks are owned by nonbank financial enterprises and must effectively treat all activities conducted by such parent company as "nonqualifying" because they are conducted outside the bank chain of ownership, the parent company has, at times, been unable to qualify as a QFBO, which, in some cases, caused the parent company to close its banking operations in the United States, i.e., "debank" *(see discussion following)*.

To deal with this problem, the Fed amended the QFBO exemption to allow such a nonbank parent company to qualify as a QFBO if its foreign bank subsidiary that has offices or bank subsidiaries in the United States can qualify as a QFBO on its own and if certain other criteria are satisfied. However, this QFBO exemption is limited, as the ultimate parent company may not own or control voting shares of a foreign company that is engaged directly or indirectly in commercial or industrial operations in the United States. However, the foreign bank subsidiary that is able to meet the QFBO exemption on its own will continue to be eligible for all exemptions under the QFBO rules described above.

The Fed has also indicated that it is willing to consider requests by foreign organizations for QFBO status beyond the current rules on a case-by-case basis. Also, the Fed has flexibility, in the case of a foreign banking organization that ceases to qualify as a QFBO, to grant special determinations that will permit foreign banks and foreign companies that do not include foreign banks to be eligible for some or all of the exemptions in appropriate cases.

Geographic Restrictions

Historically, the United States has been virtually alone among major industrialized nations in imposing geographic restrictions on its banking organizations. Before the IBA, foreign bank branches and agencies were not subject to any Federal interstate geographic restrictions imposed on U.S. banks. The IBA's policy of national treatment subjected branches accepting domestic deposits to the same types of interstate geographic restrictions imposed on U.S. banks. However, the Interstate Act removed or greatly modified these restrictions for all banking institutions in the United States.

Home State Selection

The selection of a home state governs the ability of a foreign bank to establish domestic deposit-taking branches in other states. The IBA, enacted in 1978, generally prohibited foreign banks from establishing branches or bank subsidiaries outside their home states. However, foreign banks that had domestic deposit-taking offices in more than one state before the enactment of the IBA were permitted to retain those offices.

A foreign bank having a branch, agency, subsidiary commercial lending company or bank subsidiary in the United States must select one state as its home state. Failing such selection, the Fed selects the home state. For a foreign bank initially entering the U.S. market, the first state where it establishes a branch, agency, subsidiary commercial lending company or bank subsidiary becomes its home state. A foreign bank may change its home state one time upon prior notice to the Fed. In addition, a foreign bank may change its home state an unlimited number of times with prior Fed approval, so long as it can show that a domestic bank within its existing home state could make the same change. When a foreign bank changes its home state, it will generally be permitted to retain all branches that the foreign bank could establish under current law if it already had its new home state.

Interstate Banking and Branching

Under the Interstate Act, a foreign bank is given the same interstate branching rights as a U.S. bank based in its home state and the same interstate bank acquisition rights as a U.S. bank holding company.

Bank holding companies and foreign banks may acquire a subsidiary bank in any state subject to certain national and state concentration limits and state aging requirements (up to five years) for *de novo* banks. Bank holding companies and foreign banks with bank subsidiaries in more than one state may merge or consolidate these bank subsidiaries into a single bank with interstate branches.

With respect to interstate branching, a foreign bank is generally given the same branching rights as a U.S. bank with the same home state as the foreign bank. A foreign bank may establish a *de novo* branch outside its home state only if the law of the host state permits both U.S. and foreign banks to establish such branches.

A foreign bank may establish agencies and limited branches outside its home state if the host state has a law specifically permitting such entry. Agencies cannot generally accept any domestic deposits and limited branches can only accept internationally related deposits permissible for an Edge Act corporation. The GLB Act, subject to certain conditions, allows foreign banks to upgrade agencies and limited branches outside their home state to full branch status, thus allowing them to accept non-retail domestic deposits.

Should a foreign bank seek to establish an interstate branch outside its home state by acquiring a branch of a U.S. bank in another state, the law of the host state must specifically permit such type of acquisition for U.S. and foreign banks. In addition, if a foreign bank seeks to establish a branch outside its home state by acquiring and then merging a U.S. bank in the host state into a branch of the foreign bank, the resulting branch would become subject to CRA requirements previously applicable to the merged U.S. subsidiary bank. CRA requirements may be difficult for an uninsured foreign bank branch to meet given prohibitions on the acceptance of retail or insured deposits. *See Table VIII*.

Supervisory Powers and Remedies

Serious safety and soundness, compliance and related problems discovered during an examination can result in the imposition by Federal and/or state regulatory agencies of formal administrative sanctions. In order of severity, the sanctions include supervisory agreements, cease-and-desist orders, civil money penalties, removal or prohibition orders against key personnel and even expulsion from the U.S. market.

Because these formal administrative sanctions are legally enforceable through substantial fines or court action, legal procedures—including public hearings—are available to protect the rights of U.S. and foreign banks and their personnel. In most situations, U.S. and foreign banks seek to resolve such formal enforcement actions through the substitution of informal commitments or agreements discussed below or, failing that, by consenting to the issuance of the formal sanctions. Regulators must generally publicly disclose the imposition of these formal sanctions.

In less serious cases, regulators will often consider more informal types of consensual administrative measures, such as commitment letters, in which banks state corrective actions that have been taken or which will be taken, and memoranda of understanding ("MOUs") that are prepared by the agencies with bank officers and which set forth a remedial action plan that responds to the regulator's concerns in a timely manner. The regulators need not disclose such informal measures because they are not legally enforceable.

Table VIII
Summary of Interstate Banking Rules Applied to Foreign Banks

Type of Office Outside Foreign Bank's Home State	Host State Authority—State Where Office to Be Established
Representative office	State may prohibit or require approval. No Federal geographic restrictions.
De novo branch of a foreign bank or of a U.S. bank subsidiary of foreign bank	Host state must enact law that permits U.S. and foreign banks to establish de novo branches (no discrimination between U.S. and foreign banks).
A U.S. bank subsidiary	Host state cannot prohibit acquisition of bank in host state on geographic grounds; however, it may require aging of host state charter to limit de novo subsidiaries.
Foreign bank agency or limited branch (not receiving domestic deposits)	State must have law expressly permitting establishment. No Federal geographic restrictions. GLB Act permits a foreign bank to upgrade existing agency or limited branch outside a foreign bank's home state to full branch status if certain conditions are met.
Edge Act corporation subsidiary of a foreign bank	State cannot prohibit. No Federal geographic restrictions.
U.S. bank subsidiary of a foreign bank, which establishes branches by merging with a host state bank	Permitted under Federal law in all 50 states.
Foreign bank establishing branch in host state by acquiring branch of a U.S. bank, by acquiring or merging host state U.S. bank or by acquiring branch of another foreign bank	State law must permit acquisition of a branch of a host state bank. Any branch of a foreign bank acquired through merger of a U.S. insured bank must meet CRA requirements, unless a limited branch. Acquisition of a branch of a foreign bank not subject to any CRA requirements.

Chapter 6
Anti-Money Laundering Compliance

Regulatory Guide for Foreign Banks in the United States*

2005–2006 edition

Chapter 6
Anti-Money Laundering Compliance

Introduction

Money laundering is hiding the source of illegally obtained cash through diverse and often complex financial transactions. Money laundering can occur by physically placing bulk cash proceeds through deposits, wire transfers or other means, separating the proceeds from the source through layers of complex financial transactions to hide the original source; or providing an apparent legitimate explanation for the illegal funds through a business or an individual.

In order to combat money laundering, Congress in 1970 passed the Currency and Foreign Transactions Reporting Act known as the Bank Secrecy Act ("BSA"). The BSA established requirements for filing certain currency and monetary instrument reports, identifying persons conducting transactions and recordkeeping and reporting by private individuals, banks, and other financial institutions. The focus of the BSA is designed to help identify the source, volume, and movement of currency and other monetary instruments transported or transmitted into or out of the United States or deposited in U.S. financial institutions. These records enable law enforcement and regulatory agencies to pursue investigations and provide evidence useful in prosecuting money laundering and other financial crimes.

The BSA applies to covered financial institutions which include a wide range of institutions in the United States, including U.S. banks, U.S. branches and agencies of foreign banks, and Edge Act and Agreement corporations. The U.S. Treasury Department has responsibility for issuing regulations to implement the BSA. Treasury has created and consolidated regulatory policy-making activity and also delegated much responsibility for BSA enforcement to FinCEN, a bureau of the U.S. Treasury. The BSA also empowers the Federal banking agencies to enforce its provisions for U.S. and foreign banking organizations that they regulate in the United States.

Several anti-money laundering enforcement laws were enacted following the BSA, among them:

The Money Laundering Control Act was enacted in 1986 and imposes criminal liability on a person or financial institution that knowingly assists in the laundering of money, knowingly engages in a transaction that involves property from criminal activity or that structures transactions to avoid reporting them. This statute directed banks to establish and maintain procedures reasonably designed to ensure and monitor compliance with the reporting and recordkeeping requirements of the BSA. All federal banking agencies issued similar regulations to implement the Anti-Money Laundering Control Act of 1986. These regulations essentially required covered institutions—including U.S. branches and agencies of foreign banks—to institute programs and policies to ensure BSA compliance.

The Anti-Drug Abuse Act of 1986 reinforced anti-money laundering efforts and requires covered institutions to implement policies requiring strict identification and recording of cash purchases of certain instruments. The Treasury Department was also granted increased authority to require financial institutions to file additional targeted reports and increase civil, criminal and forfeiture sanctions for laundering crimes.

In1992, the Annunzio-Wylie Anti-Money Laundering Act strengthened the sanctions for BSA violations and the role of the U.S. Treasury. Two years later, Congress passed the Money Laundering Suppression Act of 1994 ("MLSA"), which further addressed the U.S. Treasury's role in combating money laundering. In April 1996, the U.S. Treasury developed a Suspicious Activity Report ("SAR") to be used by all banking organizations in the United States. A banking organization is required to file a SAR whenever it detects a known or suspected criminal violation of federal law or a suspicious transaction related to money laundering activity or a violation of the BSA.

In response to the September 11, 2001, terrorist attacks, Congress passed the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the "PATRIOT Act"). Title III of the PATRIOT Act is the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001. The PATRIOT Act is the single most significant AML law that Congress has enacted since the BSA itself. The PATRIOT Act imposes significant new anti-money laundering requirements. Among other things, the PATRIOT Act criminalized the financing of terrorism and augmented the existing BSA framework by strengthening customer identification procedures; prohibiting financial institutions from engaging in business with foreign shell banks; requiring financial institutions to have due diligence procedures, and, in some cases, enhanced due diligence procedures for foreign correspondent and private banking accounts; and improving information sharing between financial institutions and the U.S. government. The PATRIOT Act and its implementing regulations also:

- Expanded the AML program requirements to all financial institutions.
- Increased the civil and criminal penalties for money laundering.
- Provided the Secretary of the Treasury with the authority to impose "special measures" on jurisdictions, institutions, or transactions that are of "primary money laundering concern."
- Facilitated records access and required banks to respond to regulatory requests for information within 120 hours.
- Required federal banking agencies to consider a bank's AML record when reviewing bank mergers, acquisitions, and other applications for business combinations.

BSA/AML Guidance

The federal regulatory agencies have developed guidance to assist financial institutions in complying with BSA and Anti-Money Laundering ("AML") laws and regulations and preventing the flow of illicit funds using U.S. bank systems. Know Your Customer guidelines recommend that all institutions implement policies and procedures to have a clear and concise understanding of its customer's practices in order to prevent individuals from using the bank to launder money. The Federal Financial Institutions Examination Council ("FFIEC") issued the BSA/AML Examination Manual. This manual is a combined effort of the following regulatory agencies: the Fed, OCC, FDIC, OTS and NCUA. The BSA/AML examination procedures are also available to ensure a consistent approach to examining financial institutions for BSA and AML compliance. The examination procedures have expanded to include new steps to address the requirements of the PATRIOT Act.

In general, the requirements described below apply to U.S. offices and subsidiaries of foreign banks engaged in banking activities in the United States, including U.S. branches and agencies, U.S. subsidiary banks or savings associations, and Edge Act or Agreement International Banking Corporations.

Banks can be used unwittingly as intermediaries in a process to conceal the true source of funds that were originally derived from criminal activity. The current focus of anti-money laundering efforts is to ensure covered financial institutions establish and implement an effective BSA/AML Compliance Program, Systems of Monitoring and Reporting for Suspicious Activity and a Customer Identification Program appropriate to the size and business of the institution.

BSA/AML Compliance Program

An effective BSA/AML Compliance Program will assure compliance with the recordkeeping and reporting requirements of BSA and AML laws and regulations and with safe and sound banking practices. The Compliance Program must be written and approved by the institution's Board of Directors and reflected in the bank's minutes. In accordance with the BSA and its accompanying regulations, a BSA AML Compliance Program must include the following components:

- Commitment and Accountability
- A system of Internal Controls and Policies and Procedures
- Independent Testing
- Know Your Customer ("KYC") and Customer Identification Programs

- Transaction Monitoring and Suspicious Activity Reporting
- Other Recordkeeping and Reporting Requirements
- Office of Foreign Assets Control Program
- Training and Awareness

Banks must take a risk-based approach in applying the compliance program components. In evaluating the level of risk, a bank should not necessarily take any single indicator as determinative of the existence of lower or higher risk. The risk assessment process should weigh a number of factors, including the risk identification and measurement of products, services, customers, and geographic locations. The bank should work with all business lines in developing the risk assessment. An effective risk assessment should take into consideration multiple factors, and depending upon the circumstances, certain factors may be weighed more heavily than others. This risk assessment should assist a bank in effectively applying and managing the BSA AML Compliance Program. Generally this approach is accepted as long as the approach is well documented and applied consistently.

Commitment and Accountability

Board of Directors and senior management roles and responsibilities have increased in the last couple of years as it relates to regulatory compliance and corporate governance. Commitment and accountability thus form the foundation of an AML Compliance Program and serve as the basis from which the other program elements work together to ensure a strong culture of compliance. Management must proactively promote a culture of compliance by clearly communicating their commitment to compliance, acting on compliance risks, and establishing compliance accountabilities, roles and responsibilities, performance expectations, and metrics.

A bank must designate a Compliance Officer responsible for the day to day coordinating and monitoring of BSA AML compliance. The Compliance Officer should have appropriate qualifications and be granted authority to enforce violations of the Bank's compliance program. The BSA AML Compliance Officer should foster the importance of compliance to all employees and be responsible and accountable for meeting the regulatory and ethical requirements associated with his or her position.

All employees must be held accountable for BSA AML compliance. Failure to comply with BSA AML compliance can result in severe penalties including civil, criminal and indirectly intangible penalties. An institution must develop and implement strong supervisory structures, clear lines of authority and escalation paths.

Internal Controls and Policies and Procedures

A strong system of controls and supervision provides assurance that employees act in accordance with laws, regulations, policies, procedures, standards, and guidelines. An institution should have appropriate governance processes in place to control business activities and manage risk. Effective internal control processes that provide clear lines of authority for key compliance functions must be established and periodically reviewed, and mechanisms must be in place to ensure timely corrective action and hold associates accountable. Internal controls should be tailored to the operating environment of the institution. Internal control processes should, at a minimum, ensure coverage of the following areas:

- CTR , Report of International Transportation of Currency or Monetary Instruments, and SAR reporting requirements;
- Identifying and reporting suspicious activity;
- BSA recordkeeping requirements for deposits, loans, funds transfers, and sales of monetary instruments;
- A KYC program which includes customer identification, due diligence and enhance due diligence requirements;
- Management reporting; and,
- Office of Foreign Assets Control compliance.

Policies must address key enterprise compliance issues governing all lines of business. Business-specific AML compliance procedures must be implemented as appropriate within the day to day operational processes. Policies, procedures, standards, and guidelines must be updated on a regular basis and clearly communicated to all employees.

Independent Testing

An institution must establish a system of independent audit testing by internal or external auditors. Audits must be performed by qualified persons with proper documentation of material weakness and corrective actions. The scope of a BSA compliance audit should include testing:

- Integrity and effectiveness of management systems and controls;
- Technical compliance with all applicable laws and regulations;
- Areas of the bank on a risk-based approach with emphasis on high-risk customers, products, and services to ensure the bank is following prescribed regulations and policies and procedures;
- Employees' knowledge of policy and procedures;
- Adequacy, accuracy, and completeness of training programs;
- Record retention; and,
- Adequacy of the bank's process for identifying and reporting suspicious activity.

Audit findings should be communicated to the appropriate levels of line of business management and the Anti-Money Laundering Compliance Officer, and senior management and be reviewed promptly. Appropriate follow-up on all identified issues requiring action should be ensured. In addition to internal and external auditors' testing, the compliance or risk functions of the bank may want to consider conducting smaller scope reviews—priority given to areas with customers, products, services or geographic locations designated as high risk, or with greater regulatory requirements. These reviews will primarily assess the business unit's compliance with the AML Compliance Program.

Know Your Customer & Customer Identification Programs

Financial institutions may be used unwittingly as intermediaries for the transfer or deposit of monies derived from criminal activity. In order to be able to identify any such activity, banks must know its customers and the kinds of activity in which they would reasonably be expected to engage. An effective Customer Identification Program ("CIP") is an important part of the effort for banks to know its customers. A bank's CIP can be integrated into the BSA AML Compliance Program, which contains provisions to be applied using a risk-based methodology.

Customer Identification Program

Financial institutions should establish minimum standards for customer identification at account opening. On May 9, 2003, the Treasury, through FinCEN and jointly with the bank regulatory agencies, issued customer identification rules for banks. The regulations went into effect October 1, 2003. A bank must implement a CIP appropriate for its size and type of business. The CIP Program needs to be approved by the bank's board of directors or approving body.

The CIP must meet each of the following general requirements and the agencies' detailed implementing regulations:

- The CIP must be part of the bank's anti-money laundering compliance program otherwise required by law;
- The CIP must include risk-based procedures for verifying the identity of each customer to the extent reasonable and practicable within a reasonable time after an account is opened. At a minimum, a bank must obtain from each customer the following information prior to opening an account: name, date of birth (for an individual), address and identification number;
- The CIP must include procedures for making and maintaining a record of all information obtained under the required procedures—records must generally be kept for five years after the date an account is closed;

- The CIP must include procedures for determining whether the customer appears on any list of known or suspected terrorists or terrorist organizations issued by any Federal government agency and designated as such by Treasury in consultation with the Federal functional regulators; and,

- The CIP must include procedures for providing bank customers with adequate notice that the bank is requesting information to verify their identities.

The regulation also provides that a bank's CIP may include procedures specifying when the bank may rely on the performance by another financial institution (including an affiliate) of any procedures of the bank's CIP and thereby satisfy the requirements. Such reliance, to be effective, must meet a number of conditions, including that the customer is opening, or has opened, an account or has established a similar banking or business relationship with the other financial institution to provide or engage in services, dealings or other financial transactions.

Under the regulations, a "customer" means a person that opens a new account and an individual who opens a new account either for an individual who lacks legal capacity or for an entity that is not a legal person. The final rule contains a list of entities that are not considered "customers," including: (i) financial institutions regulated by a Federal functional regulator; (ii) banks regulated by a state regulator; (iii) governmental agencies and instrumentalities; (iv) companies that are publicly traded (except for their foreign offices, subsidiaries or affiliates); and (v) a person that has an existing account with a bank, provided that the bank has a reasonable belief that it knows the true identity of the person.

The definition of "account" means a formal banking relationship established to provide or engage in services, dealings or other financial transactions, including a deposit account, a transaction or asset account, a credit account or other extension of credit. The definition has been clarified so that it applies only to financial transactions and not general business dealings a person may have with a bank. Additional nonexclusive examples of covered products and services include safety deposit box and safekeeping services, cash management, custodian and trust services. The rule also provides a list of products and services that will not be considered an "account," including where a formal banking relationship has not been established, an account is acquired through an acquisition, merger or purchase and assumption transaction, or an account is established to participate in an employee benefit plan.

The CIP is applicable to new customers on or after October 1, 2003. A bank does not need to capture the identification requirements for the existing customers as long as affirmative customer identification and transaction information is properly documented and maintained.

Enhanced Due Diligence

Banks should perform appropriate Enhanced Due Diligence ("EDD") as a component of its KYC Program. EDD should be reasonably designed to know and verify the true identity of its customers and to detect and report instances of criminal activity, including money laundering or terrorist financing. The procedures, documentation, types of information obtained, and levels of KYC due diligence to be performed will be based on the level of risk associated with the relationship (products, services, Lines of Business, geographic locations) between the bank and the customer and the risk profile of the customer. Each Line of Business shall establish standards and procedures for performing KYC due diligence and Enhanced Due Diligence that are appropriate given the associated risks of their business and their particular customers. Such standards and procedures shall comply with the requirements of law applicable to such business and the jurisdiction in which it operates and shall incorporate the components detailed below, except to the extent that compliance would conflict with requirements of law of a particular jurisdiction.

Foreign Correspondent Account and Record Keeping

FinCEN has adopted regulations implementing provisions of the PATRIOT Act that prohibit covered financial institutions from providing correspondent accounts to "foreign shell banks." Institutions are required to take reasonable steps to ensure that correspondent accounts provided to foreign banks are not being used to indirectly provide banking services to foreign shell banks.

Covered financial institutions that provide correspondent accounts to foreign banks must implement enhanced due diligence measures for correspondent accounts and maintain adequate records on ownership of each such foreign bank whose shares are not publicly traded and who does not file with the Fed a FR Y-7 Annual Report *(see discussion in chapter 7)* and the name and address of an agent in the United States agent designated for service of legal process. Institutions are required to terminate those correspondent accounts of foreign banks that fail to turn over their account records in response to a lawful request of the Secretary of the Treasury or the Attorney General of the United States.

The definition of "correspondent account" for these purposes is broadly worded. The definition includes any transaction account, savings account, asset account or extension of credit maintained for a foreign bank, as well any other relationship with a foreign bank to provide regular services, dealings and other financial transactions. Treasury has indicated that most isolated or occasional transactions that a covered financial institution conducts with a foreign bank would not constitute a correspondent account covered by the rule.

A foreign shell bank is a bank without a physical presence in any country. However, the limitations on the direct or indirect provision of correspondent accounts to foreign shell banks do not apply to a foreign shell bank that is a regulated affiliate. A "regulated affiliate" is a foreign shell bank that (i) is an affiliate of a depository institution, credit union or foreign bank that maintains a physical presence in the United States or a foreign country, and (ii) is subject to supervision by a banking authority in the country regulating such affiliated depository institution, credit union or foreign bank.

Forfeiture

Under the PATRIOT Act the circumstances under which funds in a U.S. interbank account may be subject to forfeiture was expanded. If a deposit of funds in a foreign bank outside of the United States is subject to forfeiture, and the foreign bank maintains an interbank account at a covered financial institution, U.S. law enforcement can seize the funds in the U.S. account as a substitute for the foreign deposit. Law enforcement is not required to trace the funds seized in the United States to the deposit abroad. The Attorney General can suspend forfeiture if a conflict of law exists and the suspension would be in the public interest. The owner of the funds can also file a claim in court contesting the forfeiture.

Private Banking Due Diligence Program (non-US Persons)

Private banking activities, which involve, among other activities, personalized services such as money management, financial advice and investment services for high net worth clients, are an important aspect of the operations of many foreign banks in the United States. The Fed, and other banking agencies, traditionally reviews private banking activities in connection with regular on-site examinations.

Specific minimum standards for private banking accounts, defined as accounts with minimum aggregate deposits of $1 million, that are established for one or more individuals, and that are assigned to or managed by a person who acts as a liaison between a financial institution and the beneficial owner(s). For all private banking accounts maintained by or on behalf of non-U.S. persons, the financial institution must report suspicious transactions and keep records of: (i) the names of all nominal and beneficial owners; and (ii) the source of funds deposited in those accounts. For any private banking account requested or maintained by or on behalf of a senior political figure or his or her immediate family members or close associates, the financial institution must conduct enhanced scrutiny of the account to detect any transactions that may involve proceeds of foreign corruption.

Transaction Monitoring and Suspicious Activity Reporting

Transaction monitoring has been an area of increasing focus for regulators and legislators. Financial institutions must play an active role in the fight against money laundering by identifying suspicious activity and transactions and reporting them to the authorities. To do so effectively, banks need to implement a formal system to monitor customer activity. A risk-based methodology needs to be applied to determine how monitoring will occur. Monitoring may occur manually or through electronic means. In order to manage the volumes of transactions and to be able to apply criteria to identify potentially suspect activity electronic solutions are more effective.

U.S. banks, U.S. branches and agencies of foreign banks, Edge Act and Agreement corporations and U.S. non-bank subsidiaries of bank and financial holding companies must also file a SAR with FinCEN if they experience one or more of the following events:

- Insider abuse involving any amount;
- Possible violations of criminal law aggregating $5,000 or more where a suspect can be identified;
- Possible violations of criminal law aggregating $25,000 or more whether or not a suspect is identified; or
- Transactions aggregating $5,000 or more that involve potential money laundering or violations of the BSA.

The BSA provides a safe harbor protection against liability that might otherwise arise for reporting suspicious activity. This safe harbor extends to anyone filing a SAR with FinCEN, whether or not the report was required by regulation.

Other Recordkeeping and Reporting Requirements

The recordkeeping requirements of BSA and AML regulations require the reporting of specific transactional reports:

- Currency Transaction Report. The Treasury's BSA regulations require financial institutions to file a Currency Transaction Report ("CTR") for a cash transaction greater than $10,000. A report is also required if a customer during the same day has multiple cash transactions that, when combined, exceed $10,000. The regulations provide certain exemptions from CTR reporting, *e.g.*, cash transactions involving other banks in the United States, and also permit a bank to maintain a list of customers whom the bank has exempted from CTR reporting because these customers routinely manage large cash transactions. The PATRIOT Act directs Treasury to review the CTR system to make it more efficient, possibly by expanding the use of exemptions to reduce the number of reports.

- Records of Purchased Monetary Instruments. The BSA also requires financial institutions to verify and record in a log, information relating to the identity of anyone who buys for cash a monetary instrument for $3,000 or more. For this purpose, a monetary instrument is defined as a bank check, cashier's check, traveler's check or money order. Additional information is required when the purchaser is not a customer of the institution. Multiple purchases during the same day aggregating to $10,000 or more require log entries and a CTR. A single monetary instrument purchased for cash in excess of $10,000 would require a CTR but not a log entry.

- Funds Transfers. Financial institutions located within the United States that initiate, transmit or receive funds transfers must obtain and keep specified information about the sender and recipient of the funds. Records must be kept for funds transfers of $3,000 or more (or the foreign equivalent) that are completed by domestic financial institutions, including U.S. branches and agencies of foreign banks.

Production of Records. Financial institutions are required upon request of the appropriate Federal banking agency, to produce records relating to its anti-money laundering compliance or its customers. The institution must produce such records within 120 hours of the request.

Special Measures. Treasury has broad regulatory authority under the PATRIOT Act to require financial institutions to perform additional record-keeping and reporting with respect to particular financial institutions operating outside the United States, institutions in particular jurisdictions, types of accounts and types of transactions, if Treasury determines that such institutions, jurisdictions, accounts or transactions are of "primary money laundering concern." Treasury must consult with appropriate Federal banking agencies to determine whether to impose special measures. Treasury may impose these measures by regulation or by order; however, any measure other than a regulation must expire within 120 days.

In general, the types of measures contemplated by this provision are maintenance of records and filing of reports with information about transactions, participants in transactions and beneficial owners of funds involved in transactions. In addition, special measures could require due diligence with respect to the ownership of payable-through accounts and maintenance of information about correspondent bank customers that have access to correspondent accounts. The Act requires Treasury, in consultation with certain other regulators, to issue regulations on the application of the term "account" to non-banks. Treasury is also required to define "beneficial ownership" and other terms used in this section, as appropriate. The timing of such regulations is left to the discretion of the Treasury.

Office of Foreign Assets Control ("OFAC")

OFAC is an office of the U.S. Department of the Treasury that administers and enforces economic and trade sanctions against targeted foreign countries, terrorism sponsoring organizations and international narcotics traffickers based on U.S. foreign policy and national security goals. OFAC acts under Presidential wartime and national emergency powers, as well as authority granted by specific legislation, to impose controls on transactions and freeze foreign assets under U.S. jurisdiction. Many of the sanctions are based on United Nations and other international mandates, are multilateral in scope, and involve close cooperation with allied governments.

OFAC has identified and named numerous individuals, agents, and entities in a list of "Specially Designated Nationals ("SDNs") and Blocked Persons" ("SDN List"). OFAC has also identified Specially Designated Global Terrorists ("SDGTs"), who constitute an unusual and extraordinary threat to national security, foreign policy and the economy, as well as Specially

Designated Terrorists ("SDTs") and Foreign Terrorist Organizations ("FTOs") who disrupt international peace processes. OFAC also administers sanctions against Specially Designated Narcotics Traffickers ("SDNTs") and Specially Designated Narcotics Trafficking Kingpins ("SDNTKs"), which are individuals or organizations involved in significant international narcotics trafficking operations. These lists can be found on OFAC's website.

OFAC regulations apply to all US citizens and permanent residents of the United States, wherever they are located, to all people and organizations physically located in the United States and to all branches, subsidiaries and controlled affiliates of US organizations throughout the world. Penalties can be assessed against banks as well as against individual employees for processing OFAC prohibited transactions. OFAC has the authority to impose corporate and personal penalties of up to $10 million and 30 years in jail, civil penalties of up to $1 million per incident, as well as to demand the forfeiture of the funds or property involved in the transactions. OFAC publishes the names of institutions involved in violations of OFAC sanctions programs, as well as a brief description of the violation, and the amount of any fine or settlement, on its public website. This greatly increases the visibility of OFAC violations, and increases the reputational risks involved in violating OFAC sanctions programs. Certain OFAC transactions may be permitted with an approved license from the Department of Treasury, or for transactions that meet certain criteria. Financial Institutions should assigned an individual day-to-day responsibility for an OFAC compliance program which would include OFAC awareness training, review OFAC related desktop procedures, and implementation of monitoring processes as appropriate.

Training and Awareness

An institution should establish an annual AML training program to relay current compliance information and procedures to employees as appropriate to their duties and positions.

Training and awareness needs must be proactively identified and prioritized based on risks. An institution must maintain proper documentation of all training materials and employee attendance.

Chapter 7

Audit/Accounting and Reporting Requirements

Regulatory Guide for Foreign Banks in the United States*

2005–2006 edition

Chapter 7
Audit/Accounting and Reporting Requirements

Bank Audit Requirements and Accounting Standards

U.S. Insured Banks—FDICIA 112 Requirements

Under Section 112 of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") and implementing FDIC regulations and guidance, each U.S. bank and savings association with assets in excess of $500 million at the beginning of its fiscal year ("covered institutions")—including U.S. bank subsidiaries of foreign banks—are required to file annual reports containing audited financial statements and a report on internal controls and compliance. The financial statements must be prepared annually in accordance with U.S. GAAP and be audited by an independent public accountant. Banks or savings associations that are subsidiaries of U.S. holding companies may satisfy the annual audit requirement by filing the audited statements of the holding company.

Each covered institution annually must prepare a management report, signed by its chief executive and chief financial officers that contains a statement of management's responsibilities for:

- Preparing the annual financial statements;
- Establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
- Complying with particular laws designated by the FDIC as affecting the safety and soundness of insured banks or thrifts.

The report must also contain assessments by management of the effectiveness of the institution's internal controls for financial reporting as of the end of the fiscal year, and the institution's compliance during such fiscal year with the designated safety and soundness laws. Designated safety and soundness laws are currently limited to Federal laws and regulations concerning loans to insiders and Federal and state laws and regulations concerning restrictions on the payment of dividends.

In addition to auditing and reporting on a covered institution's annual financial statements, an independent public accountant must examine, attest to and report separately on management's assertions about internal controls (but not about compliance). The attestations are to be made in accordance with generally accepted professional standards for attestations.

Federal law also requires uniform and consistent GAAP accounting standards at all insured U.S. banks and savings associations. However, the Federal banking agencies may determine that the application of any GAAP principle to any insured bank or savings association with respect to any regulatory report or statement is inconsistent with congressional objectives and may prescribe an accounting principle that is no less stringent than GAAP.

Recently, for covered institutions with between $500 million and $1 billion in total assets, the FDIC proposed that management would no longer be required to assess and report on the effectiveness of internal control over financial reporting , the external auditors would no longer be required to examine and attest to management's internal control assertions, and the outside directors on the audit committee would no longer be required to be independent of management. However, these institutions would still have to comply with the annual financial statement audit requirement. The proposal would also not

relieve public covered institutions from their obligations to comply with the provisions of SARBOX and the SEC's implementing rules on internal control assessments by management and attestations by external auditors and, if applicable, audit committee independence. The amendments are proposed to take effect December 31, 2005.

Relationship of Sarbanes-Oxley Act Audit Requirements to FDICIA 112

The vast majority of insured banks are subsidiaries of bank holding companies that are public companies. Some banks that are not subsidiaries of bank holding companies are public companies in their own right and have to register their shares with one of the federal banking agencies. These public companies and their independent public accountants must comply with SARBOX—including those provisions governing auditor independence, corporate responsibility and enhanced financial disclosures—and the implementing SEC regulations.

Auditor Independence. FDIC guidelines interpreting FDICIA 112 provide that each covered institution, whether or not it is a public company, and its external auditor must comply with the SEC's auditor independence requirements that are in effect during the period covered by the audit of the institution's financial statements. If a covered institution satisfies the annual independent audit requirement by relying on the audit of its parent holding company, the holding company's external auditor must meet the SEC's independence requirements. Accordingly, all covered institutions must review the final rules on auditor independence that the SEC adopted under SARBOX in January 2003 to ensure that they and their external auditors take appropriate actions to comply with these rules consistent with the time frames specified in the transition guidance.

In summary, the final SEC rules:

- Revise the SEC's existing regulations related to the non-audit services that, if provided to an audit client, would impair an accounting firms' independence;
- Require that a public company's audit committee preapprove all audit and non-audit services provided to the company by the auditor of its financial statements;
- Prohibit certain partners on the audit engagement team from providing audit services to the public company for more than five or seven consecutive years, depending on the partner's involvement in the audit, except that certain small accounting firms may be exempted from this requirement;
- Prohibit an accounting firm from auditing a public company's financial statements if certain members of management of that public company had been members of the accounting firm's audit engagement team within the one-year period preceding the commencement of audit procedures; and
- Provide that an audit partner's receipt of compensation based on the sale of engagements to an audit client for services other than audit, review and attest services would impair the accountant's independence.

Management's Responsibility for Financial Reporting and Controls. Section 302 of SARBOX requires a certification by the principal executive officer and the principal financial officer in each quarterly and annual report that a public company files under the Exchange Act. The SEC adopted a final rule implementing Section 302 that became effective August 29, 2002. This final rule prescribes the specific wording of the required certification and this wording may not be changed in any respect. In addition, each principal executive officer and principal financial officer of a public company must provide a separate certification.

As noted above, the FDIC annual report must contain an assessment by management of the effectiveness of internal control over financial reporting as of year-end as well as a report by the institution's independent auditor on management's assertion concerning internal control. To date, independent auditors have performed the attestation work necessary to satisfy the FDIC's reporting requirements by following Section 501 of the American Institute of Certified Public Accountants' (AICPA) attestation standards, *Reporting on an Entity's Internal Control over Financial Reporting*, commonly referred to as "AT 501." Using language substantially similar to that in Section 36 of the FDI Act, Section 404 of SARBOX requires public companies to include in their annual reports under the federal securities laws a statement of management's responsibilities for internal control over financial reporting, management's assessment of the effectiveness of this internal control, and an attestation report on this assessment by the public company's independent auditor. The independent auditor's attestation and reporting on the effectiveness of internal control for public companies must be performed in accordance with the Public Company Accounting Oversight Board's (PCAOB) Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*.

The SEC's regulations implementing Section 404 and PCAOB Auditing Standard No. 2 take effect for "accelerated filers" for fiscal years ending on of after November 15, 2004. A public company that is not an accelerated filer, including a foreign private issuer that is not an accelerated filer, will begin to be required to comply with the Section 404 requirements for its first fiscal year ending on or after July 15, 2007. A foreign private issuer that is an accelerated filer and that files its annual reports on Form 20-F or Form 40-F, must begin to comply with the internal control over financial reporting and related requirements in the annual report for its first fiscal year ending on or after July 15, 2006.

Since the PCAOB's adoption of Auditing Standard No. 2, the FDIC has received questions from bankers and auditors about the applicability of this standard to institutions subject to its rules and has issued the following guidance:

- For an FDIC insured institution that is not a public company, its independent auditor need only follow the AICPA's existing internal control attestation standards in AT 501—until any revisions to these standards on which the AICPA is working take effect—to satisfy the FDIC's regulations, absent any future amendments to these regulations that would require the use of a different set of standards.

- For a public institution that is a not an accelerated filer, its independent auditor is not required to follow PCAOB Auditing Standard No. 2 until its effective date in 2007. Until then, the auditor need only follow the existing internal control attestation standards in AT 501. In addition, an institution subject to FDIC rules that is a subsidiary of a public holding company that is an accelerated filer, but is not itself a public company, has flexibility in complying with the FDIC's internal control requirements. If certain conditions in the FDIC's regulations are met, management and the independent auditor may choose to report to the FDIC on internal control over financial reporting at the consolidated holding company level. In this situation, the auditor's work would be performed for the public holding company in accordance with PCAOB Auditing Standard No. 2. Alternatively, the institution may choose to comply with the internal control reporting requirements of the FDIC rules at the institution level and its independent auditor can follow existing AT 501. However, this alternative may not be cost-effective

Auditor Access to Supervisory Information

U.S. banks, including U.S. branches and agencies of foreign banks, are encouraged by the Federal banking agencies to provide their external auditors with a copy of certain reports and supervisory documents, including the most recent call report, the most recent examination report and pertinent correspondence from the regulator and any supervisory agreement or other enforcement action entered into or taken by a Federal or state regulator with or against the institution. External auditors are also encouraged by the Federal banking agencies to attend examination exit conferences upon the completion of fieldwork or other meetings between supervisory examiners and an institution's management or board of directors, at which examination findings are discussed that are relevant to the scope of the audit. External auditors must preserve the confidentiality of any bank examination or supervisory information they receive.

Branches and Agencies of Foreign Banks

Insured branches of foreign banks that have total assets in excess of $500 million are also subject to the annual audit requirements of FDICIA 112 for insured banks and savings associations, which were described above. Uninsured branches and agencies of foreign banks are not subject to the FDICIA 112 audit requirements.

Aside from insured branches, Federal law and regulation does not prescribe any external audit requirements for U.S. branches or agencies. However, each U.S. branch or agency is expected to have an internal audit program that is fully adequate to the office's asset size, complexity of operations and type of risk exposures. In lieu of (in the case of very small offices) or in support of internal audit programs, an office, when appropriate, may rely on periodic visits by head office or regional headquarters auditors or may outsource the internal audit function, or parts thereof, to an independent accounting or consulting firm.

Special Audit Procedures

Special audit procedures are required by the Fed when both the O (Operational controls) component of ROCA and the composite ROCA rating for a branch or agency are 3 or worse. If both the O component and ROCA rating are 3, the special procedures may be performed by the internal audit function if it is considered satisfactory. If the internal audit function is less than satisfactory, or if both the O component and ROCA rating are 4 or worse, then an external audit is required. An external audit is also required if the branch or agency receives an O and composite ROCA rating of 3 after the internal audit function has performed special audit procedures.

State Audit Requirements

Florida law requires a foreign bank to conduct an annual internal or external audit of any branch or agency it may have established in the state, and, in connection therewith, certain minimum audit procedures are set forth in state regulations. In New York, Part 5 of the banking regulations of the NY Banking Department requires special audit procedures to be performed by external auditors for branches and agencies in certain supervisory situations. Part 5 also requires comprehensive on-site internal audits in certain supervisory situations and encourages all branches and agencies to employ qualified internal auditors as an important aspect of adequate internal control.

International Banking Facilities

Although there are no unique accounting issues applicable to an IBF compared to its establishing institution, IBF accounts must be maintained separately on a subsidiary ledger of the establishing institution. A separate general ledger for the IBF is an acceptable alternative to a subsidiary ledger. To facilitate accounting and bookkeeping, the establishing banking institution should create a special coding system for IBF transactions. The coding system should identify and check for qualifying customers and transactions and trigger the necessary actions to be taken.

The Internal Audit Function and its Outsourcing

In March of 2003, the Federal banking agencies issued an updated policy statement on internal auditing for banking institutions, which reflects auditor independence requirements of SARBOX and the agencies' experience with a prior policy statement and recent developments in internal auditing. The Federal banking agencies' examination policies call for examiners to review a banking institution's internal audit function and recommend improvements, if needed. Under agency guidelines and policies, each banking institution is expected to have an internal audit function that is appropriate to its size and the nature and scope of its activities.

In addressing various quality and resource issues, many banking institutions have been engaging independent public accounting firms and other outside professionals in recent years to perform work that traditionally has been done by internal auditors. These arrangements are often called "internal audit outsourcing" "internal audit assistance," "audit cosourcing" and "extended audit services" (collectively referred to as "outsourcing").

In their policy statement, the agencies set forth key characteristics of the internal audit function, describe sound practices concerning the use of outsourcing vendors, and discuss the prohibition on internal audit outsourcing to a public company's external auditor under SARBOX and the effect of this prohibition on insured depository institutions subject to the annual audit and reporting requirements of FDICIA 112 *(discussed earlier in this Chapter)*.

In discussing the internal audit function of a foreign bank, the agencies indicate in the policy statement that the foreign bank should cover its U.S. operations in its risk assessments, audit plans and audit programs. A foreign bank's U.S. domiciled audit function, head office internal audit staff, or some combination thereof normally performs the internal audit of the U.S. operations. Internal audit findings (including internal control deficiencies) should be reported to the senior management of the U.S. operations of the foreign bank and the audit department of the head office. Significant adverse findings also should be reported to the head office's senior management and the board of directors or its audit committee.

When a U.S. or foreign bank outsources internal audit, the interagency statement emphasizes that the Board or senior managers are still responsible for ensuring that the system of internal control, including the internal audit function, operates effectively. There should be a written contract governing the outsourcing arrangement that includes certain minimum provisions detailed in the policy statement, *e.g.*, the scope and frequency of the work to be performed.

SARBOX prohibits an accounting firm from acting as the external auditor of a public company during the same period that the firm provides internal audit outsourcing services to the company. In addition, if a public company's external auditor will be providing auditing services and non-audit services, such as tax services that are not otherwise prohibited by SARBOX; the company's audit committee must preapprove each of these services.

The SEC adopted final rules implementing the non-audit service prohibitions and audit committee preapproval requirements of SARBOX in January of 2003. According to these rules, an accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides internal audit outsourcing or other prohibited non-audit services to a public company audit client. These rules generally became effective on May 6, 2003, although a one-year transition period is provided for contractual arrangements in place as of that date. Under this transition rule, an external auditor's independence will not be deemed to be impaired until May 6, 2004, if the auditor is performing internal

audit outsourcing and other prohibited non-audit services for a public company audit client pursuant to a contract in existence on May 6, 2003. However, the services being provided must not have impaired the auditor's independence under the preexisting independence requirements of the SEC, the Independence Standards Board and the AICPA.

Regulatory Reporting Requirements

As a basic element of off-site supervision, U.S. regulators require a number of reports from U.S. branches and agencies of foreign banks, from their U.S. bank and other subsidiaries, and from the parent foreign bank. Foreign banks or their U.S. operations also have to file certain reports with the U.S. Treasury or Commerce Departments regarding capital flows and foreign investment. In addition, as discussed below, U.S. operations of foreign banks must file reports required by the Treasury Department in its efforts to combat money laundering.

The Fed uses various reports to collect information from head offices of foreign banks in order to assess the parent bank's ability to be a source of strength to its U.S. banking operations and to determine compliance with U.S. laws and regulations.

Forms FR Y-7, FR Y-7Q, FR Y-7N and FR Y-7NS

FR Y-7. The Fed requires that each foreign bank having a branch or agency or a commercial lending company, Edge Act or Agreement corporation or bank subsidiary in the United States (an "FBO") file an annual report on Form FR Y-7. The report requires financial and managerial information on the reporting FBO, including financial statements covering the foreign bank's two most recent fiscal years stated in local currency of the FBO's Head Office and prepared in accordance with local accounting practices. Additional information includes an organization chart and information demonstrating the foreign banking organization's eligibility for QFBO status. The FR Y-7 also requires certain ownership information on the FBO. Tiered FBOs can satisfy the reporting requirements through submission of the FR Y-7 by the top-tier FBO. The FR Y-7 must be signed by an authorized officer of the FBO. The FR Y-7 is due no later than 120 days after the bank's fiscal year-end.

FR Y-7Q. The FR Y-7Q report collects consolidated regulatory capital information, including risk based capital information, from all FBOs either quarterly or annually. FBOs that have elected to become financial holding companies are required to file the FR Y-7Q on a quarterly basis. All other FBOs (those that have not elected to become FHCs) are required to report the FR Y-7Q annually. Data is due 90 days after the report date.

FR Y-7N and FR Y-7NS. These reports collect financial information for U.S. nonbank subsidiaries held by FBOs, other than through a U.S. bank holding company or bank. The FR Y-7N consists of a balance sheet and income statement; information on changes in equity capital, changes in the allowance for loan and lease losses, off-balance sheet items, and loans; and a memoranda section. The FR Y-7NS collects four financial data items for smaller, less complex subsidiaries.

Each top-tier FBOs must file the FR Y-7N report quarterly for each nonbank subsidiary that has total assets of $1 billion or total off-balance sheet activity of at least $5 billion. The entire FR Y-7N is filed annually for each individual nonbank subsidiary with total assets of $250 million but less than $1 billion. The FR Y-7NS is an abbreviated report that must be filed annually by nonbank subsidiaries with assets of at least $50 million but less than $250 million.

Form FR Y-10F

All FBOs must file Form FR Y-10f to report information on banking and certain nonbanking activities conducted in the United States, either directly or indirectly through subsidiaries (except for subsidiaries held through a U.S. bank holding company or a foreign bank holding company that does not qualify as a QFBO). The FR Y-10f is an event- generated report—a foreign bank must file the report within 30 calendar days of the occurrence of a "reportable transaction." Reportable transactions include the following:

- Commencement of operations;
- Acquisitions of interests in banking or nonbanking companies;
- Mergers or Acquisitions;
- Commencement of new activities;
- Changes to previously reported items;

- Certain large merchant banking and insurance investments;
- Termination of a previously reportable activity; and
- Openings and closings, issuance and surrender of licenses and relocations of U.S. branches, agencies, representative offices, and the commencement or termination of the management by a U.S. branch or agency of a non-U.S. branch of foreign banks.

The scope of information to report depends upon the reportable transaction. There are five schedules: (i) the Banking Schedule, (ii) the Nonbanking Schedule, (iii) the Merger schedule, (iv) the 4(k) Schedule which collects required post-transaction notice for activities, formations and acquisitions of companies, and large merchant banking and insurance company investments, (v) the Branch, Agency, and Representative Office Schedule

Information contained in the FR Y-7, FR Y-7Q, FR Y-7N, FR Y-7NS and FR Y-10f is generally available to the public, unless the foreign bank requests confidential treatment for specific information. A request for confidential treatment must be approved by the Fed. The data contained in the FR Y-7Q is treated as confidential until 120 days after the report date, at which time it is generally available to the public unless a request for confidential treatment was approved. Confidential treatment may be available for confidential commercial information, the public disclosure of which would be competitively harmful to the foreign bank or its subsidiary in the U.S. market.

Form FR Y-8

All U.S. bank and financial holding companies and foreign bank holding companies with U.S. bank subsidiaries must file a quarterly report on Form FR Y-8 on affiliate transactions for each insured depository institution subsidiary. This filing, which is confidential, must be submitted by the 30th calendar day after the report date. The report requires disclosure of certain intercompany transactions of each U.S. bank subsidiary. The report is used by the Fed to monitor bank exposures to affiliates and to ensure compliance with Section 23A of the Federal Reserve Act and Regulation W.

Branch/Agency Financial Condition Reports

Besides the other reporting requirements described in this Guide, all branches and agencies of foreign banks in the United States must file a quarterly report on Form FFIEC 002, Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks. Consolidation is allowed on request when two entities of the same foreign bank are located in the same metropolitan area and have the same insurance status. The report is due 30 days after the end of each quarter. It collects balance sheet and off-balance sheet information, including detailed supporting schedule items, from all U.S. branches and agencies of foreign banks. The FFIEC 002 is generally prepared in accordance with U.S. Generally Accepted Accounting Principles ("GAAP").

Federal supervisory agencies use the Form FFIEC 002 for on-site examinations and for the analysis of the operations of foreign banks in the United States. Economists in the Federal Reserve System and in the private sector use the report for tracking market and credit conditions.

U.S. branches and agencies that manage or control an offshore branch from the United States are also required to file the Supplement FFIEC 002S, which includes certain information on assets and liabilities at such offshore offices managed from the United States. The Form FFIEC 002S information provides data on the amount of banking business with U.S. residents by offshore branches of foreign banks.

Reserve Requirement Reports

In connection with maintaining required reserve requirements, U.S. branches and agencies of foreign banks must file every week a Form 2900, Report of Transaction Accounts, Other Deposits and Vault Cash (Branch and Agency Version). The form is required of any U.S. branch or agency if its parent foreign bank has total worldwide consolidated bank assets in excess of $1 billion or if its parent foreign bank is controlled by a foreign company or by a group of foreign companies that own or control foreign banks that in the aggregate have total worldwide consolidated bank assets in excess of $1 billion. These reports are used by the Fed for the calculation of Federal required reserves and for construction of the monetary aggregates.

IBF liabilities are exempt from Fed reserve requirements and are thus excluded from Form 2900. U.S. branches and agencies of foreign banks should also exclude from reporting as deposits for reserve requirement purposes any liabilities to other U.S. branches or agencies of the same foreign bank.

A foreign bank's U.S. branches and agencies operating within the same state and Federal Reserve District must prepare and file a Form 2900 on an aggregated basis. The lower reserve tranche *(3 percent—discussed in Chapter 5)* should normally be assigned to one office or to a group of offices reporting on an aggregated basis.

U.S. branches and agencies of foreign banks must also file with the FR 2900 a report on their Eurocurrency positions—Form FR 2951. The data on FR 2951 are currently used for the measurement and interpretation of international capital flows through the U.S. banking system. When, in prior years, the Fed imposed reserve requirements on certain Eurocurrency liabilities, the form was also used to collect information on such liabilities. U.S. depository institutions, including Edge Act or Agreement corporations, with foreign branches or that borrow from abroad must file a similar report—the FR 2950—with the FR 2900.

Other Reports

The FR 2069 (Weekly Report of Assets and Liabilities for Large U.S. Branches and Agencies of Foreign Banks) collects information on selected balance sheet items, including a breakdown of loans, securities, deposits and borrowings. This weekly report, along with other asset and liability reports aids the Fed in analyzing the current condition of the bank.

A foreign bank with U.S. branches and agencies may voluntarily file the Form FR 2225, which provides the Fed with a foreign bank's worldwide capital figure, which, in connection with a net debit cap multiple, is used to calculate the bank's daylight overdraft limit. As explained in Chapter 4, the Fed calculates a foreign bank's net debit cap for purposes of daylight overdraft limits by applying the multiple associated with the net debit cap to the foreign bank's capital measure. A foreign bank seeking to maximize its daylight overdraft capacity may find it advantageous to file the FR 2225.

The FFIEC 019 (Country Exposure Report for U.S. Branches and Agencies of Foreign Banks) collects information, by country, from U.S. branches and agencies of foreign banks on direct, indirect and total adjusted claims on foreign residents. The report also collects information regarding the respondents' direct claims on related non-U.S. offices domiciled in countries other than the home country of the parent bank that are ultimately guaranteed in the home country. A breakdown of adjusted claims on unrelated foreign residents provides exposure information. The Federal banking agencies use the data to monitor significant foreign country exposures of U.S. branches and agencies of foreign banks. Data are also used to evaluate the financial condition of these branches and agencies. The report is filed quarterly by branches and agencies of foreign banks domiciled in the United States with total direct claims on foreign residents in excess of $30 million.

U.S. Subsidiary Banks

Subsidiary banks in the United States are subject to a separate, extensive set of regulatory reporting requirements, including quarterly financial condition reports. See website of the Federal Financial Institutions Examination Council. Bank holding companies also have to file regulatory reports on their consolidated operations and U.S. nonbank subsidiaries. See website of the Federal Reserve Board.

Bank Stock Loans

Federal law requires that any FDIC insured institution or any foreign bank that maintains a branch, agency or commercial lending company subsidiary in the United States report to its primary regulator any loans secured by 25 percent or more of the shares of an FDIC-insured depository institution. These reports must be filed within 30 days of the date that the institution determines that the 25 percent level has been reached.

State Reporting Requirements

State bank regulators will typically require or receive duplicate copies of certain of the Federal reports, including the FFIEC Form 002 for branches and agencies and the FR Y-7 Annual Report. State regulators also have their own reporting requirements, which generally relate to asset pledge (capital equivalency deposit) and asset maintenance requirements that might apply *(see discussion in Chapter 4)*, as well as reporting requirements that might apply to state banks, such as with respect to unclaimed property.

Penalties for Late, Inaccurate or Misleading Reports

U.S. law imposes substantial, escalating penalties for any foreign bank, or any office or subsidiary that fails to submit reports required by the Federal banking agencies under the IBA within the time periods specified or submits or publishes any false or misleading report or information. Penalties are mitigated if a foreign bank maintains procedures to avoid any inadvertent error and the error is unintentional. Absent such procedures, or in cases of knowing failure or reckless disregard for the accuracy of information filed, penalties can increase from $20,000 to $1 million per day of the violation.

U.S. Financial Regulatory Websites

Regulatory Guide for Foreign Banks in the United States*

2005–2006 edition

U.S. Financial Regulatory Websites

Board of Governors of the Federal Reserve System ("Fed")
www.federalreserve.gov

Federal Deposit Insurance Corporation ("FDIC")
www.fdic.gov

Federal Financial Institutions Examination Council ("FFIEC")
www.ffiec.gov

Financial Crimes Enforcement Network ("FINCEN")
www.fincen.gov

National Association of Securities Dealers ("NASD")
www.nasd.com

Office of the Comptroller of Currency ("OCC")
www.occ.treas.gov

Office of Foreign Assets Control ("OFAC")
www.treas.gov/offices/enforcement/ofac

Office of Thrift Supervision ("OTS")
www.ots.treas.gov

Securities Exchange Commission ("SEC")
www.sec.gov

Glossary of Terms and Abbreviations

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Glossary of Terms and Abbreviations

Agencies—Offices of foreign banks that can engage in a commercial banking business in the United States but cannot generally accept domestic deposits.

Agreement Corporations—State-chartered international banking corporations that operate under an agreement with the Fed to limit their activities to those permissible for Edge Act corporations.

AML—Anti-Money Laundering.

Article XII Investment Companies—Companies chartered under New York State Banking Law that make commercial loans and accept credit balances.

Asset Maintenance Requirements—Requirements imposed on U.S. branches and agencies of foreign banks to ensure there are adequate U.S. assets to cover third-party U.S. liabilities.

Asset Pledge Requirements—Asset pledge maintained by U.S. branches and agencies of foreign banks as a form of capital cushion to cover costs of any liquidation and deposit liabilities.

Bank—A U.S. institution chartered by Federal or state authorities to engage in the banking business, including the acceptance of demand deposits and the making of commercial loans.

Bank Holding Company—A U.S. or foreign company that owns or controls a U.S. bank.

Bank Secrecy Act—A U.S. law intended to prevent money laundering.

Basel Accord—Risk-based capital rules agreed to by the Basel Committee on Banking Supervision.

BHC—Bank holding company

BHC Act—The Bank Holding Company Act, the U.S. law pertaining to the regulation of U.S. bank holding companies.

BIF—The Bank Insurance Fund, which provides Federal insurance for deposits in commercial banks and insured branches of foreign banks.

Branches—Offices of foreign banks that can engage in a commercial banking business in the United States, including the acceptance of domestic wholesale deposits.

BSA—The Bank Secrecy Act.

CAMELS Rating—Supervisory rating system for U.S. banks composed of Capital adequacy, Asset quality, Management, Earnings, Liquidity and Sensitivity to market risk.

Capital Equivalency Deposit—Asset pledge maintained by U.S. branches and agencies of foreign banks as a form of capital cushion to cover costs of any liquidation and deposit liabilities.

CCS Test—The test of comprehensive, consolidated supervision that must be met by a foreign bank to obtain Fed approval in any application to establish a branch, agency or commercial lending company or bank subsidiary in the U.S.

CED—Capital Equivalency Deposit.

Change-in-Bank-Control Act—Federal law that requires a person to file a notice with U.S. regulatory authorities before he or she seeks to acquire control of a U.S. bank or bank holding company or savings association or savings and loan holding company.

CIP—Customer Identification Program required by the PATRIOT Act for U.S. financial institutions.

Combined Rating—Fed supervisory rating for all U.S. operations of a foreign bank.

Combined ROCA Rating—Supervisory rating for all U.S. branches, agencies or commercial lending company subsidiaries of a foreign bank. Factored into the Combined Rating.

Commercial Lending Companies—Companies that make commercial loans and accept credit balances—see Article XII Investment Companies.

CRA—The Community Reinvestment Act, which is applicable to all insured depository institutions and insured branches of foreign banks in the United States, is intended to ensure banks serve low and moderate-income communities.

Credit Balances—Balances at agencies and commercial lending companies generated from the conduct of lawful banking operations that are not considered deposits.

Credit Unions—U.S. financial institutions that are owned by members that share a common bond. Credit unions primarily engage in retail banking activities.

De Minimis Deposits—A small amount of initial deposits under $100,000 (1 percent of monthly average of third-party deposits) that can be maintained by uninsured branches of foreign banks without violating restrictions on acceptance of domestic retail deposits.

De Novo Offices or Subsidiaries—Newly licensed or chartered branches or agencies or banking subsidiaries.

Discount Window—Program through which U.S. depository institutions and U.S. branches and agencies of foreign banks that maintain reserves with the Fed can borrow on a secured basis from the Federal Reserve Banks to meet liquidity needs.

Dual Banking System—The availability of either a Federal or state license or charter to engage in banking activities in the U.S.

Edge Act Corporations—Corporations chartered by the Fed to engage in international banking operations in the U.S. or abroad.

Examination Manual for U.S. Branches and Agencies of Foreign Banks—Fed manual describing examination policies and procedures for U.S. branches and agencies of foreign banks.

Exchange Act—The Securities Exchange Act of 1934.

FACT Act -- In December 2003, the President signed the Fair and Accurate Credit Transactions Act (the “FACT Act”) into law. It amends the Fair Credit Reporting Act in numerous respects, includes provisions to address identity theft, the accuracy of consumer reports, the duties of furnishers of information, the ability of consumers to opt out of receiving marketing solicitations from affiliates.

FBO—Foreign Banking Organization.

FBSEA—The Foreign Bank Supervision Enhancement Act of 1991.

FDI Act—The Federal Deposit Insurance Act.

FDIC—The Federal Deposit Insurance Corporation, a Federal banking agency that insures deposits in U.S. banks and savings associations and regulates, supervises and examines insured state banks that are not members of the Federal Reserve System and insured state branches of foreign banks.

FDICIA—The Federal Deposit Insurance Corporation Improvement Act of 1991.

FDICIA 112—Section of FDICIA that requires all U.S. banks and savings associations (and insured branches of foreign banks) with more than $500 million in assets to comply with annual external audit and attestation requirements.

Fed—The Board of Governors of the Federal Reserve System, the central bank of the United States, which regulates, supervises and examines State banks that are members of the Federal Reserve System, Edge Act and Agreement corporations, the international operations of national and State member banks, bank and financial holding companies and the uninsured State-licensed branches, agencies, commercial lending companies and representative offices of foreign banks.

Federal Agency—An agency of a foreign bank licensed by the Office of the Comptroller of the Currency.

Federal Branch—A branch of a foreign bank licensed by the Office of the Comptroller of the Currency.

Federal Deposit Insurance—Mandated insurance of deposits (up to $100,000 per depositor) required for U.S. banks and savings associations and funded by risk-based premiums assessed on U.S. banks and savings associations; not available to new branches of foreign banks after September 25, 1991.

FFIEC 002—Quarterly Condition Report Form for U.S. branches and agencies of foreign banks.

FFIEC 002S—A supplement to the FFIEC 002 covering offshore branches of foreign banks managed from U.S. branches or agencies.

FFIEC 019—Country exposure report for U.S. branches and agencies of foreign banks.

Financial Holding Company—A bank holding company authorized to do banking, securities, insurance, merchant banking and other financial activities under the GLB Act.

Financial Subsidiary—A subsidiary of a national or state bank that can conduct the expanded activities permissible for a financial holding company, except insurance and annuity underwriting, and real estate investment and development.

FinCEN—The Treasury Department's Financial Crimes Enforcement Network.

FRBNY—The Federal Reserve Bank of New York.

FR K-2—The FR K-2 comprises a set of applications and notifications for foreign banking organizations seeking to open a branch, agency, or commercial lending company or representative office in the United States.

FR Y-7—Annual report filed with the Fed by all foreign banks (and their parent foreign companies) that have branches, agencies, commercial lending company, Edge Act or Agreement corporation or bank subsidiaries in the United States.

FR Y-7N—Report on large U.S. nonbank subsidiaries owned or controlled by foreign banks that must file the FR Y-7. The report must be filed quarterly for each U.S. nonbank subsidiary with assets of $1 billion or more or off-balance sheet activity of $5 billion or more. The report must be filed annually for each individual U.S. nonbank subsidiary with assets of $250 million or more but less than $1 billion.

FR Y-7NS—Report on U.S. nonbank subsidiaries with assets of at least $50 million but less than $250 million that must be filed annually by all foreign banks that are required to file the FR Y-7.

FR Y-7Q—Report on consolidated regulatory capital information filed with the Fed by foreign banks that must file the FR Y-7. Financial Holding Companies must file the report quarterly; other foreign banks must file the report annually.

FR Y-8—Quarterly report filed by U.S. bank holding companies, financial holding companies and foreign banks with U.S. bank subsidiaries on transactions between each U.S. bank subsidiary and its affiliates.

FR Y-10f—Report filed by foreign banks within 30 days after the occurrence of certain structural events.

FR 2069—Weekly report of assets and liabilities for large foreign bank branches and agencies.

FR 2225—Daylight overdraft capital report for branches and agencies of foreign banks.

FR 2900—Report filed with the Fed by U.S. banks and U.S. branches or agencies of foreign banks on reserve requirements.

FR 2950—Weekly or quarterly report by U.S. banks and Edge corporations that borrow abroad.

FR 2951—Weekly or quarterly report filed with the Fed by U.S. branches and agencies on their Eurocurrency positions.

Functional Regulation—The regulation of similar financial activities by the same financial regulator, *e.g.*, banking by bank regulators, securities by SEC, insurance by State Insurance Commissioners, and holding company or affiliate regulators' reliance on that industry-specific regulation and supervision.

Functionally Regulated Subsidiary—A subsidiary within a financial holding company that is a broker-dealer, investment adviser or investment company regulated by the SEC, or an insurance company regulated by a State Insurance Commissioner, or a company regulated by the Commodity Futures Exchange Commission, with respect to its commodity activities.

GAAP—U.S. Generally Accepted Accounting Principles.

GAO—U.S. General Accounting Office.

GLB Act—The Gramm-Leach-Bliley Act, the financial modernization legislation signed into law on November 12, 1999.

Home State—State in which a foreign bank is deemed to be principally residing for purposes of interstate branching and banking restrictions.

IBA—The International Banking Act of 1978.

IBF—International Banking Facility.

Illinois FBO—Illinois Foreign Banking Office.

Insured Branch—A branch of a foreign bank the deposits of which are insured by the BIF of the FDIC.

International Banking Facility—A set of books kept in the U.S. at U.S. banks, Edge Act and Agreement corporations or U.S. branches and agencies of foreign banks at which international deposits can be received free of reserve requirements and deposit insurance assessments and at which associated international loans can be booked.

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

KYC—Know Your Customer

Lending Limits—Prudential limits on the amount of credit that can be extended by a bank to one borrower or a related group of borrowers.

Limited Branch—A branch of a foreign bank that can engage in commercial banking activities but that can only accept internationally related deposits permissible for an Edge Act corporation.

Merchant Banking Activities—Specified investment and venture capital activities permissible for financial holding companies, but not until November 2004 for financial subsidiaries.

MOU—A Memorandum of Understanding—an informal, consensual document entered into by a depository institution in the U.S. with its primary regulator to remedy less serious prudential and compliance problems.

Multiple Savings and Loan Holding Company—A company that owns two or more U.S. savings associations.

NASD—National Association of Securities Dealers.

National Bank—A U.S. bank chartered by the Office of the Comptroller of the Currency, an agency of the Federal government.

NCSIF—The National Credit Union Share Insurance Fund that insures deposits in credit unions.

1996 Act—The Economic Growth and Regulatory Paperwork Reduction Act of 1996.

NY Banking Department—The New York State Banking Department.

OCC—The Office of the Comptroller of the Currency—a bureau of the U.S. Treasury Department, which charters, regulates, supervises and examines national banks and Federal branches and agencies of foreign banks.

OFAC—Office of Foreign Assets Control, an office within the U.S. Treasury Department that administers and enforces economic and trade sanctions against targeted foreign countries, terrorism sponsoring organizations and international narcotics traffickers based on U.S. foreign policy and national security goals.

OTS—The Office of Thrift Supervision—a bureau of the U.S. Treasury Department, which charters, regulates, supervises and examines Federal savings associations, which regulates, supervises and examines state savings associations and which regulates, supervises and examines savings and loan holding companies.

PATRIOT Act—The USA PATRIOT Act enacted on October 26, 2001, to prevent, detect and prosecute terrorism and international money laundering.

PCAOB—Public Company Accounting Oversight Board.

Prompt Corrective Action—U.S. law and regulation that increases regulatory supervision of U.S. banks and insured branches of foreign banks as capital declines below certain specified levels.

Push-Out—The required transfer under the GLB Act of bank securities or investment advisory activities to an SEC registered broker-dealer or investment adviser.

PwC—PricewaterhouseCoopers.

QFBO—Qualifying Foreign Banking Organization—a test that must be met by foreign banks to be exempt from U.S. holding company regulation of nonbank activities outside the United States and to benefit from certain special exemptions for the holding of foreign nonfinancial affiliates with U.S. operations.

RAS—The Regulatory Advisory Services practice of PricewaterhouseCoopers.

Regulation K—Fed regulation governing the U.S. operations of foreign banks and foreign operations of U.S. banks.

Regulation W—Fed regulation governing transactions between U.S. depository institutions and their affiliates. Also applies to transactions between U.S. branches and agencies of foreign banks and certain GLB Act affiliates.

Representative Office—An office of a foreign bank that is limited to representational and administrative functions and that cannot engage in any banking operations in the United States.

Reserve Requirements—Reserves required of all depository institutions in the United States for monetary policy purposes.

ROCA—Supervisory-rating system for U.S. branches and agencies of foreign banks composed of Risk management, Operational controls, Compliance and Asset quality.

SAIF—Savings Association Insurance Fund—fund that provides Federal insurance for deposits in savings associations.

SAR—Suspicious Activity Report—a report that must be filed by depository institutions in the United States to report possible criminal activity.

Sarbanes-Oxley Act of 2002—Enacted on July 30, 2002, this statute was a response to major corporate and accounting scandals involving some of the most prominent companies in the United States. The Act generally applies to U.S. and non-U.S. issuers of securities in the U.S. public capital markets and includes reforms dealing with accounting, corporate accountability, corporate governance, enhanced financial disclosures, white collar crime criminal enhancements and other provisions.

SARBOX—The Sarbanes-Oxley Act of 2002.

Savings Associations—U.S. depository institutions that can be either mutually or stock-owned that have traditionally engaged in accepting savings deposits and financing residential mortgages.

SEC—The U.S. Securities and Exchange Commission.

SOSA—Strength Of Support Assessment—the strength of support rating assigned to a foreign bank parent by the Fed in consultation with other Federal and state banking agencies.

State Agency—An agency of a foreign bank licensed by state banking authorities.

State Bank—A U.S. commercial bank chartered by a banking agency of any of the 50 states or the District of Columbia.

State Branch—A branch of a foreign bank licensed by state banking authorities.

Subsidiaries—Under U.S. banking regulation, companies owned 25 percent or more by a bank holding company or foreign bank.

Umbrella Regulator—The description of the Fed's regulatory and supervisory role for financial holding companies, giving effect to the principle of functional regulation of subsidiaries.

Uninsured Branches—Branches of foreign banks whose deposits are not insured by the BIF of the FDIC.

Unitary Savings and Loan Holding Company—A company that owns a single U.S. savings association.

Well Capitalized—To qualify and maintain FHC status, all of the U.S. depository institution subsidiaries of a FHC must be and remain well capitalized. To be considered well capitalized, a U.S. depository institution must have an overall risk-based capital ratio of at least 10 percent, a Tier 1 risk-based capital ratio of at least 6 percent, and a Tier 1 leverage ratio of at least 5 percent. To be considered well capitalized, a foreign bank FHC must meet the same risk-based ratios as a U.S. depository institution, but need not meet the leverage ratio requirement.

Well Managed—To qualify and maintain FHC status, all of the U.S. depository institution subsidiaries of a FHC must be and remain well managed, *i.e.*, have a satisfactory CAMELS rating and a satisfactory management rating. To be well managed, a foreign FHC must have received a satisfactory Combined ROCA rating.

PricewaterhouseCoopers has a specialized group of former bank regulators, bankers, bank regulatory attorneys and economists who are dedicated to providing business advisory services to our clients on financial institutions regulatory, supervisory and consumer compliance matters. The group is called Regulatory Advisory Services ("RAS") and is based in Washington, D.C., but works for clients throughout the United States. Most members of the group were senior regulators, examiners or lawyers at the Office of the Comptroller of the Currency, Federal Reserve Board in Washington, Federal Reserve Bank of New York or Federal Reserve Bank of Boston.

Since 1987, RAS has assisted the full spectrum of financial institutions – U.S. money-center and regional banks, U.S. offices and subsidiaries of foreign banks, larger community banks, savings associations and credit unions in:

- Acquisition/divestiture due diligence and regulatory applications and notifications;
- Credit and treasury risk management;
- Regulatory risk management;
- Assessment and evaluation of consolidated risk management processes against regulatory expectations and requirements and market best practices;
- Enterprise-wide assessments of the level of fair and predatory lending risk present in various types of consumer lending operations through retail, direct and wholesale channels;
- Assisting official regulatory bodies in developed and emerging market countries in enhancing their supervisory processes and asset securitization;
- The design and implementation of statistically based tools for testing and/or monitoring potential disparate treatment in loan pricing and loan decisioning for mortgage and credit card products;
- Compliance procedures, policies, manuals and publications;
- Diagnosing process problems, determining corrective measures and supporting the implementation of corrective measures that respond to supervisory concerns;
- Building the regulatory infrastructure for securities affiliates; and
- Training in all aspects of regulation and corporate governance.

Assisting Clients in Building a Solid Foundation for Success

Applications, Determinations and Notifications

Depository Institution Acquisitions

Depository Institution Charters

Changes in Control

Acquisition Due Diligence

Foreign Bank Licenses and Approvals

Merchant Banking Activities

New Activities, Products or Services

Nonbank Acquisitions

Securities Activities

State Applications

Compliance and Regulatory Risk Management

Bank Examinations

Bank Secrecy/Anti-Money Laundering

Fair Lending and Disparate Treatment

Prudential Regulations

Regulatory Reporting

Securities Activities

Supervisory/Remedial Action Plans

Training/Compliance Manuals

Trust Compliance

Sound Risk Management Requirements and Practices

Affiliate Transactions

Capital Adequacy

Consolidated Supervision

Credit Risk Management

Data Systems Security and Recovery

Enterprise-wide Compliance Management

Loan Loss Reserves

Mortgage Banking

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Treasury Risk Management

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