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New Federal Reserve Board Regulations Regarding Foreign Banks in the United States

On April 2, 1992, the Federal Reserve Board (Board) issued interim regulations that will govern the approval, supervision, and termination of foreign bank offices in the United States (including branches, agencies, commercial lending companies, and representative offices).[1] The Board issued these regulations under the Foreign Bank Supervision Enhancement Act of 1991 (FBSEA),[2] enacted on December 19, 1991, which granted the Board expanded powers to regulate state-chartered foreign bank offices.

The Board proposed the FBSEA in response to recent foreign bank scandals, particularly those involving Bank of Credit and Commerce International (BCCI) (a Luxembourg-based bank that illegally gained control of several U.S. banks) and Banca Nazionale del Lavoro (BNL) (an Italian bank whose U.S. branch was found to have been making illegal loans to Iraq). These scandals could have been avoided, the Board was persuaded, if federal oversight of those banks' U.S. operations had been greater. Opponents of the FBSEA, however—which included, most notably, the New York State Bank Superintendent and other state bank regulators—contended that state regulation of foreign banks was quite adequate and that an overlay of federal regulation would only increase the costs of doing business in the United States for foreign banks.

This article briefly reviews the impact of the new FBSEA regulations on the U.S. offices of foreign banks. The analysis is divided into the following sections: (1) approval of new offices; (2) examinations; (3) termination of offices; (4) limitations on loans; (5) restrictions on deposit taking; (6) acquisitions; (7) special

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1. 57 Fed. Reg. 12,992 (Apr. 15, 1992) (to be codified at 12 C.F.R. §§ 211, 225, 263, 265) [hereinafter Board regulations]. The regulations were subject to a sixty-day comment period.

2. Title II, Subtitle A of the Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2286-2305 (1991) [hereinafter FBSEA].

provisions regarding representative offices; (8) study regarding subsidiary structure; and (9) conclusion.

I. Approval of New Offices

A. Joint Board and State Regulator Approval

The FBSEA requires for the first time that all foreign banks obtain Board approval before establishing a state-chartered office in the United States.[3] This requirement applies only to new entrants; existing foreign bank offices are grandfathered.

The Board regulations make clear that the Board does not intend to supplant the authority of state regulators, such as the New York State Banking Department, to license foreign banks. In fact, the regulations are careful to use the word "approval" rather than "license" when discussing Board oversight of foreign bank entries into the U.S. market.[4] Nevertheless, foreign banks seeking to establish state-chartered offices now must submit applications to two different regulatory authorities.

In some cases, the Board application requirements will be more onerous than state requirements. For instance, the Board requires that a notice of a foreign bank application be published in a local newspaper and that the public be given an opportunity to comment on the application.[5] In addition, as discussed below, the Board has established its own standards of approval. However, the Board is now working with the various state regulatory agencies to develop a standard application form, which should ease the paperwork burden on foreign banks.

B. Standards for Approval

The FBSEA gives the Board broad discretion in approving or disapproving foreign bank offices. One of the more controversial requirements imposed by the FBSEA is that the foreign bank must be subject to "comprehensive supervision or regulation" by its home country authorities "on a consolidated basis."[6] This requirement is designed to prevent future scandals such as that involving BCCI.

In its regulations, the Board interprets this standard as requiring that a foreign bank be regulated by its home country supervisor in such a manner that the supervisor receives sufficient information on the *worldwide* operations of the foreign bank, including the relationship of the bank to affiliated companies, so

3. FBSEA, *supra* note 2, § 202(a).
4. Board regulations, *supra* note 1, 12 C.F.R. § 211.25(a)(1)(i).
5. *Id.* § 211.25(b)(2)-(3).
6. FBSEA, *supra* note 2, § 202(d)(5).

that the supervisor is able to assess the bank's overall financial condition and compliance with law. The following factors must be considered:[7]

- Does the home country supervisor ensure that the foreign bank has adequate procedures for monitoring and controlling the bank's activities worldwide?
- Does the home country supervisor receive information regularly on the condition of the foreign bank and all of its subsidiaries and offices outside the home country through examination reports, audit reports, or otherwise?
- Does the home country supervisor obtain information on the dealings and relationships between the foreign bank and its affiliates, both foreign and domestic?
- Does the home country supervisor receive from the foreign bank financial reports that are consolidated on a worldwide basis?
- Does the home country supervisor evaluate prudential standards, such as capital adequacy and risk asset exposure, on a worldwide basis?

One might have supposed that the Board would have chosen to issue determinations that particular countries have been found to satisfy the above criteria. Instead, the standards will be applied on a case-by-case basis, with a separate determination made for each foreign bank applicant. The Board has gone so far as to declare that it may grant the application of one foreign bank and deny the application of another from the same country, in recognition of the fact that different types of institutions from the same country may be subject to different levels of supervision.[8]

C. Bank Secrecy Issues

The Board regulations permit it to require that a foreign bank applying to establish a U.S. office assure the Board that the bank will provide to the Board all information on the operations of the bank and its affiliates necessary to determine the bank's compliance with U.S. law.[9] This requirement could pose difficulties for foreign banks from countries that have bank secrecy laws protecting such information. A foreign bank therefore could be faced with a choice between violating its domestic law or having its application to the Board denied.

In recognition of this potential dilemma, the Board regulations permit it to grant approvals to foreign bank offices on the condition that future termination of activities may be required if the bank is unable to provide information on those activities or on the activities of the bank's affiliates "necessary for the Board to determine and enforce compliance with U.S. banking laws."[10]

7. Board regulations, *supra* note 1, 12 C.F.R. § 211.25(c)(1)(ii).
8. *See* Board Staff Report accompanying Board regulations (Mar. 30, 1992).
9. Board regulations, *supra* note 1, 12 C.F.R. § 211.25(c)(2)(v).
10. *Id.* § 211.25(c)(4).

II. Examinations

The FBSEA authorizes the Board to examine any U.S. office of a foreign bank, even if state-chartered.[11] The Board regulations provide that such examinations are not mandatory, but discretionary.[12] If such examinations are performed, they must be coordinated with state supervisory authorities.[13]

Under both the FBSEA and the Board regulations, foreign bank offices must be examined at least once every twelve months.[14] For foreign banks in New York, which is the home of more than 200 state-chartered foreign bank branches and agencies, this timetable will be a change from current practice, under which foreign banks are examined by the New York State Banking Department only every two years, with an informal "visitation" in the off year.

In New York, the New York State Banking Department and the Board are planning to conduct annual joint examinations of foreign banks. However, for most foreign banks, such joint examinations will not start taking place until late 1993 or early 1994, when the Board will have hired more bank examiners. This joint examination inevitably will be more costly for foreign banks.

III. Termination of Offices

The FBSEA empowers the Board to terminate the license of a state-chartered office of a foreign bank if either:

- The foreign bank is not "subject to comprehensive supervision or regulation on a consolidated basis by the appropriate authorities in its home country," or
- "there is reasonable cause to believe" that the foreign bank has "committed a violation of law or engaged in an unsafe or unsound banking practice in the United States," as a result of which continued U.S. operations "would not be consistent with the public interest."[15]

The Board regulations regarding termination basically restate this statutory standard.[16] They also provide that the Board will request and consider the views of the relevant state supervisor. Any termination order will be issued only after notice and an opportunity for a hearing. If a foreign bank wishes to terminate the activities of any U.S. office voluntarily, the bank must notify the Board at least thirty days in advance.[17]

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11. FBSEA, *supra* note 2, § 203(a).
12. Board regulations, *supra* note 1, 12 C.F.R. § 211.27(a).
13. *Id.* § 211.27(b).
14. *Id.* § 211.27(c).
15. FBSEA, *supra* note 2, § 202(a).
16. Board regulations, *supra* note 1, 12 C.F.R. § 211.26.
17. *Id.* § 211.26(f).

IV. Limitations on Loans

The Board regulations impose restrictions on loans by state branches and agencies to a single borrower so that state-licensed foreign banks are not given an advantage over federally licensed foreign banks.[18] The restrictions imposed by the Board are the same that apply to federal branches and agencies: the limit on loans to a single borrower is 15 percent of the entire bank's capital and surplus if the loan is unsecured, and an additional amount equal to 10 percent of capital and surplus if the loan is secured.[19] All loans made to the same borrower and certain related borrowers by all of the bank's branches and agencies must be aggregated for purposes of this test.

This new lending limit restriction makes a change in existing New York law. For branches, New York currently applies the loan limit percentages set by federal law, but a branch has not been required to aggregate its loans to a borrower with loans made to the same borrower by any other U.S.-based branches or agencies of the same bank.[20] Moreover, New York state-chartered agencies currently have *no* lending limit.

V. Restrictions on Deposit Taking

The FBSEA contains a provision that has greatly worried foreign banks with U.S. branches that accept corporate or other wholesale deposits. Section 214(a) of the FBSEA requires that foreign banks establish a federally insured subsidiary in order to accept or maintain deposit accounts of less than $100,000, unless the foreign bank was accepting or maintaining such deposit accounts at an insured branch on the date that the FBSEA was enacted. Congress originally intended section 214(a) to apply only to *retail* deposits, but the word "retail" was left out of the legislation (whether by accident or by design is a matter of dispute).

Unfortunately, the Board regulations do not resolve this problem. Instead, the Board has reserved for the future the promulgation of regulations to address this issue.[21] In the meantime, the Board has notified all banks that it will not enforce section 214(a) as written.

VI. Acquisitions

The FBSEA eliminated a provision of the International Banking Act (IBA) that exempted foreign banks and companies controlling foreign banks from certain requirements of the Bank Holding Company Act of 1956 (BHCA) if the foreign

18. *Id.* § 211.29.
19. *See* International Banking Act of 1978, § 4(b), 12 U.S.C. § 3102(b) (1988).
20. N.Y. Banking Law §§ 103, 202-f.
21. Board regulations, *supra* note 1, 12 C.F.R. § 211.30.

bank operated in the United States only through branches, agencies, or commercial lending companies.[22] As a result, a foreign bank or company that controls a foreign bank maintaining a branch or agency in the United States is now subject to all of the provisions of the BHCA as if the foreign bank or company were a banking holding company under that Act.

The Board regulations have implemented this change by specifying that, in general, a foreign banking organization with a branch, agency, or commercial lending company subsidiary in the United States is subject to the application requirements of the BHCA for the acquisition of greater than 5 percent of the voting shares of a U.S. bank or U.S. bank holding company.[23] Such an application is not required, however, for the acquisition of shares of a foreign banking organization that does not control a bank in the United States.[24]

VII. Special Provisions Regarding Representative Offices

The FBSEA requires for the first time that foreign bank representative offices, which act essentially as liaison offices and may not engage directly in the banking business in the United States, are to be subject to Board approval, examination, and termination.[25] In approving representative offices, the FBSEA requires that the Board take into account the same standards used in approving a foreign bank branch or agency.

This requirement poses a dilemma for the Board, because the standards used in approving foreign bank branches and agencies do not necessarily have any relationship to the liaison functions of a representative office. Therefore, in its regulations, the Board has determined that it will apply the branch/agency standards of the FBSEA only "to the extent it deems appropriate."[26] The regulations also provide that the Board will examine representative offices "in the manner and with the frequency determined by the Board."[27]

New York law does not currently require any licensing, examination, or supervision of representative offices of banks with total assets of $500 million or more. However, a bill now pending in the New York State Legislature and expected to be enacted this year would eliminate this dollar limit and subject all New York bank representative offices to state licensing, examination, and supervision.

VIII. Study Regarding Subsidiary Structure

In 1991, when the U.S. Treasury Department first proposed the revision of the U.S. bank regulatory system, the department advocated a requirement that for-

22. FBSEA, *supra* note 2, § 207.
23. Board regulations, *supra* note 1, 12 C.F.R. § 225.11.
24. *Id.* § 225.12.
25. FBSEA, *supra* note 2, § 204.
26. Board regulations, *supra* note 1, 12 C.F.R. § 211.25(d)(1).
27. *Id.* § 211.27(d).

eign banks be permitted to do business in the United States only through separately capitalized subsidiaries. This requirement was fought by foreign banks and did not become law. Nevertheless, the FBSEA requires that the Board complete a study by December 19, 1992, regarding "whether foreign banks should be required to conduct banking operations in the United States through subsidiaries rather than branches."[28]

In issuing the foreign bank regulations, the Board announced that working groups have been formed for this study and have commenced discussions of the relevant issues. Although most members of the Board are known to oppose a subsidiary requirement for foreign banks, the study is expected to examine all aspects of the issue.

The chief argument in favor of requiring foreign banks to conduct operations in the United States via subsidiaries is that, if a foreign bank fails, U.S. regulators can more easily protect persons or entities that deal with the bank's U.S. subsidiary than those that deal with a U.S. branch or agency. The regulators can afford better protection because a subsidiary has its own capital and its own distinct assets and liabilities, is subject to restrictions on transactions with its parent bank, and can survive or fail independently of its owners. A branch or agency, in contrast, has no separate capital, may deal with the home office or other branches without restriction, and will fail if the bank as a whole fails.

On the other hand, because a branch or agency has the entire worldwide capital of the bank behind its transactions and its lending limit is based on such worldwide capital, a branch or agency can undertake a larger and more varied business than a subsidiary. Therefore, its ability to engage in international commerce on behalf of the bank is greater than that of a subsidiary. Also, if the Board recommends requiring foreign banks to adopt a subsidiary structure, there is a risk that other countries would retaliate by applying a similar requirement to U.S. bank branches overseas.

IX. Conclusion

The Board regulations impose an unprecedented overlay of federal regulation on foreign banks with state-chartered offices in the United States. Such banks now will be subject to supervision and regulation by two authorities instead of one. As a result, foreign banks will face a greater paperwork burden, more personnel time devoted to satisfying federal as well as state requirements, and greater compliance costs. In particular, foreign banks can expect that the Board will conduct extensive inquiries regarding parent company activities worldwide and the extent to which those activities are regulated by the home country supervisor.

Nevertheless, the regulations should relieve to some extent the concern of foreign banks that they could be subjected to conflicting obligations to state and

28. FBSEA, *supra* note 2, § 215(a).

federal regulators. The Board appears to be sensitive to the new burdens that the regulations will impose on foreign banks. It also has indicated that it will work to avoid duplication of effort by coordinating application, examination, and termination procedures with state regulatory authorities. This process already is underway with the primary state regulator of foreign banks, the New York State Banking Department.

The Board regulations, however, have left unanswered two important questions for foreign banks: (1) Will foreign banks be permitted to continue accepting wholesale deposits below $100,000 without being required to establish a federally insured subsidiary? and (2) will the Board recommend that all foreign banks be required to establish a separately capitalized subsidiary in order to do business in the United States? The answers to both of these questions should be forthcoming later this year.