International Lawyer

Volume 26 | Number 4 Article 11

1992

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There is no simple answer to how foreign banks are dealing with the changing legal and supervisory environment since the environment is still very much in the midst of change. There is no doubt, however, that the changes have been dramatic to date and will continue to bring about a fundamental restructuring in the future.

The basic vehicle for change is, of course, the Foreign Bank Supervision Enhancement Act which became law last December. The Enhancement Act was ostensibly passed in reaction to the BCCI scandal, but in fact goes beyond addressing just those problems which existed with BCCI to impose an entirely new regulatory framework on foreign banks doing business in the United States.

The Enhancement Act carries out its purpose by addressing two fundamental aspects of a foreign bank's operations here—that of establishing or expanding business operations in this country, by imposing new application requirements, and that of conducting ongoing operations here, by imposing expanded examination procedures on U.S. operations. In addition, the Enhancement Act threw in a few curve balls which could have a significant impact on foreign banks doing business here.

I. Applications

The means by which a foreign bank can establish or expand its operations in the United States has changed dramatically as a result of the imposition by the Enhancement Act of a new requirement for Federal Reserve Board approval of the establishment of a branch, agency, or representative office in the United

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**Remarks presented to the American Bar Association Section of International Law and Practice, Apr. 10, 1992.

States. The Enhancement Act also requires that any foreign bank which does not control a U.S. bank but which has a U.S. branch or agency must obtain Board approval before acquiring more than 5 percent of any class of voting shares of a U.S. bank or a company that controls a U.S. bank. These requirements are in addition to the existing regulatory framework at the state level for licensing branches and agencies or at the OCC for the licensing of federal branches and agencies. The Enhancement Act provides that the Board may at its option take into account a number of factors, including:

(1) whether regulators in the foreign bank's home country have consented to the proposed office;
(2) the financial and managerial resources of the foreign bank and its experience in international banking;
(3) whether the applicant and its U.S. affiliates are in compliance with U.S. law; and
(4) whether the foreign bank has provided "adequate assurances" that it will provide information on the operations and activities of the bank and its affiliates as the Board deems necessary.

Underlying all of these factors is the fundamental principle imposed by the Enhancement Act that all foreign banks should be subject to comprehensive supervision or regulation on a consolidated basis by home country regulators. This requirement is mandatory rather than optional as with the other factors. Thus the Enhancement Act prohibits the Board from approving a foreign bank's application to establish an office in the United States unless the Board is satisfied that this comprehensive consolidated supervision standard has been met.

It should be apparent that these standards are inspired by the BCCI case, but it may also be apparent that these standards leave room for interpretation when they are to be applied to the vast majority of foreign banks that do not fall into the class of a BCCI-type institution. Fortunately, the Board has shed some light on these uncertainties by issuing interim regulations last week designed to set more specific procedures for foreign bank applications.

In particular, the interim regulations attempt to clarify the comprehensive consolidated supervision standard by interpreting it to mean: "whether the foreign bank is supervised or regulated in such a manner that its home country supervisor receives sufficient information on the worldwide operations of the foreign bank (including the relationship of the bank to any affiliate) to assess its overall financial condition and compliance with law and regulation."

Some of you think that this does not in fact add a substantial amount of clarification to the issue. However, the interim regulations list five factors (which are not exclusive) that the FRB will consider in evaluating this standard. These include evaluating whether the home country supervisor:

(1) ensures that the foreign bank had adequate procedures for monitoring and controlling its activities worldwide;

(2) obtains information on the condition of the foreign bank and its foreign offices and subsidiaries outside the home country through regular examination or audit reports;
(3) obtains information on the dealings and relationships between the foreign bank and its foreign and domestic affiliates;
(4) receives financial information which is consolidated on a worldwide basis or which otherwise permits analysis of the foreign bank's worldwide consolidated financial condition; and
(5) evaluates prudential standards, such as capital adequacy and risk asset exposure, on a worldwide basis.

Again, it is easy to see how a BCCI-style organization would fail even to come close to satisfying these standards. Nonetheless, considerable uncertainty must still be faced as to how these standards will be applied in more typical cases. The Board staff has indicated that these standards as enumerated will allow it sufficient flexibility in carrying out its responsibilities, which of course is desirable. One would like to think, however, that foreign banks based in industrialized countries, such as Japan and countries in the European Community, will have little difficulty in establishing that these standards are satisfied; however, it would likely create significant compliance burdens if every foreign bank, even from these countries, is required to establish in each application that its home country meets these requirements. It would seem far more efficient if the Board could assess at least the principal industrialized nations in this regard independent of the application process and perhaps publish a list of countries which it believes satisfy the comprehensive consolidated supervision standard.

Certain application procedures have also been clarified by the interim regulations. For example, the regulations define when a foreign bank is deemed to have established an office, in such a way as to include not only *de novo* offices, but also where the foreign bank:

(1) acquires a U.S. office by merger with or acquisition of another foreign bank where the target bank does not continue to operate in the same corporate form;
(2) upgrades the status of a U.S. office, such as from a representative office to a branch or agency or from an agency to a branch; and
(3) relocates an office from one state to another.

Applications are required for all offices established after December 19, 1991, the date of enactment of the Enhancement Act; the FRB has previously determined that offices that were approved by state regulators or the OCC, but that had not commenced operations at that time also require Board approval. However, the interim regulations suggest that the Board may develop abbreviated procedures for approving branch and agency applications for banks that already have other U.S. offices and that have been found to satisfy the comprehensive consolidated supervision standard. I hope that these procedures will be significantly abbreviated.

Finally, the interim regulations suggest that in evaluating an application to establish a representative office, the Board may require less information than it would for a branch or agency application. I also hope that this concept will be liberally applied.

As can be seen, these interim regulations do offer some clarification in the application requirements of the Enhancement Act. However, they do leave considerable doubt about how the application procedure will work in practice. It is encouraging to note that the Board has indicated in the interim regulations that it intends to work closely with state regulatory authorities or the OCC, and that it will rely to the extent possible on information otherwise available to the state authority or the OCC or otherwise provided by the applicant. However, it is clear that the Board will be seeking considerably more information than that which is typically provided in current state and OCC applications. I can only hope that the Board will see the importance of facilitating the application process in order to enable foreign banks to implement their business plans in the most efficient manner possible.

II. Examinations

One of the most significant aspects of the Enhancement Act has been its expansion of the authority of the Federal Reserve to examine U.S. offices of foreign banks. The Board is directed to coordinate its examinations with the OCC, the FDIC, and state authorities, but branches and agencies must be examined on-site at least annually. In addition, the Board is expressly authorized to conduct simultaneous, nationwide examinations of all offices of a foreign bank. This new authority has substantially broadened the examination responsibility of the Federal Reserve, but is a program which the Federal Reserve is only now beginning to implement. My bank has had the distinct honor of being one of the first foreign banks examined under this new authority, and I believe that qualifies me to offer a few observations on the experience.

The examination was a first for The Bank of Tokyo in two respects: it was the first time that our bank had been examined on a simultaneous basis, and it was the first time that our New York agency had been examined by the Federal Reserve together with the New York State Banking Department.

The nationwide, simultaneous aspects of the examination were somewhat awesome in scope. In order to set the scene, you should keep in mind that my bank has the largest presence of any foreign bank in the United States; if its U.S. assets were measured on a consolidated basis against U.S. domestic banks, our bank would rank among the largest fifteen banks in this country. Our bank is here in the form of major subsidiary banks in New York and California, through nine branches and agencies in different cities across the country, and through a number of nonbank financial subsidiaries located in different cities. Undertaking an examination which simultaneously reviews all of those offices is a daunting task

and I admire the Federal Reserve for taking us on. At least one news report suggested that we were selected for examination in part as a training exercise; it certainly was for us and I hope it was for the Federal Reserve as well.

The examination of the branches and agencies was undertaken by representatives of the local Federal Reserve Banks for the reserve districts where the various branches and agencies were located. I understand that all of the examination teams, however, were coordinated in the scope of their examinations by the San Francisco Federal Reserve Bank, which is the Federal Reserve Bank that under the Bank Holding Company Act is our bank's "appropriate Federal Reserve Bank." In most cases, but not all, the Federal Reserve examiners were joined by examiners from the state regulator with jurisdiction over the particular branch or agency.

The subsidiary banks, which are not Fed members, were not examined directly by Federal Reserve examiners but instead were examined by the FDIC or state authorities. Some of our nonbank subsidiaries have already been examined by Federal Reserve examiners, and several have been notified that they will be examined in coming weeks.

On balance, I would say that the examination process was a positive one, although quite rigorous. The size of the examination teams was much larger than we had been used to. As an example, our Dallas agency, which was opened only late last year and has a total staff of five, was visited by eleven examiners from the Dallas Fed and the Texas Banking Commission. The examination of the branches and agencies covered two months and, needless to say, required the use of substantial internal resources to meet the examiner's requirements. The examination focused both on asset quality matters as well as on internal procedures and controls. If I had to identify particular areas of concern to state and Federal Reserve examiners, I would say that the state examiners tended to focus their efforts on asset quality while the Federal Reserve examiners emphasized internal procedures, policies, and controls.

In responding effectively to this kind of a simultaneous examination, and in particular one in which the focus is on internal procedures and controls, it is critical that a foreign bank maintain a strong compliance program or an effective internal audit function. In my institution, considerable effort has been devoted over the last several years to upgrading internal procedures and controls through detailed, written policies and procedures. The ability to present those policies to examiners when they arrive will significantly facilitate a successful conclusion of the examination.

Among those areas where such policies are critical are treasury and funding operations and liquidity management, foreign exchange trading, swaps, options, and derivative products management. It is extremely important to be able to provide the examiners both with the detailed policies and procedures for conducting those operations, and also to be able to show that the bank's position in these areas is carefully monitored, as much as possible on a real time basis, by the bank's management.

A second critical area where a foreign bank needs to make certain that it has effective procedures in place is in the area of adequacy of loan procedures and maintenance of credit files. Many foreign banks have traditionally made loans to the U.S. offices or affiliates of their home country customers based on loan practices and procedures typical for the home country. In recent years, we have seen a dramatic shift by examiners toward insistence on strict compliance with U.S. credit policies and practices in making loans to all customers in the United States. I can say with absolute confidence that an inadequate credit file can no longer be justified by reference to home country relationships or to credit reviews or legal documents located at the head office. Thus you should advise your foreign bank clients to make sure that

- all of the materials in their credit files are in English,
- all credit files contain complete details of the credit, including a statement of purpose of the loan and a full description of repayment sources,
- where real estate or other collateral is involved, their credit files contain appraisals which are current,
- if the credit is supported by a foreign parent company guarantee, the guarantee is in the U.S. office's credit files and not at the head office, and
- if securities are pledged as collateral, the securities are held in the United States.

In addition to maintaining credit files, foreign bank offices should make certain that they have a complete loan policy manual in place. This policy manual should fully govern loan approval and the loan administration system. It should include at a minimum

- a description of the types of loans an office is authorized to make, with appropriate limitations and conditions,
- internal exposure limits for borrowers and industries,
- loan committee procedures,
- loan participation practices,
- loan pricing standards,
- past due and nonaccrual policies, and
- a loan grading system for ongoing loan monitoring purposes.

What these concerns argue for most fundamentally is strong centralized management of the foreign bank's operation within the United States. Traditionally, many foreign banks with several offices in the United States have tended to operate those offices with autonomy from one another, with reporting lines going directly from each office to the head office. One important way of preparing for a simultaneous examination is to make certain that adequate and consistent policies and practices are in place in all offices. Thus my recommendation to foreign banks is to develop a strong, centralized compliance and auditing function located in a principal office in the United States which can serve as both a source of guidance to the individual offices as well as a means of verifying and enforcing the implementation of internal policies and procedures that will consistently meet U.S. examination standards.

Having just given foreign banks advice on how to deal with a simultaneous examination which I think the Federal Reserve would approve of, I now, with some trepidation, would like to offer some observations to the Federal Reserve on how to conduct those examinations. It is apparent, I think, that the Fed is still developing its simultaneous examination techniques, and that it is not yet a fully polished process. One area where further development would be desirable is with respect to consistency among the individual Federal Reserve Banks in their examination practices. For example, over the years the various Federal Reserve Banks have developed different standards for evaluating asset quality, so that comparable assets in different offices of the same foreign bank may be evaluated on different standards. A related area where consistency would be welcome would be with regard to the issue of whether branches and agencies should maintain reserves on their books, the extent of those reserves, and the degree to which recognition will be given to reserves maintained in the home country.

A second general area is in the development by the FRB of clear policy grounds for specific aspects of the examination procedure. I believe that the examination procedure should be a positive, mutual exercise rather than an adversarial one. Thus the Federal Reserve should be able to articulate clear policy grounds for its examination inquiries. To say this is not to question the legal authority of the Federal Reserve to examine a foreign bank office in detail, but in some cases, the burdens of complying with an examination request should be supported by a reasoned basis for the request.

Finally, it may be timely for the Federal Reserve to review the basis on which the "appropriate Federal Reserve Bank" is determined for foreign banks. The "appropriate Federal Reserve Bank" is that which generally oversees the foreign bank in the United States and in particular is the reserve bank that coordinates the simultaneous examination. Regulation Y determines that a foreign bank's "appropriate Federal Reserve Bank" is that of the reserve district where a foreign bank with one or more domestic subsidiary banks had the largest concentration of domestic deposits in those subsidiary banks when the foreign bank became a bank holding company. For many banks, this is an event which occurred many years ago. For a foreign bank with no subsidiary bank, the Regulation Y test is based on where its largest concentration of branch, agency, and commercial lending companies was located on January 1, 1980. The first test, for foreign banks with subsidiaries, completely ignores branch and agency assets, and the second test does not allow for growth or shifts in asset concentrations over time. While I recognize the advantages of having a consistent, well-established relationship with a reserve bank, I believe that the Federal Reserve should consider a means of periodically reviewing a foreign bank's aggregate asset concentrations to determine if reassignment of the "appropriate Federal Reserve Bank" is called for. If foreign banks do in fact centralize their U.S. management and compliance functions in a single U.S. office, this is likely to be the largest office on an aggregate basis. Obviously, supervision and examination would best be centralized in the Federal Reserve Bank located closest to this function.

In summary, I would have to say that the examination experience was positive, although the compliance costs are significant. I have always thought that there are two kinds of traffic cops—one who wakes up in the morning and says to himself that he is going to go out and use all of his judgment, experience, and discretion to make the highways as safe as possible; the other kind is one who wakes up and says to himself that he is going to write twenty tickets that day, no matter what. In spite of the pressures that the BCCI scandal has put on the examination process, I am happy to say that preliminary indications at least are that the Federal Reserve will be the first kind of traffic cop.

One final issue remains unclear to me regarding the simultaneous examination procedure. That is, do we get the final score? To date, each of our offices has been evaluated on examination on a stand-alone basis. I do not yet know whether a final, overall summary or appraisal of the bank's U.S. operations will be issued, and if so, how it will be arrived at. I certainly await an answer to this question with great interest.

III. Curve Balls

If I may, I will refer briefly to a couple of the "curve balls" in the Enhancement Act that I mentioned at the outset. The first is the so-called retail branch deposit issue, brought about by a provision of the Enhancement Act which on its face seems to ban foreign bank branches from taking any deposits of less than $100,000, providing instead that those deposits can be taken only through U.S. domestic subsidiary banks. It has been a long-standing practice, sanctioned by federal bank regulators, for foreign banks to accept wholesale or commercial deposits of less than $100,000 as well as such deposits from foreign depositors. A considerable body of opinion suggests that the Enhancement Act was intended only to restrict branches from taking domestic, retail (that is, individual) deposit accounts and was not meant to eliminate wholesale deposit-taking activities. Federal regulators have indicated that on an interim basis foreign banks may continue to accept wholesale deposits, pending clarification of the status of the law by technical correction legislation or other congressional guidance. Because this provision, as narrowly construed, would cause considerable disruption in foreign bank activities in this country and serves no safety and soundness or competitive benefit, I hope that this matter will be quickly resolved in favor of preserving wholesale deposit-taking.

Finally, I cannot end without saying a word about the branch roll-up issue. This relates to a requirement originally proposed by the Treasury Department that all foreign bank activity in the United States be conducted through subsidiary banks rather than through branches and agencies. Although this requirement was not included in the Enhancement Act as passed, the Act did require that the Fed and the Treasury undertake a joint study, to be completed in December of this year, analyzing the appropriateness of such a requirement. Without discussing

the issue at length, let me just say that such a requirement would have a dramatic negative impact on international banking as done in the United States, and could result in a significant reduction in available capital in this country. I trust that the Fed and the Treasury will reach the same conclusion as was recently reached by the New York State Banking Superintendent's Advisory Committee on Transnational Banking Institutions, which was issued last week, and oppose such a requirement.