FEDERAL RESERVE BANK OF DALLAS

DALLAS, TEXAS 75222

Circular No. 79-83
May 3, 1979

REGULATION Y--BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL

(Proposed Amendment to Redefine "Foreign Bank Holding Companies")

TO ALL MEMBER BANKS,
BANK HOLDING COMPANIES,
AND OTHERS CONCERNED IN THE
ELEVENTH FEDERAL RESERVE DISTRICT:

The Board of Governors of the Federal Reserve System has issued a proposal to amend Regulation Y which would revise the definition of "foreign bank holding companies" to include only those foreign organizations that are principally engaged in banking outside the United States.

Printed on the following pages is a copy of the Board's proposal as published in the *Federal Register*. Interested persons are invited to submit comments to the Secretary, Board of Governors of the Federal Reserve System, Washington, D.C. 20551, to be received no later than June 20, 1979. All comments should be in writing and refer to Docket No. R-0219.

Any questions concerning the proposed rule should be directed to the Attorney's Section of our Holding Company Supervision Department, Ext. 6182.

Sincerely yours,

Robert H. Boykin

First Vice President

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FEDERAL RESERVE SYSTEM

[12 CFR Part 225]

Bank Holding Companies and Change in Bank Control

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed rule.

SUMMARY: The Board of Governors of the Federal Reserve System proposes to revise its regulation governing foreign bank holding companies. Under current regulations, foreign bank holding companies are afforded certain exemptions from the nonbanking prohibitions applicable to bank holding companies. The proposed rule would amend the definition of "foreign bank holding company" to include only those foreign organizations principally engaged in banking outside the United States.

DATE: Comments must be received by June 20, 1979.

ADDRESS: Send comments to the Secretary, Board of Governors of the Federal Reserve System, Washington, D.C. 20551. All comments should refer to Docket No. R-0219.

FOR FURTHER INFORMATION CONTACT: Michael G. Martinson, Senior Financial Analyst, Division of Banking Supervision and Regulation (202-452-3621); or C. Keefe Hurley, Jr., Senior Attorney, Legal Division (202-452-3269), Board of Governors of the Federal Reserve System.

SUPPLEMENTARY INFORMATION: Section 4(c)(9) of the Bank Holding Company Act ("Act") (12 U.S.C. 1843(c)(9)) permits the Board, by regulation or order, to grant an exemption from the nonbanking prohibitions of the Act with respect to the nonbanking activities of foreign bank holding companies that do the greater part of their business outside the United States if the exemption would not be substantially at variance with the purposes of the Act and would be in the public interest. The Board has exercised its regulatory authority pursuant to section 4(c)(9) and granted foreign bank holding companies limited exemptions from the nonbanking prohibitions of the Act (see § 225.4(g) of Regulation Y, 12 CFR 225.4(g)). The Board's regulatory exemptions relate primarily to

nonbanking activities that are conducted outside the United States. In order to qualify for these exemptions, the foreign organization must be a "foreign bank holding company" which, according to the regulation, means a bank holding company organized under the laws of a foreign country, more than half of whose consolidated assets are located, or consolidated revenues derived, outside the United States.

Although not required by the regulation, most foreign bank holding companies are also foreign banks with a high degree of banking expertise. The banking experience of such foreign banks has generally contributed to the managerial strength of their subsidiary banks. In the Board's judgment, it would be inconsistent with the purposes of the Act and would not be in the public interest for the exemptions afforded by section 4(c)(9) of the Act and § 225.4(g) of Regulation Y to be extended to a foreign organization that is not principally engaged in banking.

Accordingly, the Board proposes to amend the regulatory definition of "foreign bank holding company" so as to include only those foreign organizations that are principally engaged in the banking business outside the United States. In order to meet this test, more than one-half of an organization's consolidated deposits must be located outside the United States. For the purpose of this test, the foreign deposits of a United States bank will not be considered to be located outside the United States.

The Board specifically invites comment on the desirability of using a proportion of deposits as a criteria for determining foreign bank holding company status. Also, the Board invites comment on the question of whether the criteria for determining foreign bank holding company status should be applied solely at the time of application or on a continuing basis. Those few foreign organizations that qualify as foreign bank holding companies under the current regulation but which would not qualify under the proposed definition, would be permitted to retain investments and engage in activities that were undertaken in reliance on the current exemption.

This action is taken in connection with a regulatory analysis of the need and purposes of the regulation, and pursuant to the Board's authority under sections 4(c)(9) and 5(b) of the Act (12 U.S.C. 1843(c)(9) and 1844(b)).

It is proposed that 12 CFR Chapter II be amended as follows:

PART 225—BANK HOLDING COMPANIES

1. By deleting existing § 225.4(g)(1)(iii) and adding a new subsection; and by adding a new § 225.4(g)(4) so that § 225.4(g) reads as follows:

§ 225.4 Nonbanking activities.

* * * * *

(g) Foreign bank holding companies.

(1) As used in this paragraph: * * *

(iii) "foreign bank holding company" means a bank holding company, organized under the laws of a foreign country, that is principally engaged in the banking business outside the United States. A company will not be considered to be principally engaged in the banking business outside the United States unless at least 50 per cent of its consolidated deposits are located outside the United States.

* * * * *

(4) A company that (i) was a bank holding company on April 21, 1979; (ii) is organized under the laws of a foreign country; and (iii) has more than half of its consolidated assets located, or consolidated revenues derived, outside the United States may continue to engage in activities or retain investments that were permissible at the time they were commenced or acquired.

* * * * *

By order of the Board of Governors, April 18, 1979.

Theodore E. Allison,

Secretary of the Board.

Regulatory Analysis of Proposed Amendment to [6] 225.4(g) of Regulation Y

Section 4(c)(9) of the Bank Holding Company Act allows the Board to exempt foreign bank holding companies from certain prohibitions on ownership of nonbanking companies. The proposed change in Regulation Y narrows the definition of foreign companies that can qualify for these exemptions to those that are primarily in banking abroad.

Need for the Purpose of the Amendment

The Board recently completed a review of its policies toward foreign bank holding companies. That review took account of the growth of foreign ownership of U.S. banking institutions, the experience gained with foreign bank holding companies since the 1970 amendments to the Bank Holding Company Act, and the provisions of the recently enacted International Banking Act of 1978. The Board's policy statement of February 23, 1979, which was issued as a consequence of that review, emphasized the Board's position that foreign bank holding companies, like domestic bank holding companies, should be sources of strength to their U.S. subsidiary banks.

In U.S. banking law, Congress has mandated a separation of banking and commerce as a way of discouraging conflicts of interest and potentially unfair competition in the United States. However, an exception to these rules and standards was provided for bona fide foreign organizations in their operations outside the United States. Thus, in Section 4(c)(9) of the Bank Holding Company Act, the Board was empowered to grant exemptions from the nonbanking prohibitions of that Act to foreign companies conducting the greater part of their business outside the United States. The legislative history of that section makes it clear that it was intended to apply to companies principally engaged in the banking business. That view was reinforced by the 1978 amendments to section 2(h) of that Act which enlarged the statutory exemptions given to foreign companies principally engaged in the banking business outside the United States.

Present provisions of Regulation Y implementing Section 4(c)(9) permit any foreign company, whether principally engaged in banking or not, to qualify for these exemptions so long as the majority of its assets or revenues are outside the United States. Most of the companies qualifying for these exemptions have in fact been principally engaged in banking, and indeed have been the large international banks. However, experience has indicated that nonbanking companies can qualify as foreign bank holding companies. Moreover, because of the revenue-generating capabilities of certain nonbanking businesses, even relatively small companies can meet the criteria and acquire a U.S. bank that by most other standards is larger than itself. These possibilities contradict the policy objective that a foreign bank holding company should be a source of financial and managerial strength to the U.S. subsidiary bank.

The purpose of the amendment is to correct this potential dificiency by limiting exemptions under section 4(c)(9) to companies principally engaged in the business of banking outside the United States.

Possible Alternatives to the Proposed Regulatory Change

One alternative would be to substantially increase the supervision of foreign bank holding companies that are not primarily banking institutions. This avoids changing the Regulation, but would increase supervisory costs and

would require bank examiners to assess operations in which they lack expertise. It also continues to permit foreign firms that are essentially commercial in nature to own U.S. banks, while similar domestic firms are prohibited from doing so.

A second alternative would be to increase the required percentage of foreign assets or revenues. This approach would ensure that the foreign organization is larger relative to the U.S. bank than is permitted now, but would not prevent a foreign nonbanking organization from acquiring a U.S. bank and qualifying for Section 4(c)9 exemptions. Additionally, it might conflict with the intent of (amended) Section 2(h) of the Bank Holding Company Act, which states that the Act's restrictions on nonbank activities do not apply to foreign organizations "principally engaged in business outside the U.S. if such shares are held or acquired by a bank holding company organized under the laws of a foreign country that is *principally* engaged in the banking business outside the U.S." (emphasis added).

A third approach would be to drop the revenue test. This would disqualify relatively small revenue intensive companies, but also fails to address the issued of nonbanking business. Foreign commercial companies could continue to apply for foreign bank holding company status based on the assets of their foreign activities.

Economic Implications and Competitive Effects

Few foreign bank holding companies would be affected by the proposed change. With few exceptions, existing foreign bank holding companies are relatively large foreign banks that meet the proposed test. Activities of any existing foreign bank holding company not meeting the test would be grandfathered by the proposed regulation. Consequently, no existing foreign bank holding company would be required to divest its U.S. bank subsidiary or its foreign nonbanking activities due to the proposed change.

Preventing nonbanking organizations from becoming foreign bank holding companies in the future should not have an adverse competitive effect in U.S. financial markets. Foreign bank holding companies generally increase competition by establishing new U.S. banks or by providing financial support and growth to existing banks. The companies most likely to do this are foreign *banks*, which are unaffected by this proposal. Foreign nonbank organizations can still acquire U.S. banks, but they would be treated as domestic bank holding companies, and required to divest of any nonbanking activities not permitted under Section 4(c)8 or 4(c)13 of the Bank Holding Company Act.

There would also be no additional compliance, reporting, or recordkeeping requirements associated with this regulatory change. Bank holding companies must continue to demonstrate that they meet the standards required to qualify as a foreign bank holding company, but the procedures would be similar to those under existing requirements.

The proposed change is designed to discourage misuse of the U.S. bank's resources and to reduce its possible risk exposure. To that extent the primary beneficiaries are the U.S. banking industry, U.S. bank depositors, creditors, and shareholders, the FDIC as insurer of bank deposits, and the other state and federal bank supervisory agencies.

Advantages of the Recommended Change

The proposed change has several advantages over the existing requirements and over the specified alternatives. Requiring that the foreign company be principally engaged in banking provides greater assurance that its management is familiar with the banking business and gives priority to managing its banking activities and maintaining its reputation in financial markets. When banking is a minor part of the parent company's business, the parent may be less inclined to monitor the bank's activities and to provide adequate support. Moreover, when the foreign parent is primarily a banking organization, there is less likelihood that the U.S. bank's resources would be diverted to its nonbanking affiliates.

Domestic bank holding companies must restrict their nonbanking activities to those permissible under Sections 4(c)8 or 4(c)13 of the Bank Holding Company Act. Section 2(h) of that Act permits other nonbanking activities, but only for foreign bank holding companies that are primarily banks. Only the recommended change restricts the Section 4(c)9 exemptions to similar institutions and avoids an unnecessarily wide exemption. The change to measurement of holding company size based on deposits, rather than assets or revenues, recognizes that banking includes different activities outside the U.S. but that deposit-taking activities are central to any banking function involving risks similar to those taken by U.S. banks.

In most countries banking is more highly regulated and supervised than other industries. Where U.S. authorities are limited in supervising the parent companies, this foreign supervision and the restriction of risks to those of a banking nature provide an additional layer of protection for U.S. banking subsidiaries, financial markets, and the U.S. public.

[Regulation Y; Docket No. R-0219]
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