FEDERAL RESERVE BANK OF DALLAS

DALLAS, TEXAS 75222

Circular No. 80-102
May 28, 1980

REGULATION K - INTERNATIONAL BANKING OPERATIONS
AND REGULATION Y - BANK HOLDING COMPANIES
AND CHANGE IN BANK CONTROL

Notice of Proposed Rulemaking Relating to
Nonbanking Activities of Foreign Bank Holding Companies
and Foreign Banks

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 for comment, proposed amendments to its Regulations K and Y relating to the nonbanking activities of foreign bank holding companies and foreign banks that have banking offices in the United States. The proposals would grant certain limited exemptions from the nonbanking prohibitions of the Bank Holding Company Act. The proposals also address the questions of the types of foreign institutions that would be eligible for exemption and the types of nonbanking activities by foreign institutions that would be eligible for exemption as well.

Printed on the following pages is a copy of the Board's notice as published in the Federal Register. Any comments or views should be submitted in writing to Theodore E. Allison, Secretary, Board of Governors of the Federal Reserve System, Washington, D.C. 20551 and should be received no later than June 30, 1980. All material submitted concerning the proposed amendments should refer to Docket No. R-0291.

Any questions concerning the proposed amendments should be directed to Ms. Sherry L. Conley, Senior Attorney, of our Holding Company Supervision Department, Ext. 6182.

Sincerely yours,

Robert H. Boykin

First Vice President

12 CFR Parts 211, 225

Reg. K; Docket No. R0291]

Nonbanking Activities of Foreign Bank Holding Companies and Foreign Banks

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed rule.

SUMMARY: Foreign banks that have branches, agencies, or commercial lending company subsidiaries in the U.S., companies controlling such foreign banks, and foreign companies that have bank subsidiaries in the U.S. are subject to the nonbanking prohibitions of the Bank Holding Company Act (12 U.S.C. 1841 *et seq.*). That Act also affords exemptions from the nonbanking prohibitions for qualifying foreign organizations. The regulation proposed for comment implements and interprets those exemptions by describing the types of foreign organizations that are eligible to use the exemptions and the types of nonbanking activities and investments that are permissible.

DATE: Comments must be received by June 30, 1980.

ADDRESS: Comments, which should refer to Docket No. R–0291, may be mailed to Theodore E. Allison, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, D.C. 20551, or delivered to Room B–2223 between 8:45 a.m. and 5:15 p.m. Comments received may be inspected at Room B–1122 between 8:45 a.m. and 5:15 p.m., except as provided in section 261.6(a) of the Board's Rules Regarding Availability of Information (12 CFR 261.6(a)).

FOR FURTHER INFORMATION CONTACT: Frederick R. Dahl, Associate Director (202/452–2726), Division of Banking Supervision and Regulation; C. Keefe Hurley, Jr., Senior Counsel (202/452–3269), or Kathleen M. O'Day, Attorney (202/452–3786), Legal Division, Board of Governors of the Federal Reserve System.

SUPPLEMENTARY INFORMATION: Section 8(a) of the International Banking Act of 1978 (12 U.S.C. 3101 *et seq.*) ("IBA") provides that a foreign bank that does business in the United States through a branch, agency or commercial lending company shall be subject to the provisions of the Bank Holding Company Act ("BHCA") in the same manner and to the same extent as a bank holding company. Companies that own such foreign banks are also subject to the provisions of the BHCA. Foreign banks and companies that control U.S. banks are "bank holding companies" and, therefore, subject to the nonbanking prohibitions of the BHCA.

Sections 4(c)(9) and 2(h) of the BHCA afford foreign institutions certain exemptions from those prohibitions subject to regulation by the Board. These exemptions are intended to limit the extraterritorial impact of the prohibitions on the nonbanking business of foreign organizations. Section 4(c)(9) authorizes the Board to exempt by regulation or order nonbanking activities of foreign organizations the greater part of whose business is outside the U.S. where the Board determines that the exemption is not substantially at variance with the purposes of the BHCA and is in the public interest. Section 225.4(g) of Regulation Y (12 CFR 225.4(g)) implements section 4(c)(9). Section 2(h) permits a foreign organization that is principally engaged in the banking business outside the U.S. to acquire and hold shares of foreign nonbanking companies, and directly to engage in nonbanking activities in the United States.

There is considerable overlap between the exemptions afforded under sections 2(h) and 4(c)(9). For example, both permit a foreign organization to engage in any type of nonbanking activity abroad, yet, there are essential differences between the two. Section 4(c)(9) depends upon the Board for its implementation both as to the kinds of organizations that qualify for the exemption and the types of nonbanking activities exempted. The Board has broad discretionary power under that section. Section 2(h), on the other hand, is self-implementing, but requires Board regulation for clarification and interpretation. By its terms it applies only to foreign institutions "principally engaged in the banking business outside the United States."

Under the Board's proposals:

1. Foreign organizations in order to qualify for either exemption would be required to be principally engaged in the banking business outside the United States (*i.e.*, more than half of their business must be banking and more than half of their banking business must be outside the United States).

2. Foreign organizations that fail to qualify for two consecutive years would no longer be entitled to the exemptions.

3. Foreign organizations that do not qualify under the proposed numerical criteria would have an opportunity to petition the Board for specific determinations as to eligibility for the exemptions.

4. Permissible nonbanking activities in the U.S. would be determined by reference to the four-digit "establishment" category of the Standard Industrial Classificaiton (SIC).

5. Activities in the United States that are included in Division H of the SIC (Finance, Insurance and Real Estate) could only be engaged in with specific Board approval under sections 4(c)(8) or 4(c)(9) of the BHCA.

The Board has attempted to resolve issues in connection with these two exemptions in a manner consistent with the purposes of the statutes and their legislative histories. There follows a discussion of these issues and the Board's proposed responses:

Qualifying foreign organizations. Because many foreign banks engage in nonbanking activities abroad that would not be permissible for U.S. bank holding companies, the failure of a foreign institution to qualify for the exemptions of sections 2(h) and 4(c)(9) would present it with the choice of either foregoing doing a banking business in the U.S. or conforming its worldwide activities to the standards that apply to domestic bank holding companies.

In April 1979, the Board proposed to change the definition of "foreign bank holding company" in § 225.4(g) of Regulation Y to ensure that organizations that qualify for the exemption afforded by section 4(c)(9), in addition to being foreign, are principally

[6] The "historical cost" of an investment consists of the actual amounts paid for shares or otherwise contributed to the capital accounts, as measured in dollars at the exchange rate in effect at the time each investment was made. It does not include subordinated debt or unpaid commitments to invest even though these may be considered investments for other purposes of this Part. For investments acquired indirectly as a result of the acquisition of a subsidiary, the historical cost to the investor is measured as of the date of acquisition; at the net assets value of the equity interest in the case of subsidiaries and joint ventures, and by the book carrying value in the case of portfolio investments.

engaged in banking outside the U.S. (44 FR 24,864). The proposal reflected the Board's policy that only foreign organizations with considerable banking experience should be permitted to acquire U.S. banks. That proposal, on which no final action was taken, is subsumed in the current proposals.

It continues to be the Board's view that a foreign organization that controls a domestic bank should be principally engaged in banking abroad to ensure that it is a source of financial and managerial strength to the subsidiary bank. Moreover, it is the Board's view that a foreign organization that engages in the banking business in the United States through a branch, agency, or commercial lending company should also be predominantly a banking organization. Thus, the Board is proposing that the statutory requirement of section 2(h), that an organization be principally engaged in banking outside the United States, also be used for the exemptions afforded by section 4(c)(9). Foreign bank holding companies and foreign banks with branches and agencies in the U.S. would receive comparable treatment under the exemptions.

The Board's proposed redefinition of "foreign bank holding company" included the term "principally engaged in the banking business outside the United States." Several commenters on that proposal pointed out that the term is susceptible to several meanings. It is the Board's view that the most reasonable interpretation of the term and that most consistent with Congressional intent is that which would include only foreign organizations for which more than half of their activities worldwide are banking and more than half of their banking activities are located outside the United States.

Definition of "Banking Business"

Under the IBA, a foreign bank with a U.S. branch or agency is subject to the nonbanking prohibitions of the BHCA. "Foreign bank" is defined in section 1(b)(7) of the IBA as including, in addition to companies that engage in the business of banking, "foreign commercial banks, foreign merchant banks *and other foreign institutions that engage in banking activities usual in connection with the business of banking in the countries where such foreign institutions are organized.*" (Emphasis added.) This expansive definition brings within the scope of the BHCA foreign institutions on the basis of banking activities that are usual in the institution's home country. It would appear that the objective of ensuring that a foreign organization that does a U.S. banking business is a source of financial and managerial strength to those banking operations can be accomplished by a test that is broader than commercial banking in the U.S. context. The Board proposes to treat as "banking" the activities in § 211.5(d) of Regulation K (12 CFR 211.5(d)) that have been determined to be usual in connection with banking or financial operations abroad.

Measurement of banking business. Under the proposed criteria, a foreign institution must meet two tests in order to qualify for nonbanking exemptions. First, more than half of its worldwide business must be banking; and second, more than half of its banking business must be outside the U.S. The first test involves a measurement of banking versus nonbanking business; the second, foreign banking versus U.S. banking.

Measurement of banking and nonbanking business poses problems primarily because under most accounting conventions consolidation occurs at ownership levels above 50 per cent, while control is assumed at 25 per cent levels of ownership under the BHCA. The proposed regulation would address these problems by using as a measurement total assets *or* total revenues, leaving it to the foreign organization to choose the level of ownership (25 or 50 per cent) at which consolidation or combining will take place.

Measurement of foreign versus U.S. banking presents fewer problems once it is determined which activities will be considered banking. The Board proposes that a foreign organization be required to meet this test on the basis of more than half of its banking assets being located *or* banking revenues being derived outside the U.S. It is also proposed that all of the assets and revenues of a U.S. subsidiary bank, branch, or agency be counted as U.S., regardless of whether the assets or revenues are booked at foreign offices of the U.S. bank or received from or belong to foreign residents.

Change in status. In its proposal to revise the definition of "foreign bank holding company," the Board invited comment on the question of whether the test should be applied only at the time of an application to form a bank holding company or continuously thereafter. Comments on this issue were divided. It was pointed out that under the tests proposed, uncontrollable events such as exchange rate fluctuations could result in temporary disqualification of some organizations.

The Board proposes that an organization that fails to qualify for two consecutive years, as reflected in its annuanl report filed with the Board, lose its eligibility for the exemptions. Such an organization could apply for a specific determination as discussed below. Activities and investments undertaken while a foreign organization qualified for the exemptions could be retained after the loss of qualified status. However, activities or investments undertaken after the end of the first fiscal year in which the organization did not meet the criteria would not be grandfathered. Such an organization would, in effect, be on notice of the possible loss of qualified status.

Other foreign organizations—Most foreign institutions currently conducting a banking business in the U.S. would qualify under the recommended defintion of "principally engaged in the banking business outside the United States." In addition, most foreign organizations with tiered structures would qualify since the test would be applied on a consolidated basis.

There are, however, instances where large reputable foreign banks owned by industrial groups would fail to qualify under the recommended test even on a consolidated basis. Some of these institutions may have the financial history, condition and banking experience to enable them to operate on a safe and sound basis in the U.S. banking market. Strict application of the "principally engaged" test would force the parents of such foerign banks to either forego doing a banking business in the U.S. or divest their nonbanking (foreign as well as U.S.) interests.

The Board has the authority under section 4(c)(9) to grant exemptions on a case-by-case basis to foreign organizations where the Board determines that under the circumstances the exemption would not be substantially at variance with the purposes of the Act and would be in the public interest. The Board would exercise this authority where application of the qualifying tests would prevent sound and reputable foreign banks from doing business in the U.S. The Board proposes to permit these organizations to apply for exemption from the nonbanking prohibitions of the BHCA. The Board would examine the particular facts and circumstances of each case to determine if granting the exemption were appropriate under section 4(c)(9). If the Board were to determine that a potential for abuse exists, the Board could deny the exemption or approve the application conditioned in a manner to prevent the occurrence of such abuses.

Nonbanking activities in the United States—Section 2(h) permits a foreign organization to engage in activities in the U.S. through a foreign nonbanking company where the U.S. activities are in the same general line of business or in a business related to that of the foreign nonbanking company. The foreign company must be principally engaged in business outside the U.S. and the exemption may not be used to engage in the securities business in the U.S. Banking and financial activities and activities permissible under section 4(c)(8) of the BHCA may only be engaged in with the Board's approval.

It is clear from the legislative history of the IBA that Congress intended the Board to use the Standard Industrial Classification system for determining the comparability of U.S. and foreign nonbanking activities. While the SIC system categories are not precise, they do appear to afford a reasonable basis for comparing activities. Because it conforms to Congressional intent, and due to the complexity and burden of devising an alternative classification system, the Board proposes that the SIC be used as the standard by which U.S. activities of exempt foreign organizations are measured. The Board invites comments on the feasibility of using the SIC for determining whether U.S. and foreign nonbanking activities are in the same general lines of business.

Section 2(H)(2)(1)(B) states that an exempt foreign company:

> may engage in the United States in any *banking or financial operations* or types of activities permitted under section 4(c)(8) or in any order or regulation issued by the Board under such section *only with the Board's prior approval under that section* (emphasis added)

The legislative history of that provision indicates that its purpose was to preserve competitive equality with domestic organizations by limiting the banking and financially related activities that a foreign institution could conduct under that exemption, and not to inhibit investments by commercial and industrial companies that have a foreign bank in their ownership structures.

It is proposed that banking or financial operations in the U.S. only be permitted where such are permissible under section 4(c)(8) of the BHCA or upon application under section 4(c)(9). Division H (Finance, Insurance and Real Estate) of the SIC would be used to determine which activities are "banking or financial." In addition to comments on this general approach to the issue, specific comments are invited as to any activities within Division H that should *not* be treated as banking or financial operations.

Section 8 of the IBA permanently grandfathered nonbanking activities of foreign banks that were commenced or applied for prior to July 26, 1978. Commenters on the proposed regulations may wish to take the opportunity to comment on any interpretive issues with respect to the grandfather provisions of the IBA.

Pursuant to its authority under the International Banking Act of 1978 (12 U.S.C. 3101 *et seq.*) and the Bank Holding Company Act (12 U.S.C. 1841 *et seq.*), the Board proposes to amend Regulation Y (12 CFR Part 225) and Regulation K (12 CFR Part 211) as follows:

PART 225—BANK HOLDING COMPANIES

1. Section 225.4(g) of Regulation Y would be revised to read as follows:

§ 225.4 Nonbanking activities.

* * * * *

(g) *Foreign banks and foreign bank holding companies.* In addition to the exceptions afforded by this Part, foreign banks and foreign bank holding companies may engage in activities and make investments under Part 211 (Regulation K).

PART 211—CORPORATIONS ENGAGED IN FOREIGN BANKING AND FINANCING UNDER THE FEDERAL RESERVE ACT

2. Regulation K would be amended by designating sections 211.1 through 211.7 as Subpart A. Section 211.1(b) of Regulation K would be revised to read as follows:

§§ 211.1-211.7 [Redesignated as Subpart A]

Subpart A

§ 211.1 Authority, purpose and scope.

* * * * *

(b) *Purpose and scope.* This Part is in furtherance of the purposes of the FRA, the BHCA, and the IBA. It applies to corporations organized under section 25(a) of the FRA (12 U.S.C. 611–631), "Edge Corporations"; to corporations having an agreement or undertaking with the Board under section 25 of the FRA (12 U.S.C. 601–604(a)); [1] and to bank holding companies with respect to the exemption from the nonbanking prohibitions of the BHCA afforded by section 4(c)(13) of the BHCA (12 U.S.C. 1843(c)(13)); to foreign banks with respect to the limitations on interstate banking under section 5 of the IBA (12 U.S.C. 3103); and to foreign banks and foreign bank holding companies with respect to the exemptions from the nonbanking prohibitions of the BHCA and the IBA afforded by sections 2(h) and 4(c)(9) of the BHCA (12 U.S.C. 1841(h) and 1843(c)(9)).

3. Regulation K would be amended by adding a Subpart B.* Within Subpart B, a new section, 211.23, would be added as follows:

Subpart B

§ 211.23 Nonbanking activities of foreign banking organizations.

(a) *Definitions.* The definitions of section 211.2 apply to this subsection subject to the following:

(1) "Directly or indirectly" when used in reference to activities or investments of a foreign banking organization means activities or investments of the foreign banking organization or of any subsidiary of the foreign banking organization.

(2) "Foreign banking organization" means a foreign bank that operates a branch, agency or commercial lending company subsidiary in the United States; a foreign bank that controls a bank in the United States; and a company of which such foreign bank is a subsidiary.

(3) "Subsidiary" means an organization more than 25 percent of the voting stock of which is held directly or indirectly by a foreign banking organization or which is otherwise controlled or capable of being controlled by a foreign banking organization.

(b) *Qualifying foreign banking organizations.* To qualify for the exemptions afforded by this section a foreign banking organization, unless specifically made eligible for the exemptions by the Board, shall meet the folowing requirements:

(1) More than 50 percent of its total assets shall be banking assets or more than 50 percent of its total revenues shall be derived from the banking business; and

[1] Section 25 of the FRA, which refers to national banking associations, also applies to State member banks of the Federal Reserve System by virtue of section 9 of the FRA (12 U.S.C. 321).

* Also included within new Subpart B will be regulations concerning interstate banking operations of foreign banks and bank holding companies, designated as section 211.22. (See 44 F.R. 62902)

(2) more than 50 per cent of its total banking assets shall be located outside the United States or more than 50 per cent of total banking revenues derived from outside the United States. All assets and revenues of a United States subsidiary bank, branch, agency, or commercial lending company shall not be considered as "outside the United States."

(c) *Determing assets and revenues.* (1) For purposes of paragraph (b) of this section, the total assets and revenues of an organization shall be determined on a consolidated or combined basis. Assets and revenues of companies in which the foreign organization owns 50 per cent or more of the voting shares shall be included when determining total assets or revenues. The foreign organization may include assets or revenues of companies in which it owns 25 per cent or more of the voting shares if all such companies within the organization are included;

(2) Assets or revenues that involve activities listed in § 211.5(d) shall be considered banking assets or banking revenues when conducted within the foreign banking organization by a foreign bank or its subsidiaries.

(d) *Loan of eligibility for exemptions.* A foreign organization that qualified under paragraph (b) of this section shall cease to be eligible for the exemptions of this section if it fails to meet the test of paragraph (b) for two consecutive years as reflected in its Annual Reports (F.R. Y-7) filed with the Board. A foreign organization that ceases to be eligible for the exemptions may continue to engage in activities or retain investments commenced or acquired prior to the end of the first fiscal year for which its Annual Report reflects nonconformance with paragraph (b) of this section. Activities commenced or investments made after that date may continue to be engaged in or held only with the consent of the Board under paragraph (e) of this section.

(e) *Specific determination of eligibility for nonqualifying foreign banking organizations.* A foreign organization that does not otherwise qualify for the exemptions afforded by this section, including organizations that cease to be eligible for the exemptions, may apply to the Board for a specific determinaiton of eligibility for the exemptions. In determining whether eligibility for the exemptions would be consistent with the purposes of the BHCA and in the public interest, the Board shall consider the history and the financial and managerial resources of the organization, the amount, type and location of its nonbanking activities, and whether eligibility of the foreign organization would result in undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices. Such determination shall be subject to any conditions and limitations imposed by the Board.

(f) *Permissible activities and investments.* A foreign organization that qualifies under paragraph (b) may:

(1) Engage in activities of any kind outside the United States;

(2) Engage directly in activities in the United States that are incidental to its activities outside the United States;

(3) Own or control voting shares of any company that is not engaged, directly or indirectly, in any activities in the United States except as shall be incidental to the international or foreign business of such company;

(4) With the prior specific consent of the Board, own or control (i) voting shares of a commercial lending company; or (ii) 25 per cent or more of the voting shares of another foreign banking organization;

(5) Own or control voting shares of any company in a fiduciary capacity under circumstances that would entitle such shareholding to an exemption under section 4(c)(4) of the BHCA if the shares were held or acquired by a bank;

(6) Subject to the following limitations, own or control voting shares of a foreign company that is engaged directly or indirectly in business in the United States:

(i) more than 50 per cent of the foreign company's consolidated assets shall be located, and consolidated revenues derived from, outside the United States;

(ii) the foreign company shall not engage directly or indirectly in the business of underwriting, selling, or distributing securities in the United States except to the extent permitted bank holding companies;

(iii) if the foreign company is a subsidiary of the foreign banking organization, its direct or indirect activities in the United States shall be subject to the following limitations:

(A) The foreign company's activities in the United States shall be the same kind of activities or related to the activities engaged in by the foreign company abroad as measured by the "establishment" categories of the Standard Industrial Classification (SIC) (an activity in the United States shall be considered related to an activity outside the United States if it consists of supply, distribution or sales in furtherance of the activity);

(B) The foreign company may acquire the assets or shares of a United States company that would cause more than 50 per cent of the foreign company's assets or revenues associated with a particular SIC category to be located in or derived from the United States only after the parent foreign banking organization has given 60 days prior written notice to the Board. The Board may, during the notification period, disapprove the investment, suspend the period, or authorize the acquisition to be made prior to the termination of the notification period;

(C) The foreign company may engage in activities in the United States that consist of banking or financial operations, or types of activities permitted by regulation or order under section 4(c)(8) of the BHCA, only with the prior approval of the Board. Activities within Division H (Finance, Insurance, and Real Estate) of the SIC shall be considered banking or financial operations for this purpose.

(g) *Exemptions under section 4(c)(9) of the BHCA.* A foreign organization that is of the opinion that other activities or investments may, in particular circumstances, meet the conditions for an exemption under section 4(c)(9) of the BHCA may apply to the Board for such a determination by submitting to the Reserve Bank of the district in which its banking operations in the United States are principally conducted a letter setting forth the basis for that opinion.

(h) *Reports.* A foreign organization shall inform the Board, through such Reserve Bank within 30 days after the close of each quarter, of all shares of companies engaged, directly or indirectly, in activities in the United States that were acquired during such quarter under the authority of this section. Such information shall (unless previously furnished) include a brief description of the nature and scope of each company's business in the United States. Information required need by given ony insofar as it is known or reasonably available to a foreign organization. If any required information is unknown and not reasonably available to the foreign banking organization, either because the obtaining thereof would involve unreasonable effort or expense or because it rests peculiarly within the knowledge of a company that is not controlled by the organization, the information need not be provided, but the organization shall (1) give such information on the subject as it possesses or can acquire without unreasonable effort or expense together with the sources thereof, and (2) include a statement either showing that unreasonable effort or expense would be involved or indicating that the company whose shares were acquired is

not controlled by the organization and stating the result of a request made to such company for information. No such request need be made, however, to any foreign government, or an agency or instrumentality thereof, if, in the opinion of the organization, such request would be harmful to existing relationships.

Board of Governors of the Federal Reserve System, April 30, 1980.

Theodore E. Allison,

Secretary of the Board.

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