FEDERAL RESERVE BANK
OF DALLAS

WILLIAM H. WALLACE
FIRST VICE PRESIDENT
AND CHIEF OPERATING OFFICER

DALLAS, TEXAS 75222

August 27, 1987

Circular 87-59

TO: The Chief Executive Officer of all member banks, bank holding companies and others concerned in the Eleventh Federal Reserve District

SUBJECT

Amendments to Regulation K - International Banking Operations

DETAILS

The Federal Reserve Board has agreed to liberalize the provisions of Regulation K to permit certain investments abroad by U.S. banking organizations through debt-for-equity swaps. The amendments will allow U.S. banks to acquire as much as 100% of nonfinancial companies in heavily indebted developing countries.

The purpose of the amendment is to provide additional flexibility for U.S. banking organizations to make investments in companies being privatized in heavily indebted developing countries. The eligible countries would be developing countries that have engaged in restructuring of sovereign debt held by foreign creditors since 1980.

However, there are restrictions on the investment. Any investments must be made by the parent bank holding company or one of its subsidiaries, not the bank itself. Also, ownership interests must be divested within five years from the date of acquisition, unless the Board extends the time for good cause, but in no event longer than a total of ten years.

Although the amendment is effective immediately, comments may be submitted by September 30, 1987, to Mr. William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551. All correspondence should refer to Docket No. R-0610.

For additional copies of any circular please contact the Public Affairs Department at (214) 651-6289. Banks and others are encouraged to use the following incoming WATS numbers in contacting this Bank (800) 442-7140 (intrastate) and (800) 527-9200 (interstate).

ATTACHMENTS

The notice of the Board's action is attached.

MORE INFORMATION

For further information, please contact Sharon Sweeney of this Bank's Legal Department at (214) 651-6228 or the following Supervision and Regulation Department personnel:

Applications: Gayle Teague (214) 651-6481

Supervision of Edge Corporations: Linda M. Myers (214) 651-6670

If you wish to receive additional copies of this circular, please contact our Public Affairs Department at (214) 651-6289.

Sincerely yours,

William H. Wallace

FEDERAL RESERVE press release

For immediate release August 12, 1987

The Federal Reserve Board announced today that it has liberalized the provisions of Regulation K to permit certain investments abroad by U.S. banking organizations through debt-for-equity swaps.

The amendment is effective immediately. However, the Board also has requested comments by September 30, 1987, as part of a continuing review of regulations governing debt-for-equity investments.

The purpose of the amendment is to provide additional flexibility for U.S. banking organizations to make investments in companies being privatized in heavily indebted developing countries. The eligible countries would be developing countries that have engaged in restructurings of sovereign debt held by foreign creditors since 1980.

The amendment will permit a U.S. banking organization to acquire as much as 100 percent of the shares of a foreign nonfinancial company in the following circumstances:

- the nonfinancial company must be in the process of being transferred from public to private ownership;
- the country in which the company is located must be a heavily indebted developing country;
- the shares are acquired through a debt-for-equity swap;
- the shares are held by the bank holding company or its subsidiaries; and,

(over)

- the ownership interest must be divested within five years from the date of acquisition, unless the Board extends the time for good cause but in no event longer than a total of ten years.

The notice of the Board's action is attached.

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Attachment

12 CFR Part 211

[Docket No. R-0610]

Regulation K; International Banking Operations

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule and request for comment.

SUMMARY: The Board has revised its regulation governing permissible foreign investments of U.S. banking organizations to permit investors to acquire from foreign governments ownership of certain foreign companies engaged in nonfinancial activities in the context of exchanging debt obligations of the government for equity ownership interests in the companies. The Board is continuing its examination of regulations governing debt-for-equity investments in heavily indebted countries and requests comments on issues related to such investments.

DATES: The final rule is effective August 18, 1987. Comments are requested on or before September 30, 1987.

ADDRESS: All comments, which should refer to Docket No. R-0610, should be mailed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551, or should be delivered to the Office of the Secretary, Room 2223, Eccles Building, 20th Street and Constitution Avenue, NW., between the hours of 8:45 a.m. and 5:15 p.m. weekdays. Comments may be inspected in Room 1122, Eccles Building, between 9:00 a.m. and 5:00 p.m. weekdays.

FOR FURTHER INFORMATION CONTACT: Ricki Rhodarmer Tigert, Assistant General Counsel (202/452-3428); Kathleen O'Day, Senior Counsel (202/452-3786), Legal Division; or James Keller, Manager, International Banking Applications (202/452-2523), Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, Washington, DC 20551. For the hearing impaired *only*, Telecommunications Service for the Deaf, Earnestine Hill or Dorothea Thompson, (202/452-3544).

SUPPLEMENTARY INFORMATION: Under the Board's regulations, U.S. banking organizations have substantial authority to make investments in foreign financial companies, including investments resulting from debt-for-equity swaps. Generally under Regulation K, a U.S. banking organization may hold as much as 100 percent of the shares of a financial company and up to 20 percent of the shares of nonfinancial companies.

The Board has had these regulations under review in connection with proposed debt-for-equity swaps in heavily indebted developing countries. The revisions adopted are the first result of this review. The Board is continuing its examination of these regulations and invites comments on issues related to debt-for-equity swaps as part of this review. Such comments are requested by September 30, 1987. The Board will consider the comments as part of its continuing evaluation of Regulation K. In addition, at the request of several members of the Senate Committee on Banking, Housing, and Urban Affairs, the Board will be preparing a report on debt-for-equity issues and will take the comments into account in preparing this report.

Involvement by U.S. banking organizations in debt-for-equity transactions has taken three forms. First, U.S. banks have earned fees by acting as brokers between other banks and multinational companies seeking to make equity investments in developing countries. Second, some U.S. and foreign banking organizations making portfolio adjustments have sold loans to other potential investors, usually multinational corporations that have in turn used them to make debt-for-equity investments in developing countries. Substantial debt-for-equity investments have been made by multinational companies because such investments have been viewed as a natural extension of their business operations. Finally, U.S. banking organizations have themselves made limited debt-for-equity investments under Regulation K.

Some countries with substantial debts to foreign creditors allow or encourage a portion of those debts to be converted into equity investments in those countries. The companies available for investment include nonfinancial companies that are currently state-owned. Private investment in such companies may provide some benefits to the countries by reducing economic inefficiencies and governmental subsidies.

A number of U.S. banking organizations are interested in making controlling investments under these programs in foreign companies that are not engaged in banking or financial activities. The Board has determined that in the following circumstances banking organizations may purchase up to 100 percent of the shares of a nonfinancial company:

—The company must be acquired from a foreign government;

—The country in which the company is located must be a country that has restructured its sovereign debt obligations to foreign creditors since 1980;

—The ownership interest in the companies acquired must be divested as soon as practicable and no later than five years from the date of acquisition, unless the Board extends

the time for good cause for up to a total of five additional years; and
—The investment must be held through a bank holding company.

The above framework provides a basis under which U.S. banking organizations may make investments in foreign companies that are not engaged in permissible activities under Regulation K through foreign government-sponsored debt-for-equity conversion programs. The Board has amended Regulation K to reflect this framework.

The liberalizing amendment would permit investments to be made in companies being privatized by a foreign government using sovereign debt held by the banking organization. If there are instances in which a program of debt-for-equity conversions established by the government of a heavily indebted developing country requires that new money be invested in addition to the proceeds of the debt obligation that is swapped, the Board will consider such investments on a case-by-case basis.

Under the amendment to Regulation K, U.S. banking organizations will be able to make investments in companies being privatized in eligible countries. These would include countries that since 1980 have rescheduled external sovereign debt.[1] The amendment would not allow, for example, a U.S. banking organization to buy a controlling interest in a company in an industrialized country where the company is engaged in activities other than those permissible under Regulation K, even if that company is in the process of being privatized.

Because the amendment is intended to provide flexibility in managing portfolios of loans to heavily indebted countries and is not intended to permit permanent investments in nonbank concerns, the equity interests acquired under this proposal must be divested after a temporary period when it becomes feasible. The debt-for-equity conversion programs usually have restrictions on repatriation of dividends and capital; the repatriation restrictions do not, however, prevent the sale of such companies to other foreign non-residents. In light of the ability to divest the company even within the period of repatriation restrictions, the Board has determined that a reasonable holding period appears to be five years. The Board retains the discretion to grant additional extensions of time totaling five additional years for good cause, normally in one-year increments.

[1] *See, e.g.*, Section 1201(e)(2)(H) of The Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2527 (1986).

Because this amendment would permit a banking organization to take controlling interests in commercial and industrial companies, even if only for a limited period of time, the Board determined that such investments should be held through the bank holding company and not through the bank itself. This form of ownership attempts to erect an effective barrier between the bank and the commercial and industrial activities of the companies to be acquired. It does this in several ways: the nonbanking activity is further isolated from the bank; ownership through the bank holding company is intended to indicate that the nonbank is not protected by the federal safety net available to banks; and the restrictions of section 23A of the Federal Reserve Act (12 U.S.C. 371c) apply as a matter of law to transactions between banks and affiliated nonbanks. In several previous cases involving non-traditional activities for banking organizations, the Board has required that the investment be held through the bank holding company. *Citibank Overseas Investment Corporation*, 70 Federal Reserve Bulletin 168 (1984); 71 Federal Reserve Bulletin 269 (1985).

Because this new investment authority would permit active involvement of a banking organization in the operations of commercial companies, the Board believes that a number of prudential measures will make an initial contribution toward limiting potential adverse effects, such as conflicts of interest and unsound banking practices.

There are several reasons for these concerns. For example, the affiliation itself could cause the banking organization to extend credit to the nonbank affiliate on other than market terms, even if the affiliate is not creditworthy. Moreover, in instances where the banking organization has joined with one or more other investors to purchase a nonbank affiliate, a bank could feel the same pressure to lend preferentially to the investing partners in order to increase the likelihood of success of the company in which they had invested.

Moreover, experience shows that banking organizations generally stand behind the losses of affiliated institutions in order to protect the international reputation of the organization as a whole. In some instances this has led to losses that have been a multiple of the investments in the affiliated organization. In the case of investments in commercial enterprises, in which banking organizations have little if any expertise, there could be an even greater risk that losses could occur.

As one approach to dealing with these concerns, the Board believes that any loans to the nonbank company acquired pursuant to this amendment should be considered "investments" in that company and subject to the same investment procedures as apply to investments made in the form of equity. Therefore, a bank holding company can make an investment in a foreign nonbank company using existing debt through any combination of loans and equity under the procedures of Regulation K. Under these procedures, any investment of up to the lesser of $15 million or 5 percent of the capital and surplus of the investor may be made under general consent, that is, without any prior notice to the Board. Thereafter, additional investments in the same company generally can be made under general consent in amounts less than or equal to 10 percent of the historical cost of the investment plus any reinvestment of dividends. Any investments that do not qualify for the general consent require 45 days prior notice to the Board. Because they involve interaffiliate transactions and in particular could involve interaffiliate lending, such additional investments would be carefully reviewed from a safety and soundness perspective.

The Board also believes that the banking organization and its nonbank affiliate should not have similar names. Even if there is a legal and functional separation between the bank and its affiliate, there is a danger that the market will perceive the banking organization and the affiliate as one. The restrictions on the sharing of a similar name by the banking organization and its nonbank affiliate would reduce the likelihood that a bank would be identified with the nonbank company and thereby reduce the pressures on a banking organization to support the affiliate in the case of losses.

Acquisition of control of nonbank companies will cause a banking organization to become engaged in the same types of businesses in which some of its customers may be engaged. In order to address this potential conflict, the revised regulation prohibits the banking organization from sharing with the nonbank affiliate any confidential information with respect to customers of the bank holding company or its affiliates that are engaged in the same or related lines of business as the nonbank company.

In addition, care should be exercised to ensure the separateness of the banking organization and the nonbank affiliate. To that end, it is expected that banking organizations will maintain few interlocks of officers and directors between the banking organization and the nonbank affiliate, and then only to the extent that it is administratively necessary.

The Board emphasizes that an investor must, consistent with prudent banking practices, carefully evaluate the soundness of an investment before it is made. In this connection, an investor would be expected to demonstrate that it has conducted a thorough due diligence review of a proposed investment. Such a review could include an examination of the proposed investment by qualified independent experts with knowledge about, and experience in, the commercial activities of the proposed investment. An investor could also demonstrate that the investment may be considered prudent through the participation of unaffiliated investors willing to put their own capital at risk in exchange for equity interests in the company being acquired. In addition, the investing banking organization could show that the operation of the nonfinancial company would be in the hands of experienced management personnel.

Pursuant to section 605(b) of the Regulatory Flexibility Act (Pub. L. 96-354); 5 U.S.C. 601 *et seq.*), the Board of Governors of the Federal Reserve System certifies that the amendment will not have a significant economic impact on a substantial number of small entities that would be subject to the regulation. The amendment would liberalize existing regulations and would not have any particular effect on small business entities.

The Board has determined that the provisions of section 553(b) of Title 5, United States Code, with respect to notice, public participation and deferred effective date are not necessary with respect to this revision to Regulation K. As noted above, this amendment liberalizes the investment restrictions of the regulation. An immediate effective date will allow banking organizations to begin to make investments under the revised provisions upon publication in the **Federal Register**.

List of Subjects in 12 CFR Part 211

Banks, banking; Federal Reserve System; Foreign banking, Investments, Reporting and recordkeeping requirements, Export trading companies, Allocated transfer risk reserve, Reporting and disclosure of international assets, Accounting for fees on international loans, Investment made through debt-for-equity conversions.

12 CFR Part 211 is amended as follows:

PART 211—[AMENDED]

1. The authority citation for Part 211 is revised to read as follows:

Authority: Federal Reserve Act (12 U.S.C. 221 *et seq.*); Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841 *et seq.*); the International Banking Act of 1978 (Pub. L. 95-369; 92 Stat. 607; 12 U.S.C. 3101 *et seq.*); the Bank Export Services Act (Title II, Pub. L. 97-290, 96 Stat. 1235); and the International Lending Supervision Act (Title IX, Pub. L. 98-181, 97 Stat. 1153, 12 U.S.C. 3901 *et seq.*), unless otherwise noted.

2. Section 211.5 is amended by adding a new paragraph (f) to read as follows:

§ 211.5 Investments and activities abroad.

* * * * *

(f) *Investment made through debt-for-equity conversions*—(1) *Permissible Investment.* In addition to an investment that may be made under other provisions of this section, a bank holding company may acquire up to and including 100 percent of the shares of (or other ownership interest in) a foreign company if:

(i) The shares are acquired from the government of an eligible country or from its agencies or instrumentalities;

(ii) The shares are acquired by conversion of sovereign debt obligations of the eligible country either through a direct exchange of debt obligations or a payment for the debt in local currency, the proceeds of which are used to purchase the shares;

(iii) The shares are held by the bank holding company or its subsidiaries, provided however that such shares may not be held by a U.S. insured bank or its subsidiaries;

(iv) The shares are divested within five years of acquisition unless the Board extends such time period for good cause shown but no such extensions may in the aggregate exceed five years; and

(v) An investment shall be made under this paragraph in accordance with the investment procedures of paragraph (c) of this section and shall be subject to paragraphs (b)(3)(i) (A) and (B) of this section.

(2) *Definitions.* For purposes of this paragraph

(i) An "eligible country" means a country that, since 1980, has restructured its sovereign debt held by foreign creditors; and

(ii) "Investment" shall have the meaning set forth in § 211.2(i) of this part and, for purposes of this paragraph, shall include loans or other extensions of credit by the bank holding company or its affiliates to a company acquired pursuant to this paragraph.

(3) *Conditions.* (i) Any company acquired pursuant to this paragraph shall not bear a name similar to the name of the acquiring bank holding company or any of its affiliates; and

(ii) Neither the bank holding company nor its affiliates shall provide to any company acquired pursuant to this paragraph any confidential business or other information concerning customers that are engaged in the same or related lines of business as the company.

Board of Governors of the Federal Reserve System, August 12, 1987.

William W. Wiles,

Secretary of the Board.

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