

THE FEDERAL RESERVE SYSTEM'S
SUPERVISION AND REGULATION OF THE
FOREIGN OPERATIONS OF UNITED STATES BANKING ORGANIZATIONS

Regulation and Supervision of
Bank Affiliated Conglomerates in Latin America

Miami, Florida
April 2-3, 1998

Ernest T. Patrikis
First Vice President
Federal Reserve Bank of New York

The views expressed herein are solely those of the author and do not necessarily reflect the views of the Federal Reserve Bank of New York or any other component of the Federal Reserve System.

The Federal Reserve System's
Supervision and Regulation of the
Foreign Operations of United States Banking Organizations 1/

I. Statutory and Regulatory Background

In the United States, several organizations are charged with the supervision and regulation of various types of banking organizations; this paper discusses the role of the [Board of Governors of the Federal Reserve System](#) (the "Board" or "FRS"). When acting as a home country supervisor, the Board is generally responsible for, among other things, the supervision of the foreign operations of bank holding companies, the foreign operations of national and State-chartered banks which are members of the FRS ("member banks"), and so-called Edge Act corporations ("Edges"). Three main statutes lay out the Board's authority over the foreign operations of U.S. banking organizations: the [Federal Reserve Act](#) (codified as amended in scattered sections of 12 U.S.C.) (the "FRA"), the International Banking Act of 1978 (codified as amended in scattered sections of 12 U.S.C.), and the Bank Holding Company Act of 1956 (12 U.S.C. "1841-1848") (the "BHC Act"). In addition, the Board's Regulation K (12 C.F.R. Part 211) and various official interpretations, staff opinions, supervisory letters ("[SR Letters](#)"), and examination manuals provide further regulatory authority and guidance.

II. General Organization of Foreign Operations of U.S. Banking Organizations

A U.S. banking organization may conduct its foreign operations through various organizational vehicles. The particular vehicle used by an organization depends upon several factors, including the size and character of its international business, domestic and foreign banking laws and regulations, the availability of capital, management capabilities, and tax implications. Foreign operations are usually conducted through a foreign branch, a subsidiary of an Edge or the bank holding company, or a foreign bank subsidiary of a member bank.

A typical structure of a U.S. banking organization's foreign operations is found in [Attachment A](#). Typically, a banking organization will conduct its foreign operations through a subsidiary of an Edge, though the bank holding company may also acquire or invest in foreign companies engaged in banking or financial activities outside of the United States. Due to historical developments and funding considerations (see [Part VI](#) below), the Edge is generally held as a subsidiary of a member bank; however, the Edge may also be held directly by the bank holding company. The Edge is permitted to engage in activities directly, though few do so. Rather, the Edge usually acts as the holding company of a banking organization's foreign activities.

A member bank is permitted to directly invest only in an Edge or in a foreign bank; it may not directly invest in other financial companies engaged in business abroad. In addition, a member bank may establish a branch in a foreign country.

III. Foreign Branches of Member Banks

The most common organizational vehicle used by U.S. banking organizations to conduct foreign operations is a foreign branch of a member bank. A branch is not a separately incorporated entity, but merely an extension of the bank. However, for many purposes in banking and commercial law, a branch is treated as if it were a separately incorporated bank. For example, the FRA requires a bank to have a foreign branch maintain its accounts separately from the head office and other foreign branches. In addition, foreign branches must be licensed by, and comply with all of the laws, regulations, and business practices of, the host country.

Foreign branches are permitted to provide a full range of general banking services. So that they may compete more effectively with banks in the host country, foreign branches may also engage in a number of activities that may otherwise be impermissible in the United States, as long as they are considered usual banking activities in the host country. Regulation K specifies such activities, which include: guaranteeing customers' debts, underwriting debt securities of the host country's government, and acting as an insurance agent or broker. (See [Attachment B](#) for a complete list of permissible activities.) A branch is not permitted, however, to engage in the general business of producing, distributing, buying or selling goods, wares, or merchandise ("General Commercial Business"); nor is a branch permitted to underwrite, sell, or distribute securities, except as noted above.

Foreign branches are permitted to take deposits from U.S. residents (as well as from non-U.S. residents). However, the Board requires adequate policies to be in place to inform the depositors of the risks of such deposits.^{2/}

A [member bank](#) must receive Board approval prior to establishing its first branch in a particular country. Thereafter, it does not need Board approval to establish additional branches in that country. In addition, once a bank has established branches in two or more countries, it may establish a branch in another country after giving the Board 45 days prior written notice. The Board considers several factors when acting on a branch application, including: the proposed activities of the branch, projected earnings, the proposed branch management, foreign government approvals, and the bank's international banking experience. The Board may also consider the supervisory practices of the host country when the Board has not previously reviewed a branch application for that country. The application procedures developed by the Board are consistent with the Board's responsibilities as home country supervisor under the Basle Committee on Banking Supervision's [Minimum Standards for the Supervision of International Banking Groups and their Cross-Border Establishments \(July 1992\)](#), as supplemented by [The Supervision of Cross-Border Banking \(October 1996\)](#), which call for the Board's specific authorization of a U.S. bank's outward expansion. Such authorization is necessary to ensure that the home and host country supervisors establish a dialogue to allocate supervisory responsibilities for the banking organization.

IV. Edge Act Corporations

Another common vehicle used by U.S. banking organizations to conduct foreign operations is an Edge. As distinguished from foreign branches, Edges are separately capitalized and incorporated, federally-chartered organizations. Though Edges are incorporated in the United States, they are organized for the purpose of engaging in international or foreign banking or other international or foreign operations. Indeed, the Edge Act (Section 25A of the FRA) was enacted to enable U.S. banks to compete more effectively with foreign-owned banking institutions, to provide a source of financing for U.S. importers and exporters, and to strengthen government control and supervision of international banking activities.

As noted above, an Edge may be owned by a bank holding company directly or through a member bank subsidiary. Note, however, that a member bank may not invest more than 10 percent of its capital and surplus in an Edge. The Board may approve an additional investment by the bank over 10 percent, but under 20 percent, unless it determines that the investment would be unsafe or unsound.

Edges are the only organizations which the Board charts as well as supervises. The Board considers several factors in acting upon a charter application: financial condition and history, general character of management, convenience and needs of the community, and competitive effects. The Board will also request information on the applicant's proposed activities, the applicant's prior experience in international banking, and the Edge's projected income. The Board seeks comments from interested members of the public prior to acting on the application.

The Edge Act permits an Edge to engage in a full range of banking activities consistent with the international nature of its business. (See [Attachment C](#) for a complete list of permissible activities.) There are few Edges engaged in banking, however.

Most Edges are holding companies for foreign investments. An Edge may invest in other Edges, U.S. corporations, or foreign corporations, provided that the corporation does not engage in general commercial business in the United States and does not engage in any other business in the United States that is not incidental to the corporation's international or foreign business. An Edge may not invest, however, in competing Edges or U.S. corporations. Further, an Edge may not, without prior Board approval, invest more than 10 percent of its capital and surplus in any one nonbanking corporation or more than 15 percent in any one banking corporation. The Board has established certain application procedures and limits on activities for investments in foreign corporations by Edges (as well as by bank holding companies and member banks) which are discussed below in [Part V](#).

An Edge may establish a foreign branch under the same conditions as a member bank, as described above in [Part III](#). An Edge may also establish a domestic branch upon 45 days prior written notice to the Board. In acting upon such a notice, the Board considers the same factors as in an application to establish an Edge. The Edge must seek comments on the proposed domestic branch from interested members of the public.

V. Investments and Other Activities Abroad of U.S. Banking Organizations

Another major vehicle used by U.S. banking organizations to conduct their foreign operations is a foreign subsidiary investment, joint venture investment, or portfolio investment. As distinguished from a foreign branch or an Edge, an organization in which a foreign investment is made is a separate and legally incorporated entity established in a foreign country under its local laws. Direct foreign investments may be made by bank holding companies, Edges, and to a limited extent, member banks (collectively, "investors").

In general, Regulation K limits activities of investors abroad to those that are banking or financial in nature and those that are necessary to carry on such activities. Member banks, however, may invest abroad only in a foreign bank, and the foreign bank may not be engaged in activities in the United States other than incidental activities. In contrast, Edges may invest in *any* foreign corporation, as long as the corporation does not engage in general commercial business in the United States and does not transact any business in the United States other than incidental business. Bank holding companies, too, may invest in any foreign corporation, as long as the corporation does not engage in any activities in the United States other than incidental activities. All foreign activities by investors must be conducted in accordance with high standards of banking or financial prudence, having due regard for diversification of risks, suitable liquidity, and adequacy of capital.

As noted, investors' activities abroad are limited to those that are banking or financial in nature. Regulation K lists those activities that the Board has previously determined meet this standard and provides that activities not on the list may be engaged in only with the Board's specific consent. The list includes several activities which are not generally permissible in the United States, such as underwriting life insurance and operating a travel agency. These activities are permitted in order to keep U.S. banking organizations competitive with their foreign counterparts who have such powers. (See [Attachment D](#) for a complete list of permissible activities.)

Foreign investments are categorized as either subsidiary, joint venture, or portfolio investments, depending on the level of ownership and control. An investment is a subsidiary investment if the investor owns more than 50 percent of the voting shares of the organization or otherwise controls it. If the investor owns more than 20 percent of the voting shares and the organization is not a subsidiary, then it is a joint venture investment. All other investments are considered to be portfolio investments.

The category of the investment affects the activities in which an investee organization may engage. For example, a subsidiary may only engage in permissible activities. If the subsidiary is a going concern, existing impermissible activities may account for up to five percent of the assets or revenues of the organization. A joint venture, however, is less restricted: impermissible activities may account for up to 10 percent of the joint venture's assets or revenues. A portfolio investment may be made in an organization which engages in even more impermissible activities. A portfolio investment, though, must be passive; an investor may not be involved in the operations of the organization except to the extent necessary to protect its investment. Also, any loans or extensions of credit made by an investor to a portfolio investment organization must be on market terms.

The Board has established several procedures for approving foreign investments that are designed to reduce the regulatory burden on investors by minimizing applications to the Board. If the proposed investment does not exceed certain absolute and relative (to the investor's Tier 1 capital) limits, then the Board will grant its general consent to the investment without requiring an application. In a recent expansion of the general consent procedure, the Board will now also grant its general consent to an investment made by a well-capitalized and well-managed investor, if the amount of the investment does not exceed certain limits relative the investor's Tier 1 capital and certain other limitations. This expanded general consent procedure is consistent with the Board's evolving policy of providing incentives to banking organizations to maintain strong capital and management, and phasing out absolute dollar limitations in favor of capital-based limitations.

An investment which exceeds the limits for the general consent procedures requires 45 days prior written notice to the Board. An investment that does not qualify for the general consent or prior notice procedures may not be made without the specific consent of the Board. In addition, the Board may, at any time and upon notice, suspend the general consent or prior notice procedures for a proposed investment and require the investor to apply for the Board's specific consent. The specific consent procedure must be followed for an investor's initial investment in its first subsidiary or joint venture, or for a proposal to engage in activities not listed in Regulation K.

VI. Lending Limits, Capital Requirements, and Affiliate Transactions

For safety and soundness purposes, the Board has established certain limitations on the lending activities of the foreign operations of U.S. banking organizations. The total loans and extensions of credit outstanding to any one person by an Edge corporation engaged in banking (as opposed to an Edge which only invests in other companies) and its direct or indirect subsidiaries may not exceed 15 percent of the Edge's Tier 1 capital. In addition, the total loans and extensions of credit to any person by a foreign bank subsidiary or an Edge subsidiary of a member

bank, and by majority-owned subsidiaries of the foreign bank or Edge, are aggregated with the loans and extensions of credit to the same person by the member bank and its majority-owned subsidiaries; this total may not exceed the member bank's lending limits. An Edge must be fully-secured for all acceptances that are outstanding in excess of 200 percent of its Tier 1 capital and, for any one person, in excess of 10 percent of its Tier 1 capital. These limitations do not apply, however, if the excess represents the international shipment of goods and the Edge is fully covered by primary obligations to reimburse it that are guaranteed by banks, or covered by participation agreements from other banks.

An Edge is required to be capitalized in an amount that is adequate in relation to the scope and character of its activities. More specifically, an Edge engaged in banking must maintain a ratio of qualifying total capital to risk-weighted assets of not less than 10 percent. The Board's risk-based capital guidelines for State-chartered member banks are used for this measurement. However, because of the restraints on investments in Edges and their limited access to the financial markets, Edges are permitted to have all of their Tier 2 capital in the form of subordinated debt. At least 50 percent of an Edge's total capital must consist of Tier 1 capital.

An Edge must have a minimum of \$2 million in capital. An Edge may increase or decrease its capital at any time, with the approval of the Board, by a vote of two-thirds of its shareholders, or by unanimous written consent of its shareholders without a meeting and without a formal vote.

Sections 23A and 23B of the FRA impose certain restrictions on transactions between a member bank and its affiliates. The restrictions of these sections, however, do not apply to transactions between a bank and its bank and nonbank subsidiaries. Thus, a bank or foreign branch of a bank may provide funding to an Edge subsidiary of the bank. However, transactions between an Edge subsidiary and the parent bank's affiliates are aggregated with transactions between the bank and its affiliates for purposes of Sections 23A and 23B's limitations and restrictions. The FRA also provides that a member bank may make loans to a foreign bank subsidiary of the member bank, notwithstanding the restrictions of Sections 23A and 23B. Transactions between a bank and an Edge subsidiary of a bank holding company, however, are subject to Sections 23A and 23B. In addition, Regulation K provides that any loans or extensions of credit made by an investor to a portfolio investment company (as described above in [Part V](#)) must be on substantially the same terms as prevailing for comparable transactions between unaffiliated parties.

VII. Supervision, Examination, and Reporting Requirements

Regulation K requires U.S. banking organizations conducting foreign banking operations to supervise and administer their foreign branches and subsidiaries in such a manner as to ensure that their operations conform to high standards of banking and financial prudence. In particular, Regulation K requires such organizations to maintain effective systems of records, controls, and reports in order to keep management informed of their activities and condition. Such reports must include internal and external audits. Regulation K also requires investors to maintain sufficient information with respect to joint ventures to keep informed of their activities and condition. Edges are also required to maintain sufficient information to allow examiners to assess the condition, operations, and activities of the Edge and any organization whose shares it holds. The FRS supervises the foreign operations of U.S. banking organizations through a combination of on-site examinations, off-site surveillance, assessing reports that are required to be filed with the FRS, and assessing the records and information described above. These methods of supervision are described below.

A. Examinations

The foreign activities of a State member bank are generally examined by FRS examiners in conjunction with their regular examination of the bank. A bank is required, as a condition of approval for its foreign offices, to maintain at its head office adequate documentation about its foreign activities so that examiners are able to adequately assess the condition of these foreign offices. In addition, the examination reports prepared by the FRS of a bank's Edge subsidiaries are assessed during the examination of the bank.

Annual or periodic on-site examinations of selected foreign branches and subsidiaries of U.S. banking organizations are conducted to determine the safety and soundness of their operations and the adequacy of reporting procedures used by the head office or parent bank to monitor the foreign office. FRS examiners often examine major foreign operations of member banks on-site, especially in Australia, Belgium, Brazil, Germany, Hong Kong, Japan, Mexico, and the United Kingdom. Examiners also go to other countries, although not routinely. Teams of examiners are generally sent from the various Reserve Banks rather than maintaining a full-time staff abroad.

FRS examiners conduct on-site examinations of Edges annually, as required by the Edge Act. Many of the examination procedures used for Edges are similar to those used for examinations of State member banks. Examiners focus on the financial impact of Edges on their parent institutions and the overall quality of management supervision of the Edge by local and parent institution management. Board policy requires Edges to be assessed as a consolidated entity (main office, all branches, and all subsidiaries and joint ventures).

FRS examiners use procedures that are generally the same as those used in examining domestic organizations, but with appropriate modifications. The FRS recently implemented a new, risk-focused framework for the examination of large complex institutions, including U.S. bank holding companies and their foreign subsidiaries, State member banks and their foreign branches, and Edges. (See Attachment E -- "[SR Letter 97-24](#).") This framework is intended to focus more effectively on an organization's principal risks and on its internal systems and processes for managing and controlling these risks. The framework is expected to improve the FRS's ability to identify and address weaknesses on a timely basis and, at the same time, be more cost-effective for the FRS and less burdensome to banking organizations. The main objective of this approach is to sharpen the focus of the supervisory process on: (1) those business activities which pose the greatest risks to the soundness of a banking organization and the financial system more generally; and (2) the assessment of an organization's management systems to identify, measure, monitor, and control its risks. The risk-focused supervision framework balances assessments of functional activities and product lines with assessments of legal entities and transactions among legal entities.

The Board has developed a rating system for examinations of the foreign operations of U.S. banking organizations. (See Attachment F -- "[SR Letter 90-21](#).") The rating system is designed to provide a general framework to summarize the examiner's views about key components of the foreign operations of the subject organization. The rating system is intended to reflect in a comprehensive and uniform manner an institution's financial condition, compliance with laws and regulations, and overall operating soundness. The system rates the following components: Capital, Asset quality, Management, Earnings, and Operations and internal controls ("CAMEO"). The CAMEO system closely parallels the rating system employed for examinations of member banks ("CAMELS"), except that a separate rating component for operations and internal controls has been substituted for liquidity. (See Attachment G -- "[SR Letter 96-38](#).") Also, the "S" (Sensitivity to market risk) component was recently added to the CAMELS system to focus on an institution's ability to monitor and manage market risk and provide a clear indication of supervisory concerns related to market risk. This component reflects the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect a banking organization's earnings or economic capital, as well as the extent to which these effects are held in check by the organization's risk management systems. In supervisory guidance, the Board has noted that foreign operations of member banks can be a significant source of market risk. After completing an examination, the examiners will provide the individual component ratings and a summary rating to the management and board of directors of the subject organization.

Examinations of U.S. banking organizations incorporate an assessment of all foreign securities activities in order to determine the degree to which these activities conform to high standards of banking and financial prudence. There is concern that the affiliation of a securities company, especially one engaged in corporate debt and equities transactions, with a banking organization could raise a potential for conflicts of interest and, in some cases, could pose substantial additional risk to the institution. Exam procedures incorporate a methodology to assess the adequacy of controls, limits, and safeguards implemented to monitor and contain these risks. Securities activities are subject to the same degree of scrutiny and rigorous assessment of risk as bank lending activities. In addition, examiners monitor the substance and nature of all

transactions between a bank and its securities affiliate.

Any U.S. banking organization that applies to expand its securities business under Regulation K must submit to a review by the Board of its foreign securities operations. The review will focus on the adequacy of internal controls and procedures for dealing with the limits imposed on securities activities, and evaluate whether the capital of existing foreign securities operations would be adequate to support any expansion.

On-site examinations of foreign subsidiaries which are less than wholly owned are sometimes precluded because of objections voiced by foreign directors, minority shareholders, or, regardless of the level of ownership, by local bank supervisors. Also, the FRS is precluded from examining branches in certain foreign countries which have strict bank secrecy laws, e.g., the Bahamas, the Cayman Islands, France, Luxembourg, and Switzerland. Where on-site examinations cannot be performed, FRS examiners use alternative techniques to carry out their supervisory responsibilities, such as the assessment of financial reports and other information available at the head office (e.g., internal management reports, internal and external audit reports), and of reports submitted by the organization to the FRS or foreign banking authorities. To the extent permitted by foreign law, examiners may also assess the examination reports of foreign supervisory authorities which have examined the foreign operations of a U.S. banking organization. The FRS may also hire independent auditing firms in secrecy jurisdictions to examine or inspect foreign operations on its behalf. Off-site assessment of documentation is also impeded by secrecy laws which may prohibit the removal of documents from the secrecy jurisdiction. U.S. banking organizations are encouraged to obtain waivers of secrecy laws from their customers to alleviate any restrictions.

In accordance with the recommendations in The Supervision of Cross-Border Banking, the FRS has established communications with a number of foreign supervisory authorities in an effort to improve cooperation and increase the flow of supervisory information between the countries. At a minimum, these efforts have helped all of the parties to appreciate more fully the nature of each other's supervisory process. Substantial progress towards improving access to supervisory information has also been made. Recently, for example, the authorities in Singapore agreed to grant FRS examiners access for the first time to offices of U.S. banking organizations in that country. The FRS has also attempted to formalize these efforts to share supervisory information by negotiating bilateral memoranda of understanding ("MOUs") with other countries. For example, the FRS entered into an MOU with the Bank of England in June of 1996 which discusses procedures for the sharing of supervisory information, notification of material supervisory concerns, regular meetings and informal contacts between the two supervisors, examinations of U.S. offices in England and English offices in the United States, and the confidentiality of shared information. The FRS has entered into similar agreements with the Chilean Superintendent of Banks and Financial Institutions and the German Federal Supervisory Agency for Financial Institutions; the FRS hopes to conclude agreements with other countries in the future.

B. Reports

The FRS requires U.S. banking organizations to file several periodic supervisory reports on the condition, income, and operations of their foreign operations. These reports can provide an overall perspective on such matters as the size of the institutions, the nature and extent of their activities (both on- and off-balance sheet), and the extent of their reliance on the head office for funding. Reports can be divided into two categories: (1) "Financial Condition/Capital Adequacy" reports are used to determine the financial health of the institution filing the report; and (2) "Compliance" reports are used to monitor the institution's compliance with various laws and regulations. Several of these reports are discussed below:

Financial Condition/Capital Adequacy Reports

- *Foreign Branch Report of Condition (FFIEC 030)*: Every bank with one or more foreign branches must file this report annually. Significant branches, with either total assets of at least \$2 billion or commitments to purchase foreign currencies and U.S. dollar exchange of at least \$5 billion as of the end of a quarter, are required to file the report quarterly. This report, like other Condition Reports discussed below, contains information on assets and liabilities, income, and operations of the subject organization.
- *Report of Condition for Foreign Subsidiaries of U.S. Banking Organizations (FR2314)*: Annual report of assets and liabilities, and all aspects of the subsidiary's operations. Significant subsidiaries must report quarterly.
- *Report of Condition for Edge Act and Agreement Corporations (FR2886b)*: This quarterly report covers the assets and liabilities, income, activities, and operations of the reporting Edge.
- *Country Exposure Report (FFIEC 009)*: This quarterly report provides information on the amount and distribution by country of foreign claims held by U.S. banks, bank holding companies, and Edges.

Compliance Reports

- *Report of Changes in Foreign Investments (FR 2064)*: Any bank holding company, member bank, and Edge must file this report after an acquisition or disposition of a reportable investment governed by Regulation K occurs. The report is designed to enable the FRS to monitor international investments made under the authority of Regulation K.
- *Notification of Foreign Branch Status (FR 2058)*: Any bank holding company, member bank, or Edge must file this report within 30 days of the opening, closing, or relocation of a foreign branch of a U.S. banking organization or its foreign subsidiaries.

VIII. Reports of Crimes and Suspected Crimes

The Bank Secrecy Act ("BSA") was enacted to prevent the use of currency to serve the interests of organized criminal activity, evade taxes, violate the securities laws, import illicit drugs, and engage in other types of illegal activity. The BSA and its accompanying financial recordkeeping and reporting regulations are applicable to financial institutions located in the United States, including Edges, but are not applicable to institutions located outside of the United States, such as foreign branches of member banks and foreign subsidiaries of U.S. banking organizations. Thus, an Edge must submit the information and reports required under the BSA. An Edge must also establish and maintain procedures reasonably designed to ensure and monitor its compliance with the BSA. An assessment of such procedures is conducted during each examination of the Edge. In addition, the examination will assess whether an institution has established know-your-customer guidelines.

State member banks are required to file a Suspicious Activity Report ("SAR") when they detect a known or suspected violation of Federal law, or a suspicious transaction related to a money-laundering activity or a violation of the BSA. Regulation K requires an Edge or any branch or subsidiary of an Edge to file an SAR in the same manner as a State member bank.

The Board has issued guidelines for examining the anti-money laundering controls of foreign operations of U.S. banking organizations. (See Attachment H -- "SR Letter 96-5.") While recognizing that the BSA does not apply to such foreign operations, the Board emphasized that foreign offices must nonetheless have acceptable anti-money laundering policies and procedures that not only comply with host country laws but also protect the bank from money launderers. The guidance specifically notes the importance of an effective know-your-customer policy and the monitoring and reporting of suspicious activities.

On April 19, 1990, the G-7 Economic Summit Financial Action Task Force on Money Laundering released its report containing 40 nonbinding recommendations on steps to combat money laundering. The recommendations are intended to assure that all participating countries have uniform comprehensive domestic anti-money laundering programs to detect, deter, report, and prosecute criminal activity related to money

laundering. The recommendations require financial institutions to take a role in guarding against, and possibly reporting on, drug money laundering operations and other suspicious transactions.

Bank secrecy laws in foreign countries designed to protect the confidentiality of banking and other financial information may prevent the FRS from obtaining information from the operations of U.S. banking organizations located abroad. However, the United States has entered into several bilateral treaties with other countries which provide for the sharing of documents and records for use in the investigation, prosecution, and suppression of certain offenses, including bank fraud, narcotics activity, and laws relating to currency and financial transactions. Mutual legal assistance treaties, for example, have been entered into between the United States and the Bahamas, the Cayman Islands, and Switzerland.

IX. Current Developments: Proposed Revisions to Regulation K

The Board recently published for comment a proposal to significantly revise Regulation K. In general, the revision is intended to improve the international competitiveness of U.S. banking organizations abroad by expanding permissible activities abroad and reducing regulatory burden associated with the conduct of such activities. Significantly, many of the revisions would only benefit well-capitalized and well-managed banking organizations. This is consistent with the Board's belief that such requirements would provide incentives to maintain strong capital and management, which would alleviate safety and soundness concerns. In addition, many of the revisions could only be taken advantage of if the activity is conducted by a bank holding company subsidiary rather than by a bank subsidiary. Here, the Board has sought to balance the need for U.S. banks to be competitive abroad with the public interest in assuring the safety and soundness of the banks, protecting the deposit insurance fund, and limiting the extension of the Federal safety net. Highlights of the proposal include:

- an expansion of authority for well-capitalized and well-managed U.S. banking organizations to engage in equity securities underwriting and dealing outside the United States;
- a relaxation of the ability of U.S. banking organizations to make portfolio investments abroad;
- a streamlined and expedited review process for U.S. banking organizations to branch abroad; and
- an expedited review of proposals by well-capitalized and well-managed U.S. banking organizations to make investments abroad.

Attachments

1/ I would like to thank Ivan J. Hurwitz, Attorney, Federal Reserve Bank of New York, for his work on this paper.

2/ The Board's Regulation D imposes certain reserve requirements on all U.S. depository institutions, including foreign branches of member banks, unless otherwise exempted. Foreign branches, however, would be at a competitive disadvantage to non-U.S. banks that are not subject to the same reserve requirements. Thus, any deposit that is payable only at a foreign office of a member bank is exempted from all reserve requirements. Regulation D defines "any deposit" as a deposit of a U.S. resident in excess of \$100,000 or any deposit of a non-U.S. resident. Deposits in foreign branches are not insured by the Federal Deposit Insurance Corporation, and in liquidation of the bank, foreign branch deposits have lesser preference than domestic deposits.

ATTACHMENT A

Typical Structure of U.S. Banking Organization Engaged in Foreign Business

[insert chart here]

ATTACHMENT B

Permissible Activities of Foreign Branches of Member Banks

In addition to its general banking powers, and to the extent consistent with its charter, a foreign branch of a member bank may engage in the following activities so far as usual in connection with the business of banking in the host country:*/

- guarantee customers' debts, or otherwise agree to make payments on the occurrence of readily ascertainable events;
- underwrite, distribute, buy, sell, and hold debt securities of the host country's government, within certain limits;
- invest within certain limitations in the securities of the central bank, clearing houses, and government-sponsored development banks of the host country; and debt securities eligible to meet local reserve requirements;
- extend credit to an officer of the bank residing in the host country for acquisition or construction of living quarters to be used as the officer's residence abroad;
- take liens or other encumbrances on foreign real estate in connection with its extensions of credit;
- act as an insurance agent or broker;
- pay to an employee, as part of an employee benefits program, a greater rate of interest than that paid to other depositors;
- engage in repurchase agreements involving securities and commodities that are the functional equivalents of extensions of credit;
- with the Board's prior approval, acquire all of the shares of a company that engages solely in activities in which the bank is permitted to engage or that are incidental to the activities of the foreign branch; and
- with the Board's prior approval, engage in other activities that the Board has determined are usual in connection with the transaction of the business of banking in the host country.

*/ Regulation K § 211.3(b), 12 C.F.R. § 211.3(b)

ATTACHMENT C

Permissible Activities of Edge Act Corporations

C-1. Banking Powers. An Edge may engage in the following banking activities consistent with the international nature of its business: 1/

- to purchase, sell, discount, and negotiate, with or without its indorsement or guaranty, notes, drafts, checks, bills of exchange, acceptances, cable transfers, etc.;
- to purchase and sell with or without its indorsement or guaranty, securities, including the obligations of the United States or of any State thereof but not including shares of stock in any corporation except as otherwise provided;

- to accept bills or drafts drawn upon the Edge;
- to issue letters of credit;
- to purchase and sell coin, bullion, and exchange;
- to borrow and lend money;
- to issue debentures, bonds, and promissory notes;
- to receive deposits outside of the United States and to receive only such deposits within the United States as may be incidental to or for the purpose of carrying out transactions in foreign countries; and
- generally to exercise such powers as are incidental to the above powers or as may be usual, in the determination of the Board, in connection with the transaction of the business of banking or other financial operations in the host country and not inconsistent with the powers specifically granted herein.

C-2. Activities in the United States. An Edge may engage in the activities listed above in the United States and are incidental to international or foreign business, and in such other activities as the Board determines are incidental to international or foreign business. The Board has determined that the following activities will ordinarily be considered incidental to an Edge's international or foreign business:^{2/}

- receive deposits from foreign governments and foreign persons;
- hold or invest in the United States funds of the Edge that are not currently employed in its international business if held in liquid forms;
- borrow money and issue debt;
- make loans;
- receive payments and collections;
- engage in foreign exchange activities;
- engage in fiduciary and investment advisory activities;
- provide banking services for employees; and
- with the Board's prior approval, engage in other activities that the Board determines are incidental to the international or foreign business of the Edge.

1/ FRA § 25A(6)(a), 12 U.S.C. § 615(a).

2/ Regulation K § 211.4(e), 12 C.F.R. § 211.4(e).

ATTACHMENT D

Permissible Activities of Foreign Subsidiaries and Joint Ventures

The Board has determined that the following activities are usual in connection with the transaction of banking or other financial operations abroad:^{*/}

- commercial and other banking activities;
- financing, including commercial financing, consumer financing, mortgage banking, and factoring;
- leasing real or personal property, or acting as agent, broker, or advisor in leasing real or personal property, if the lease serves as the functional equivalent of an extension of credit;
- acting as fiduciary;
- underwriting credit life insurance and credit accident and health insurance;
- performing services for other direct or indirect operations of a United States banking organization;
- holding the premises of a branch of an Edge or member bank or the premises of a direct or indirect subsidiary, or holding or leasing the residence of an officer or employee of a branch or subsidiary;
- providing investment, financial, or economic advisory services;
- general insurance agency and brokerage;
- data processing;
- organizing, sponsoring, and managing a mutual fund if the fund's shares are not sold or distributed in the United States or to U.S. residents and the fund does not exercise managerial control over the firms in which it invests;
- performing management consulting services;
- underwriting, distributing, and dealing in debt securities outside the United States;
- underwriting, distributing, and dealing in equity securities outside the United States, subject to certain limitations;
- operating a travel agency provided that the travel agency is operated in connection with financial services offered abroad by the investor or others;
- underwriting life, annuity, pension fund-related, and other types of insurance, where the associated risks have been previously determined by the Board to be actuarially predictable, subject to certain limitations;
- acting as a futures commission merchant for financial instruments of the type, and on exchanges, that the Board has previously approved;
- acting as principal or agent in swap transactions subject to certain limitations;
- engaging in activities that the Board has determined in Regulation Y (12 C.F.R. 225.25(b)) are closely related to banking under Section 4(c)(8) of the BHC Act; and
- with the Board's specific approval, engaging in other activities that the Board determines are usual in connection with the transaction of the

business of banking or other financial operations abroad and are consistent with the FRA or the BHC Act.

*/ Regulation K § 211.5(d), 12 C.F.R. § 211.5(d).
