U.S. Banking Law and the FBO – What You Need to Know

U.S. Regulatory/Compliance Orientation for Head Office, Recently Arrived Officers of International Banks and Representatives Who Would Benefit from a More Thorough Understanding of the U.S. Regulatory/Compliance System

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U.S. Bank Regulatory Framework for Domestic Banking Organizations

- Relatively complex set of statutes and regulations administered by multiple federal and state banking agencies
  - Dual banking system; choices among types of state and federal charters and among responsible federal banking agencies
- Periodic debate about structure of banking/financial regulation
  - Basic structure and framework survived regulatory reform debate following recent financial crisis.
  - Dodd-Frank Act added new regulatory authorities, standards and requirements.
  - Dodd-Frank eliminated one banking regulator (OTS) and created a new consumer protection agency (CFPB).
- As in many countries, banking regulation focuses primarily on protecting the safety and soundness of the bank.
  - Dodd-Frank Act introduced greater emphasis on systemic risks—risks posed by systemically significant institutions and risks that transcend individual institutions.
  - Focus on consumer protection has grown, as reflected in Dodd-Frank Act.
The United States has historically placed greater emphasis than other countries on restricting the activities of banking organizations and on restricting geographical expansion.

- Historical concerns that banks would become too powerful
- The “wall” separating banking and commerce
- Special concerns regarding securities, insurance and real estate
- New restrictions in Dodd-Frank Act on:
  - proprietary trading
  - sponsoring and investing in private equity and hedge funds
  - certain derivatives activities
- Dodd-Frank Act relaxed restrictions on geographic expansion.
Current U.S. bank regulatory requirements depend significantly on where within a banking organization’s structure particular activities are conducted.

Most major U.S. banking organizations are organized as a holding company with bank and non-bank subsidiaries.

A company that “controls” (a broadly defined term) a U.S. “bank” (a term defined by many exceptions) is regulated by the Federal Reserve as a “bank holding company” under the Bank Holding Company Act (the “BHCA”).

- Depending on state law, a bank holding company may also be regulated by a state banking authority.
Regulatory Requirements and the Structure of Banking Organizations (cont.)

- Regulation of “banks” (including many bank-like institutions):
  - Considered “special” because of FDIC deposit insurance, role in payments system, etc.
  - Extensive safety and soundness supervision and other regulation (lending limits, capital regulation, restrictions on transactions with affiliates)
  - Activities historically limited to traditional banking activities and certain related activities; since 1980’s, bank-permissible activities have expanded to include certain securities, insurance, derivatives and commodities activities.
    - The most restricted areas remain real estate investment and development and equity investments in commercial companies.
    - New restrictions in Dodd-Frank Act
  - Interstate branching restrictions were liberalized in the 1990’s, and Dodd-Frank Act generally permits nationwide *de novo* branching.
Regulatory Requirements and the Structure of Banking Organizations (cont.)

- Regulation of “bank holding companies” (“BHCs”):
  - Subject to “umbrella supervision” by the Federal Reserve
  - Expected to be a source of financial and managerial strength to bank subsidiaries
    - Added as a statutory requirement in Dodd-Frank Act
  - Basel Accord-based capital regulation at the holding company level
    - New requirements in Dodd-Frank Act would apply U.S. bank-level minimum capital requirements to U.S. BHCs
  - Permissible activities—especially if the BHC qualifies as a “financial holding company”—include activities that are not permissible for a bank.
  - Under Dodd-Frank Act, heightened prudential standards would apply to certain large, interconnected BHCs.
Key U.S. Banking Agencies and the Entities They Supervise and Regulate

- State banking agencies: state-chartered banks, trust companies, thrifts, etc. and state-licensed banking offices

- Federal Reserve: bank holding companies, thrift holding companies, FBOs and U.S. banking offices of FBOs; primary federal role for state “member” banks and trust companies
  - Under Dodd-Frank Act, new role as supervisor of systemically significant financial companies (BHCs and non-bank financial companies)

- Federal Deposit Insurance Corporation: primary federal role for state “nonmember” banks and state thrifts; additional role for other insured depository institutions (as deposit insurer)

- Office of the Comptroller of the Currency (OCC): national banks and trust companies, federal thrifts and federally licensed banking offices of FBOs
How the U.S. Framework Applies to International Banks
Background

- The U.S. bank regulatory framework for international banks (and for domestic banking organizations), depends heavily on the structure of the banking organization in the United States.
  - Most international banks conduct banking operations in the United States through banking offices (branches, agencies and representatives offices).
  - Many international banks also control nonbank affiliates in the United States, such as investment banks, asset management firms, etc.
  - Some international banks control U.S. bank subsidiaries, which include some of the largest U.S. banks.
- A major challenge for the development of U.S. banking regulation for international banks has been how to “translate” the U.S. bank regulatory framework developed for domestic banks/bank holding companies to the international bank structure.
U.S. Banking Entities

- Direct Offices
  - Insured Branches: FDIC-insured; limited in number due to legislative changes in 1991
  - Uninsured Branches: limited deposit-taking authority, including “wholesale” deposits (at least $250,000), foreign-source deposits, and certain other permissible deposits; otherwise, banking powers similar to U.S. banks
  - Agencies: more restricted deposit-taking powers than branches (foreign-source deposits, international trade-related deposits, etc.)
  - Representative Offices: marketing and customer liaison offices that generally cannot “bind the bank” to transactions, accept deposits, make loans, etc.

- U.S. Bank Subsidiaries
  - Subject to supervision and regulation in the United States virtually to the same extent as U.S. banks controlled by domestic BHCs
Direct banking offices can be state or federally licensed.

In many respects, regulation is similar to regulation of separate bank subsidiaries, with adaptations to reflect special nature (e.g., lending limits measured as a percentage of the “parent” bank’s capital).

Dual characteristics of direct offices (as “separate” in some respects but not in others) can sometimes create tensions between regulatory policies.
Regulation of “Foreign Banking Organizations” (“FBOs”)

- Definition: (1) a non-U.S. bank that operates a U.S. branch or agency or controls a U.S. bank or commercial lending company subsidiary; and (2) any bank or other company that controls such a bank

- Function: Serves to define the types of entities that will be subject to regulation by the Federal Reserve, in a manner generally comparable to how the Federal Reserve regulates U.S. BHCs (with certain important exceptions and modifications)

- Examples
Evolution of Statutory Framework and U.S. Policies Toward FBOs

- Before 1978
  - State regulation of branches or agency offices
  - State and federal regulation of U.S. bank subsidiaries
  - Federal Reserve regulation of FBOs that controlled U.S. bank subsidiaries but not of FBOs that conducted banking operations only through direct banking offices (the vast majority of FBOs)
  - Congress grows concerned with ability of foreign banks to avoid federal prohibitions and restrictions applicable to domestic banks – especially restrictions on nonbank activities conducted through affiliates and on geographic expansion
Evolution of Statutory Framework and U.S. Policies Toward FBOs (cont.)

- **International Banking Act of 1978 (IBA)**
  - **Key policy:** “national treatment”
  - Gives FBOs choice of state or federal license for banking offices (dual banking system)
  - Generally imposes geographic and nonbank activities restrictions
    - “Grandfathers” existing multi-state offices and existing nonbank activities
    - Preserves statutory authority unique to FBOs to engage in nonbanking activities outside the United States and certain U.S. nonbank activities

- **Foreign Bank Supervision Enhancement Act of 1991 (FBSEA)**
  - Enacted in response to perceived gaps in U.S. supervisory authority (e.g., collapse of BCCI)
  - Strengthens Federal Reserve authority over FBOs
    - Board approval (in addition to state or federal licensing approval) of all new offices of FBOs; among other things, approval requires determination that applicant is subject to “comprehensive consolidated supervision” by its home country supervisor
    - Limits powers of state-licensed branches to powers of federally licensed branches
    - Limits ability of FBOs to obtain FDIC insurance for U.S. branches
Evolution of Statutory Framework and U.S. Policies Toward FBOs (cont.)

- **Riegle-Neal Act of 1994**
  - Facilitates interstate branching, relaxes previous rule limiting out-of-state bank acquisitions
  - Consideration given to requiring FBOs to “roll up” their U.S. branches and agencies into separately incorporated banks, but requirement not adopted

- **Gramm-Leach-Bliley Act of 1999**
  - Allows well-capitalized and well-managed FBOs to qualify as “financial holding companies” (FHCs)
  - Newly permissible U.S. financial activities include securities underwriting and dealing, insurance underwriting and sales and merchant banking

- **Dodd-Frank Act of 2010**
  - Introduced new framework for systemic risk supervision, including for FBOs that become subject to heightened prudential standards
  - Federal Reserve authority to adapt U.S. requirements to internationally headquartered institutions, taking into account national treatment, equality of competitive opportunity and comparable home country standards
  - New derivatives regulatory regime
  - New statutory requirements and prohibitions (“Volcker Rule”, swaps “push-out”)
Key Concepts in the Regulatory Framework for FBOs
The concept of “control” and “subsidiary” (a company that is “controlled” by its parent) are key concepts in the BHCA framework applicable to FBOs.

Consequences for viability of investment activities and acquisitions

The BHCA and Federal Reserve regulations and interpretations define “control” broadly to include:

- 25% or more of a “class” of “voting securities” (defined terms)
- Majority board representation
- Controlling influence over management or policies – depends on the overall facts and circumstances of the investment, including percentage of total equity held, officer or director “interlocks,” veto rights, other relationships.

BHCA “control” does not necessarily mean exclusive or even dominant control, and there can be more than one “controlling” entity.
Acquisitions of and Investments in U.S. Depository Institutions

- For FBOs, acquisitions of 5% or more of a “class” of “voting securities” (technically defined terms) of an insured depository institution generally require prior approval by the Federal Reserve.

- In general, holdings of an FBO and all of its “subsidiaries” must be aggregated toward the 5% threshold. (Certain exemptions apply, such as shares held in a fiduciary capacity, shares acquired in foreclosure, etc.)
BHCA restrictions on nonbank activities and investments generally apply to FBOs in the same manner as they apply to U.S. BHCs, with some important exceptions.

Baseline rule: Direct and indirect (through subsidiaries) activities and investments are limited to banking and activities “closely related to banking” (a defined list of activities that includes commercial and consumer lending, securities brokerage, limited insurance agency activities, certain leasing activities, investment advice, etc.).
Key exceptions for FBOs and BHCs

- FBOs/BHCs that qualify as “financial holding companies” are authorized to engage in broader “financial,” “incidental” and “complementary” activities (including securities underwriting and dealing, insurance underwriting and sales and merchant banking investments).

- FBOs/BHCs may invest in up to 5% of a class of voting securities of an issuer so long as the investment is “passive” and “noncontrolling”.

- FBOs/BHCs may hold shares of companies and other assets acquired in satisfaction of “debts previously contracted in good faith” (“DPC”) — e.g., in a workout or foreclosure.

- FBOs/BHCs may hold shares in a fiduciary capacity if certain requirements are met.

- FBOs/BHCs may control subsidiaries engaged in servicing functions.
FBOs that qualify as “qualifying foreign banking organizations” ("QFBOs") benefit from additional exceptions designed to limit the extraterritorial effect of the BHCA on FBOs.

QFBO Tests (which are implemented in detailed assets and revenue tests established by the Federal Reserve):

- More than half of worldwide business is banking
- More than half of worldwide banking business is outside the United States

Key QFBO exemptions for nonbank activities:

- Acquire or invest in companies that do not engage in business in the United States (no U.S. subsidiary or office other than a rep office)
- Make noncontrolling investments in non-U.S. companies that engage in business in the United States if certain requirements are met
- Make controlling investments in non-U.S. companies that engage in business in the U.S. so long as the U.S. activities are the same as or related to the non-U.S. activities and certain other requirements are met
BHCA § 4(c)(6): Exemption for investments up to 5% of a class of voting securities so long as “passive” and “non-controlling”

Certain other BHCA exemptions depend on whether investment is considered “controlling” for BHCA purposes (e.g., 25% of more of a class of voting securities).

Federal Reserve annual reporting requirements apply to investments in 5% or more of a class of voting securities of U.S. companies and non-U.S. companies engaged in business in the United States.

These tests generally apply to investments by the FBO and its direct and indirect subsidiaries on an aggregated basis, and aggregation can present difficult compliance issues for global institutions.
Insurance Activities

- Under the BHCA, FHCs and “financial subsidiaries” held under authority of the GLBA can exercise broad insurance powers.

- Other BHCs and banks may engage in credit-related insurance underwriting activities.

- Depending on state law, and whether the bank is chartered under federal or state law, banks can generally engage in insurance agency activities through subsidiaries (subject to limitations in some cases).

- BHCA restrictions apply to FBOs and their subsidiaries; bank restrictions apply to U.S. branches and agencies.
Real Estate Investment

- Real estate activities remain a highly restricted area for U.S. banks and BHCs.

- Banks and BHCs that are not FHCs generally may not engage in real estate investment, development, management or brokerage. However:
  - FHCs may engage in real estate investment activities, including through real estate investment funds.
  - Banks and BHCs may acquire real estate in foreclosure, subject to holding period limitations.
  - Banks and BHCs may acquire real estate interests that promote community development.
  - Banks and BHCs may engage in certain specific types of activities related to real estate lending and investing.
  - The Federal Reserve proposed to permit FHCs to engage in real estate management and brokerage, but the proposal generated controversy and was never adopted.
  - Some FBOs can continue to engage in “grandfathered” real estate activities conducted before the IBA was adopted in 1978.
Securities Activities

- Historically, U.S. banking laws severely restricted securities investment and securities underwriting and dealing by banks and restricted affiliations between banks and securities firms.

- GLBA significantly liberalized restrictions on affiliations with securities firms but retained most restrictions on bank activities.

- During regulatory reform debate, some proposals to reinstate pre-GLBA restrictions (not adopted)

- “Volcker Rule” prohibits some proprietary trading activities by banking organizations

- Restrictions on bank securities activities apply to U.S. branches and agencies of FBOs, and thus most securities investment and underwriting and dealing activities must be performed in nonbank affiliates.

- Several exceptions apply, including for:
  - Investing in, underwriting and dealing in Treasury bonds and other government securities
  - Private placements
  - Brokerage activities

But these activities are subject to “push out” requirements (see below).
Transactions with Affiliates

- Transactions by a U.S. bank with its affiliates are subject to detailed regulations under Sections 23A and 23B of the Federal Reserve Act and Regulation W. For FBOs that are FHCs, these regulations also apply to U.S. branches and agencies (but not to the FBO’s head office or non-U.S. branches and agencies) for transactions with certain affiliates.

  - For example, extensions of credit to an affiliate and other “covered transactions” are subject to quantitative limitations based on a percentage of the bank’s capital and surplus.

  - Extensions of credit to an affiliate generally must also be fully collateralized (subject to specific coverage requirements depending on the nature of the collateral).

  - Transactions with affiliates generally required to be on arm’s length terms.

- Regulation W contains numerous exemptions and requirements that should be analyzed for particular transactions.

- Under Dodd-Frank Act, credit exposures from certain derivatives transactions with affiliates are treated as “covered transactions” for purposes of Sections 23A and 23B and Regulation W.
Anti-tying Rules

- U.S. banks are subject to specific prohibitions on “tying” – conditioning the availability or pricing of a product or service on the customer obtaining another product or service (the “tied product/service”). These prohibitions also apply to U.S. branches and agencies of FBOs (but not to the FBO’s head office or non-U.S. branches and agencies).

- Debate over role of market power and coercion analysis

- Several important exemptions, including:
  - Exemption where “tied” product is a traditional bank product (loan, discount, deposit or trust service)
  - Exemption for certain non-U.S. customers

- Proposed Federal Reserve interpretation would have clarified treatment of “relationship banking”; banking industry has supported adoption of a wholesale customer exemption.
In the area of securities regulation, GLBA reflected a policy of “functional regulation” — favoring regulation of activities by function rather than by legal entity.

Before GLBA, U.S. “banks” (including U.S. branches and agencies of FBOs) were exempt from SEC registration as broker-dealers.

GLBA replaced this blanket approach with activity-specific exemptions. As a result, all other securities brokerage and dealing activities must be “pushed out” to an SEC-registered broker-dealer affiliate.

For FBO’s, the effects of the “push-out” rules are especially important in the area of private banking.

Dodd-Frank revised some aspects of GLBA’s approach to “functional regulation” but left the “push-out” rules intact.
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