

U.S. Banking Law and FBOs: What You Need to Know

U.S. Regulatory/Compliance Orientation
Institute of International Bankers

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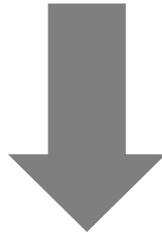
December 14, 2017

U.S. Banking Entities: An Overview

- **Foreign banks may have a U.S. presence through direct or indirect banking entities**
 - Representative office
 - Agency
 - Insured branch
 - Uninsured branch
 - Commercial lending company subsidiary
 - U.S. bank subsidiary
- **U.S. dual banking system**
 - Licenses/charters may be federal or state
 - Different supervisory/examination authorities
- **Foreign banking organization (FBO)**
 - Definition: (1) Non-U.S. bank that operates a state or federal branch or agency or controls a U.S. bank or commercial lending subsidiary; and (2) any bank or other company that controls the non-U.S. bank
 - FBOs subject to Federal Reserve regulation in manner similar to bank holding companies but with some key differences as we will discuss later in the presentation

Representative Office

FOREIGN
BANK



REPRESENTATIVE
OFFICE



- Licensed by state authority
- Federal Reserve approval generally required
- Activities limited to representative and liaison functions
- If rep office only U.S. banking presence, not FBO, not subject to BHCA

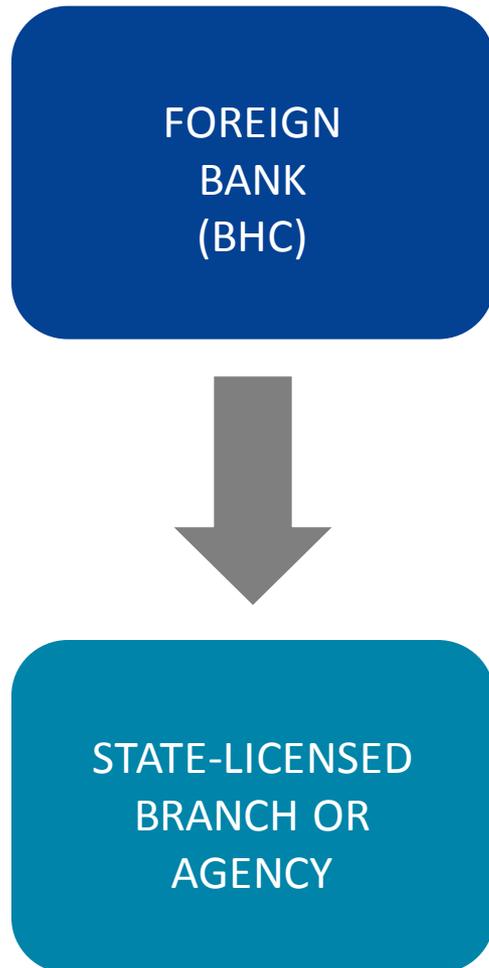
Representative Office

- U.S. office of a foreign bank that is not a branch, agency or commercial lending subsidiary
- Establishment is governed by state law and requires Federal Reserve approval
 - General consent or after-the-fact approval by Federal Reserve possible under certain circumstances
- Foreign bank can maintain one or more representative offices in the U.S.
- May be established alongside other banking or nonbanking entities
- No Bank Holding Company Act (BHCA) implications if no other direct or indirect U.S. banking presence
- Supervised and examined by state regulator and Federal Reserve

Representative Office

- Powers are limited by federal and state law
- Functions generally as a customer liaison or marketing office and powers generally include
 - Representative and administrative functions on behalf of the foreign bank
 - Soliciting new business (except for deposits or deposit-type liabilities)
 - Soliciting loans (New York representative offices may solicit loans of \$250,000 or more)
 - Soliciting investors to purchase loans from bank
 - Assembling credit information, securing title information, preparing loan applications, inspecting properties
 - Making recommendations on loan applications
- Federal law prohibits contracting for any deposit, lending money, or engaging in any other banking activity for the foreign bank
- Federal law permits loan approval by representative office only if foreign bank maintains a U.S. branch or agency through which loan will be disbursed
 - State law may be more restrictive

Branch/Agency: State



- Establishing FBO deemed BHC
- FBO licensed by state to maintain branch/agency
- Federal Reserve prior approval required
- State and Federal Reserve regulate, supervise and examine
- Federal Reserve has supervisory authority for U.S. operations of FBO
- Branch may accept some deposits but agencies generally limited to credit balances

State Branch/Agency

Deposit-taking:

- Insured branches: deposits FDIC-insured; no longer an option unless “grandfathered”
- Uninsured branches: may only accept initial wholesale deposits equal to or greater than the SMDIA (currently \$250,000)
 - Deposits permissible in any amount from certain foreign sources and large U.S. businesses, among others
- Agencies: generally cannot accept deposits from U.S. citizens/residents, only credit balances

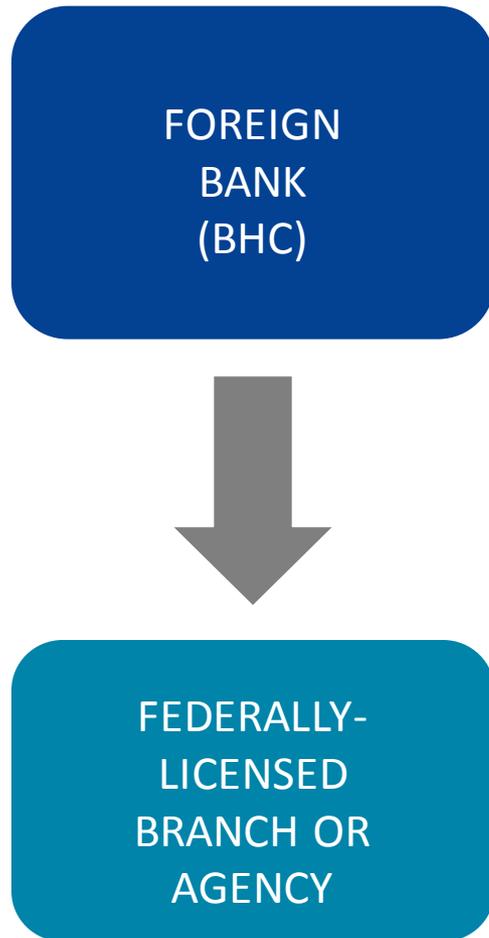
Other:

- Generally consistent with bank powers
 - Certain exceptions (for example, lending limits based on foreign bank capital)
- State branches/agencies may not engage in activities not permissible for federal branches/agencies without Federal Reserve (or FDIC) approval, and state law may be stricter
- May exercise trust powers with approval from licensing authority
- Have access to Fed discount window

State Branch/Agency

- Branches/agencies are not separately capitalized entities and not subject to regulatory minimum capital requirements
 - NY: Asset pledge requirement
 - Maintain assets on deposit at a New York bank, pledged to DFS
 - Generally, amount is the *greater of*: (i) 1% of average total third-party liabilities of the branch or agency for the previous month; or (ii) \$2 million
 - Well-rated banks: 1%, or a lesser percentage, of total liabilities, capped at \$100 million
 - NY: Asset maintenance requirement
 - DFS may impose asset maintenance requirements where necessary to protect the interests of the public, depositors and creditors
- Regulators monitor and may impose restrictions on net due-from head office positions
- Supervised and examined by state licensing authority and Federal Reserve

Branch/Agency: Federal



- Establishing FBO deemed to be a BHC
- Licensed by OCC
- Federal Reserve approval required
- Supervision and examination by OCC
- Federal Reserve has supervisory authority for U.S. operations of FBO

Federal Branch/Agency

- Supervision and examination by the Office of the Comptroller of the Currency (OCC)
 - Federal Reserve is U.S. “umbrella” supervisor for FBO
- Generally, same deposit-taking restrictions as state-licensed branches and agencies
- Federal branches/agencies have same “rights and privileges” as national banks
 - Some differences (for example, lending limits based on foreign bank capital)
- May exercise trust powers with OCC approval
- Have access to Fed discount window
- Foreign bank cannot maintain a federal branch/agency in state where it has state-licensed branch or agency
- Foreign bank cannot maintain a federal branch in state where it maintains a federal agency

Federal Branch/Agency

- Branches/agencies are not separately capitalized entities and not subject to regulatory minimum capital requirements
 - OCC capital equivalency requirement: maintain a deposit account with a Federal Reserve member bank in an amount equal to the *greater of*: (i) the capital that would be required to organize a national bank at the same location; or (ii) 5 percent of the total third-party liabilities of the federal branch or agency
 - If multiple federal branches/agencies, asset pledge may be combined
- Asset maintenance requirements:
 - OCC may impose asset maintenance requirements on a federal branch/agency; an asset maintenance agreement may require the federal branch/agency to maintain a stated percentage of assets to third-party liabilities

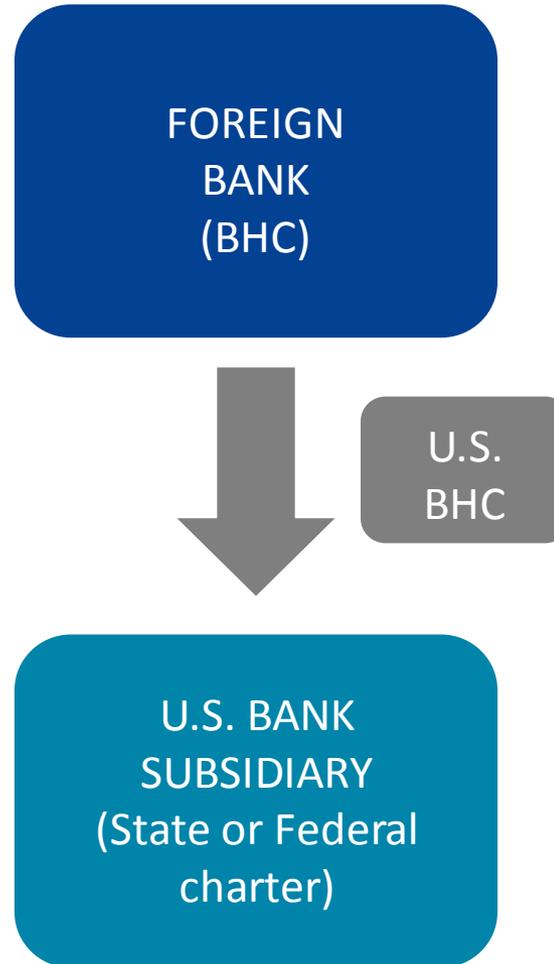
Consequence of Establishing Branch/Agency

- **Bank Holding Company (BHC) Status**
 - Once a banking presence is established, FBO is “deemed” a bank holding company (with US branch/agency presence) or is a defined bank holding company (with control of a US bank)
 - Subject to the U.S. Bank Holding Company Act (and sometimes state BHC laws)
- **Bank Holding Company Act (BHCA)**
 - Historically, U.S. has placed greater emphasis than other countries on:
 - Restricting activities of banks and their affiliates, and
 - Restricting geographic expansion
 - BHCA is the tool through which:
 - Affiliations between banks and nonbanks are restricted
 - Federal Reserve exercises authority to approve:
 - Ownership of banks
 - Affiliation of banks with nonbanks
- There are many different aspects of bank holding company status, and we will discuss more over the next several slides.

Extraterritorial Reach of the BHCA

- Under Federal Reserve rules, generally a “foreign banking organization” or “FBO” is defined as:
 - (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 other bank or other company that controls such a non-U.S. bank (the non-U.S. bank’s “parent”, if any).
- “Qualifying foreign banking organizations” (QFBOs) – additional exceptions that limit the extraterritorial effect of the BHCA on FBOs.
 - QFBO Tests (detailed assets / 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 non-controlling 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

U.S. Bank Subsidiary



Acquiring “Control” of a U.S. Bank

- A foreign bank also may become a bank holding company by acquiring “control” of a U.S. bank.
 - The concept of “control” and “subsidiary” (a company that is “controlled” by its parent) are key concepts in the BHCA framework applicable to FBOs.
- 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, or
 - 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, etc.).
- BHCA “control” does not necessarily mean exclusive or dominant control, and there can be more than one “controlling” entity.

BHCA Effect on Investments

- Once a foreign bank is treated as a BHC (either through branch/agency and/or control of a U.S. bank), the BHCA must be considered in relation to all investments and investment strategies.
 - *All Companies:* FBOs/BHCs may invest in up to 5% of a class of voting securities of any issuer so long as the investment is “passive” and “noncontrolling”.
 - *U.S. Bank:* Unlike non-BHCs which are not affected by the BHCA until acquiring “control” of a U.S. bank, acquisitions by a BHC of 5% or more of a “class” of “voting securities” of an insured depository institution generally require prior approval by the Federal Reserve.
 - *U.S. Nonbanking Financial Companies:*
 - For a BHC, acquiring more than 5% of a class of voting securities of a nonbanking financial company requires prior notice to and approval of the Federal Reserve
 - For an FHC (which we will discuss later), after-the-fact notice may be sufficient for a nonbanking financial company acquisition.
 - Acquisition of control of a financial company will require that the company be treated as a subsidiary, abide by BHCA regulations and generally have policies and procedures consistent with those of the BHC
 - *DPC:* 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.
 - *Fiduciary:* FBOs/BHCs may hold shares in fiduciary capacity if certain requirements are met.
- In general, holdings of an FBO and all of its “subsidiaries” must be aggregated toward the ownership limits, except in certain cases such as DPC, fiduciary, etc.

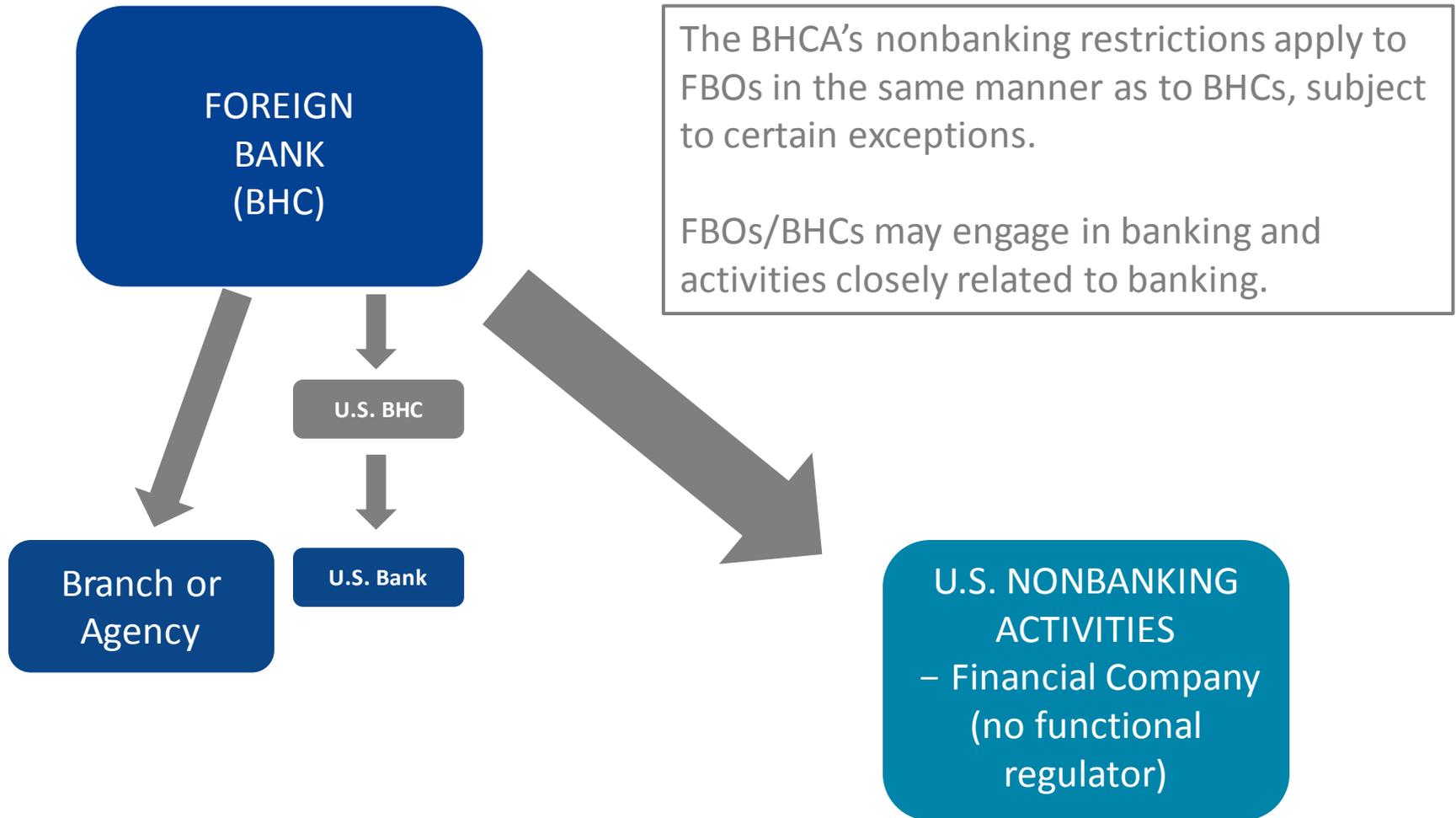
Bank/Branch/Agency Transactions with Affiliates

- Once an FBO has a bank subsidiary, a branch or an agency, the banking offices can be subject to restrictions on transactions with affiliates.
- Statute/Rule: Sections 23A/23B of the Federal Reserve Act; Regulation W.
- Applicability:
 - Any U.S. insured depository institution (a U.S. bank) for transactions with all affiliates, subject to limited exceptions.
 - For FBOs that are FHCs, U.S. branches and agencies (but not the FBO's head office or non-U.S. branches and agencies) for transactions with certain affiliates engaged in insurance, securities or merchant banking.
- Restrictions
 - “Covered transactions” with an affiliate, including extensions of credit, purchases of assets, guarantees, credit exposure from derivatives or securities financing transactions, etc., are subject to quantitative limits based on a percentage of the bank's capital and surplus.
 - Extensions of credit to an affiliate generally must 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, market terms.
- Regulation W contains numerous exemptions and requirements that should be analyzed in the context of particular transactions.

Bank/Branch/Agency Tying Restrictions

- Once an FBO has a bank subsidiary, a branch or an agency, the banking offices can be subject to prohibitions on “tying”.
- Definition: “Tying” is conditioning the availability or pricing of one product or service on the customer obtaining another product or service (the “tied product/service”).
- Applicability: U.S. banks and U.S. branches/agencies of FBOs (but not the FBO’s head office or non-U.S. branches and agencies).
- 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.

BHC Non-banking Activities



BHC Non-banking Activities

Overview

- A FBO/BHC may engage in banking activities and activities closely related to banking, but the BHCA otherwise generally prohibits a FBO/BHC's acquisition or control of voting shares of any company which is not a bank.
- Permitted activities include (not limited to) acquisition of:
 - 5% or less of the outstanding voting shares of a company;
 - shares of a company the activities of which the Federal Reserve has determined to be closely related to banking (e.g., extending credit, leasing, trust company functions, investment advisory activities, certain insurance agency and underwriting activities, data processing); and
 - Shares held in a fiduciary capacity.

BHC Non-banking Activities

Filings and guidance

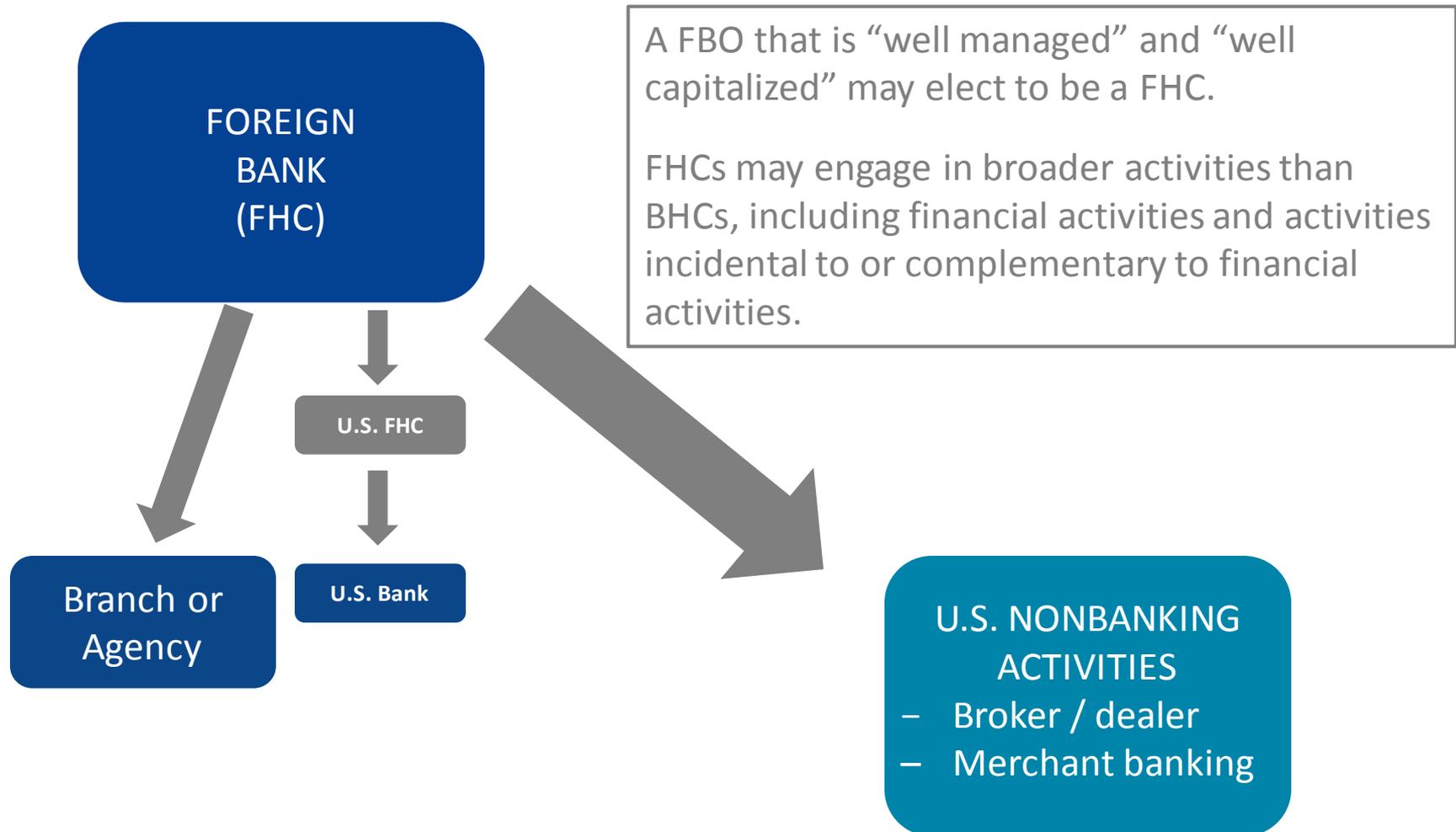
- The Federal Reserve's prior approval is generally required to engage in or acquire a company engaged in a nonbanking activity.
 - Within 30 days, the appropriate Reserve Bank shall approve the notice or refer it to the Board.
 - A subsequent notice is generally required to alter a nonbanking activity in any material respect from that initially approved.
- Prior Federal Reserve approval is generally not required:
 - To engage in BHC-permissible nonbanking activities (§225.28(b)), if certain requirements are met (notice to appropriate Reserve Bank required within 10 business days);
 - For certain servicing activities for the FBO/BHC; and
 - For certain nonbanking acquisitions.
- A FBO/BHC can request an advisory opinion regarding the scope of permissible nonbanking activities.

QFBO Non-banking Activities

Overview

- A QFBO qualifies for certain additional exemptions from the BHCA nonbanking prohibitions, including (not limited to):
 - A QFBO may engage in activities of any kind outside the U.S., and engage directly in activities in the U.S. that are incidental to its activities outside the U.S.; and
 - A QFBO may own or control voting shares of a foreign company that is engaged directly or indirectly in business in the U.S. other than that which is incidental to its international or foreign business, subject to certain limitations (e.g., more than 50% of the foreign company's consolidated assets shall be located, and consolidated revenues derived from, outside the U.S.).

FHC Non-banking Activities



FHC Non-banking Activities

Overview

- A FBO may elect to be treated as a financial holding company (FHC) if it is “well capitalized” and “well managed”.
- A FBO/FHC may engage in broader activities than a BHC, including activities that are:
 - closely related to banking;
 - usual in connection with the transaction of banking abroad;
 - financial in nature;
 - incidental to financial activity; or
 - complementary to financial activity and do not pose a substantial safety and soundness risk.
- Financial activities include certain insurance activities, securities underwriting activities, and merchant banking investments.

FHC Non-banking Activities

Filings and guidance

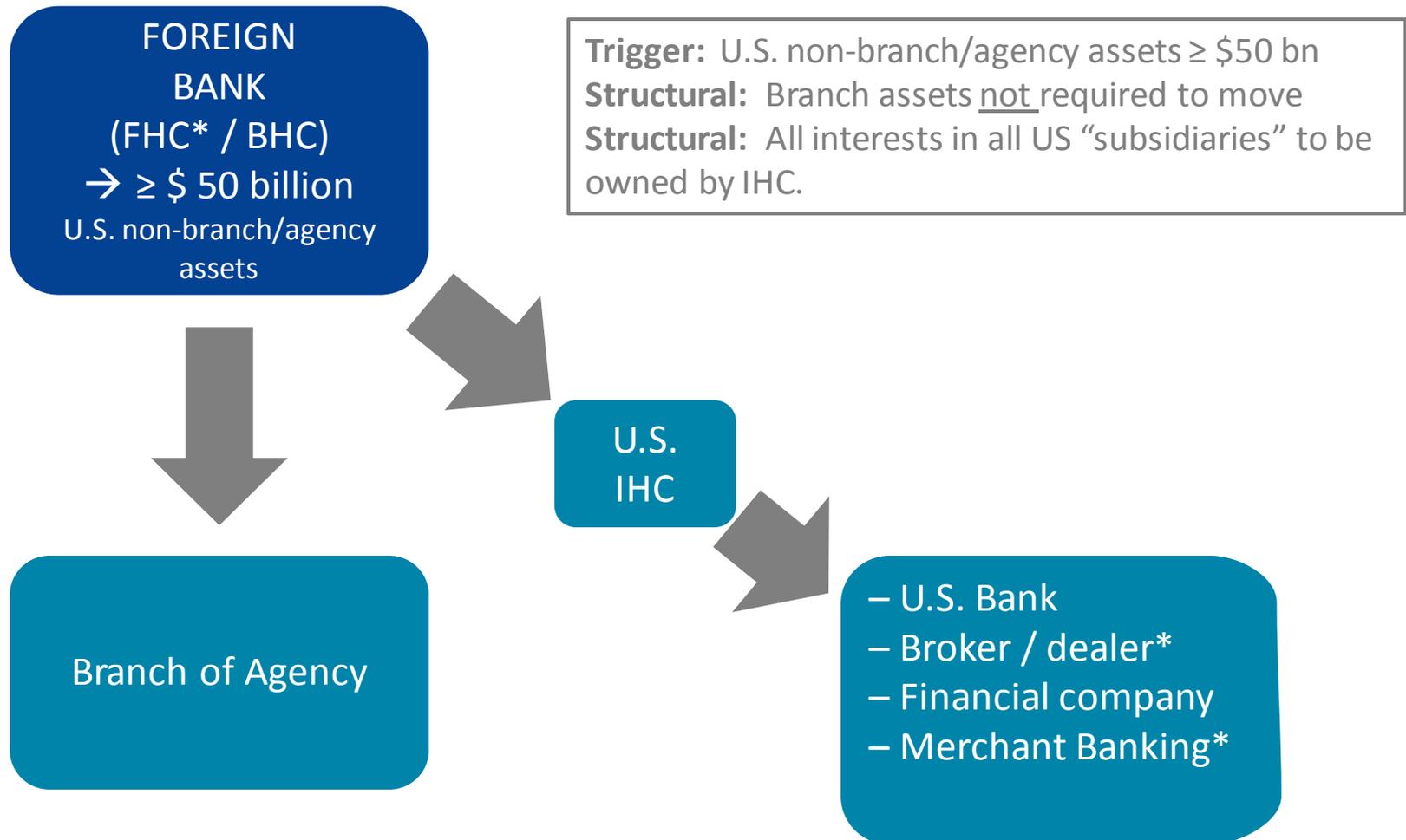
- A FBO may file a written declaration with its appropriate Reserve Bank to elect to be treated as a FHC; the election generally becomes effective on the 31st day after it is received.
- Subject to certain exceptions, a FBO/FHC and its non-depository institution subsidiaries may engage in any FHC-permissible activity without providing prior notice to or obtaining prior approval from the Federal Reserve (post-transaction notice is generally required within 30 days).
- A FBO/FHC may request a determination that an activity is financial in nature or incidental to a financial activity; or an advisory opinion about whether a specific proposed activity falls within the scope of FHC-permissible activities.

FHC Non-banking Activities

Compliance Considerations

- The Federal Reserve requires a FBO that is a FHC to promptly notify the Federal Reserve if it ceases to be “well capitalized” or “well managed”.
- If the Federal Reserve finds that a FBO that is a FHC ceases to be “well capitalized” or “well managed”:
 - The Federal Reserve will notify the FBO;
 - The FBO must execute an agreement to comply (within 45 days);
 - The Federal Reserve may impose limitations or conditions on conduct or activities (until conditions corrected);
 - The FBO may not commence additional activities in the U.S. or acquire control or shares of any company under section 4(k) of the BHCA without prior Federal Reserve approval (until conditions corrected); and
 - The Federal Reserve may order the FBO to terminate U.S. branches and agencies and divest commercial lending companies (if conditions not corrected after 180 days).

IHC



IHC – Structural Considerations

- **Trigger: \$50 billion of U.S. non-branch/non-agency assets**
 - Measured as average assets of 4 most recent quarters (or lesser number of quarters, if have not filed for that length of time) on FR Y-7Q
- **Establishment**
 - FBOs that met the asset trigger as of June 30, 2014 already established IHCs as of July 1, 2016; required to file “implementation plans” ahead of time
 - FBOs that cross \$50 bn asset trigger later are required to establish IHC by first day of 9th quarter after date of crossing asset trigger; Federal Reserve may require implementation plan
- **Organization of IHC and its Subsidiaries**
 - Organized under U.S. law, but may be LLC, LP, etc.
 - Governed by a board of directors or managers
 - No branch assets are required to move to the IHC – no “subsidiarization”
 - “Entire ownership interest” of all U.S. “subsidiaries”, must be held by IHC, except
 - Section 2(h)(2) companies organized in U.S., and
 - DPC subsidiaries of a branch/agency
 - May request alternative organizational structure – Federal Reserve considers “whether applicable law would prohibit [FBO] from owning or controlling one or more of its U.S. subsidiaries through a single U.S. [IHC], or whether circumstances otherwise warrant an exception based on [FBO’s] activities, scope of operations, structure or similar considerations”
 - Provide notification/certification within 30 days of establishment of IHC

IHC – Regulatory Considerations

- Generally treated as a BHC/FHC
- Requirements (to be discussed in later panel):
 - Minimum capital requirements
 - Liquidity requirements
 - Risk management and board risk committee requirements
 - Capital plan submission requirements
 - Stress testing / Comprehensive Capital Analysis & Review (CCAR)