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Here are annexes to Mulford letter, as requested.

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PROPOSED AMENDMENT TO THE FINANCIAL INSTITUTIONS SAFETY AND CONSUMER CHOICE ACT (FISCCA)

FISCCA establishes a requirement that foreign banks, if they wish to carry out non-banking activities in the United States through separate subsidiaries, must conduct their banking operations in the US exclusively through a separately incorporated and capitalized subsidiary. Such a requirement would severely impair the ability of foreign banks to benefit from the US reforms: because such banks would no longer be able to operate branches in the US, they would be unable to operate or to extend credit on the basis of consolidated world capital of the bank and would also incur substantial costs in restructuring their US operations; this would substantially harm their ability to enter and compete effectively in the US market. These adverse effects would even be more onerous if the new rules applied retroactively to those foreign banks authorized by the International Banking Act (IBA) to continue to operate US securities subsidiaries while conducting banking activities through branches in the US.

Moreover, enactment of the proposed restrictions on the ability to operate through branches in the US could negatively affect efforts to liberalize the international activities of financial institutions currently under way in several fora (such as the OECD and the Uruguay Round) in which the US is participating actively at present. They would also undermine present and future international work among banking supervisors in Basle to facilitate the international activities of banks.

Specific proposals

The most important change to introduce in section 231 of FISCCA is to delete the new sections 8(a)(2) and 8(a)(3) of the IBA. The enclosed proposed amendment (Annex 1), which has been under discussion in Washington, would accomplish it. This amendment could be modified in two respects as indicated in Annex 2.

Arguments in favour of this approach - Response to counter-arguments

a) It has been argued that branches of foreign banks are not easy to supervise, that the present proposal would imply a very complicated regulatory structure, and that it would pose the question of how the new section 8(a)(1) of the IBA, which subjects foreign banks to the Financial Services Holding Company (FSHC) Act, would apply to foreign banks if they do not need to set up an FSHC in the US. Any possible validity of the supervision arguments would be mooted by

the new Federal Reserve proposals to strengthen the regulation and supervision of US branches and agencies of foreign banks(1). It would also be contradicted by the current regulatory and supervisory practice in the US in the area of access by banks to non-banking activities. For example, in January 1990 the Federal Reserve Board authorized three foreign banks to establish separate securities subsidiaries ("section 20 subsidiaries") in the US, while not preventing them from continuing their existing branch operations in the US.

The solution to the regulatory structure problem would be to copy the model of the IBA. While respecting the ability of foreign banks to operate in the US in the form of branches and agencies, the IBA applied to such branches and agencies of foreign banks operating restrictions and regulatory conditions equivalent to those applied to domestic banks. Thus, section 8 of the IBA establishes that, as regards non-banking activities, foreign banks operating US branches or agencies are generally subject to the same restrictions that the Bank Holding Company Act imposes on domestic and foreign bank holding companies.

A solution based on the IBA model - which had the specific purpose of enabling foreign banks to compete on a level playing field - would safeguard the equality of competitive opportunities of foreign banks, while at the same time would subject the activities of foreign banks operating branches and agencies to an appropriate and no more (but also no less) favourable regulatory framework than that applicable to domestic banks.

b) Allowing foreign banks to continue to operate in the US through branches while at the same time being able to set up securities and insurance subsidiaries would not be "better than national treatment". The ability of foreign banks to operate branches in the US was respected by the IBA as a key element of its policy of granting foreign banks competitive opportunities equal to those enjoyed by US banks (as recognized in the US Treasury National Treatment Study, pages 29-48). If the "better than national treatment" argument is followed to its logical conclusion, it would imply that in other countries and as a general rule the right of establishment of branches in the banking area is "better than national treatment".

The ability to operate through branches is essential for foreign banks - including US banks - to be able to operate in foreign countries on the basis of the consolidated world-wide capital of the bank and thereby to compete effectively with domestic banks on equal terms (see for instance the Treasury's own remarks on page

(1) These proposals, which were introduced on 9 May by Senators Riegle, Garn and Kerry, include inter alia: (a) a requirement for federal approval by the Federal Reserve Board for the establishment of state-licensed branches or agencies; (b) specification of standards for authorization of branch and agency applications; (c) enhanced tools for supervising the US operations of foreign banks, including sharing information with supervisory authorities of other countries; and (d) an extension of the prior approval requirement for acquisitions of more than 5 % of the voting shares of a US bank (which applies to domestic and foreign bank holding companies) to foreign banks with branches or agencies in the US (at present the threshold is 25 % for such banks).

132 of the US National Treatment Study(2) and also the arguments in favour the freedom to branch used by the Treasury on page 50 of its February 1991 paper "Modernizing the Financial System"(3)). As a proof of this, most of the foreign activities conducted abroad by US banks are carried out through branches (as of December 1989, while US banks' subsidiaries abroad held a total of $ 191 billion, foreign branches of US banks held a total of $ 305 billion) and, conversely, most of the activities conducted by foreign banks in the US are carried out through branches (as of 30 June 1990, branches of foreign banks held $ 475 billion in the US as compared with $ 153 billion held by US subsidiaries of foreign banks).

The right of establishment of branches cannot be questioned. Such a restriction on the ability to operate through branches and agencies would be likely perceived as a reversal of the trend towards liberalization of international banking operations and would create an unfortunate precedent which could have serious consequences for the way in which third countries may decide to deal in future with the establishment and operation of branches of foreign banks. In particular, it would be at odds with the recently agreed provisions of the OECD Capital Movements Code, which creates a right of establishment for branches and agencies of foreign banks and financial firms(4). It could also put under question work being carried out in Basle(5) on capital adequacy to facilitate, among other things for the operation through branches, the international activities of banks.

A different question concerning national treatment relates to the treatment of foreign banks' securities firms grandfathered under the IBA. As indicated in Annex 2, if the ability of foreign banks to carry out in the US non-banking activities through separate subsidiaries and at the same time to conduct their traditional banking activities in the US through branches and agencies is preserved, it would be then appear not to be unfair to subject grandfathered securities firms to the new regulatory structure, provided that the range of the activities they may conduct at present and their growth are not curtailed.

c) A requirement to transform foreign banks' branches into separately capitalized subsidiaries would be rendered unnecessary by the principle of functional supervision adopted in FISCCA and with the

(2) Referring to the prohibition of establishment by foreign banks of branches in Canada, it states that this prohibition "presented several administrative and operational problems for US banks, increased their costs of doing business and adversely affected their ability to compete effectively with the large Canadian banks".

(3) Where it is argued that carrying out banking activities through branches instead of through separate subsidiaries would increase profits, help build and attract capital into the industry, and avoid numerous parallel and unnecessary costs (such as the need to have separate boards of directors, regulatory reports, examinations, audited financial statements, support and control systems, and computer systems separate from those of the head office).

(4) The OECD Council decided in May 1989 to establish specific provisions on the establishment and operation of branches and agencies of non-resident investors in the banking and financial services sector, which will be contained in Annex II to Annex A of the Code of Liberalization of Capital Movements.

(5) Basle Committee on Banking Regulations and Supervisory practices.

fact that the focus of supervision and capitalization is now turning from the holding company to the bank itself, by ensuring its proper capitalization and protecting the deposit insurance fund through "firewalls". Precisely because of the principle of functional supervision and of the ability to erect "firewalls" around the banking activities, there would be no reason why foreign banks' branches operating in the US could not continue to be supervised as they are at present (or under the new proposals by the Federal Reserve Board), while at the same time the requirement for the creation of separately capitalized and supervised subsidiaries for non-banking activities would apply to the foreign banks. It is difficult to see why the supervision and regulation of the activities of foreign banks, which are in any case supervised and capitalized separately, should change substantially if the same bank is affiliated with securities and insurance companies which are also separately supervised capitalized.

d) It has been argued that the Treasury proposal is comparable to the EC requirement for establishment of a subsidiary in the European Community to benefit from the single banking license. This comparison is not correct. Foreign banks, if they wish so, will be permitted to operate in the Community both through direct branches and through subsidiaries operating under the liberalizing provisions of the Second Banking Directive. In other words, non-EC banks would not be forced to close their direct branches in the Community either as a condition for operating subsidiaries under the single license provisions of the 2nd Banking Directive (which allows banks to engage directly in securities activities), or as a condition for operating separate securities or insurance subsidiaries in the Community.

Annexes: 1. Amendments to the Financial Institutions Safety and Consumer Choice Act
2. Further changes which could be introduced in the amendments proposed in Annex 1.

Annex 2

Paragraph (B), introduced by the proposal contained in Annex 1, could be modified as indicated below (changes underlined), and a new paragraph (C) could be inserted on page 116, after line 19:

(B) Notwithstanding paragraphs (1) and (2), each appropriate Federal Banking Agency, in reviewing a notice under section 4 of the Financial Services Holding Company Act by a foreign bank or company described in this subsection, shall consider whether the financial strength of such bank or company is sufficient ~~comparable to a Zone 1 or Zone 2 FSHC under section 35 of the Federal Deposit Insurance Act and~~ for purposes of meeting the requirements of subsections 4(i), (j), and (k) of the Financial Services Company Act.

(C) When assessing the financial strength of the foreign bank or company in the application of paragraph (B), each appropriate Federal banking agency shall take into account maintaining competitive equality among domestic and foreign banks, and differences in domestic and foreign accounting standards.

The following amendment to sections 4(j) and (k) of the Financial Services Holding Company (FSHC) Act could be inserted: add at the beginning of those sections the words "Without prejudice to the application to foreign banks and companies of the provisions of sections 8.(a)(1)(B) and (C) of the International Banking Act,".

The rationale for these modifications to the amendment enclosed in Annex 1 is to avoid any automatic application of Zone 1 and Zone 2 criteria to foreign banks. The focus would then shift from a strict assessment of comparability with Zone 1 and Zone 2 criteria to an evaluation by the appropriate Federal banking agency of the financial adequacy of the foreign bank or company. Even if it is expected that Zone 1 and Zone 2 criteria would be taken into account in such an assessment, these criteria would not be the only elements to be considered, and the Federal banking agency would be able to take into account other relevant elements. At this stage, before knowing the full details of their application, it is difficult to state unequivocally the extent to which Zone 1 and Zone 2 criteria may apply as such to foreign banks, and therefore it is necessary to provide for the introduction of some flexibility, on the condition that no more favourable treatment is granted.

As regards the treatment of securities firms grandfathered under the IBA, it could be indicated that the Federal Reserve Board has discretion to terminate the authority to carry out securities activities conferred under sub-section 8.(c)(1) of the IBA to a securities affiliate in the US of a foreign bank, provided that any such activities are considered as permissible activities for financial services holding companies in the US and therefore may be carried out by securities subsidiaries or affiliates of foreign banks in the US.