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FOREIGN INVESTMENT

Fed Opens the Door to Increased Chinese Investment in U.S. Banking Organizations



By MICHAEL E. BLEIER AND TRAVIS P. NELSON

On May 9, 2012, the Federal Reserve Board (“FRB”) released three orders approving investments in the U.S. banking market by entities based in China. The investments, which consist of the acquisition of 80 percent of a national banking association and the establishment of two foreign branch offices, are particularly notable because the investments are coming from China, the Chinese Government will be an indirect owner of a national bank, and the conclusions

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that the FRB draws regarding the financial regulatory system of China are significant and will facilitate greater investment in U.S. banking organizations by Chinese-based companies in the future (98 BBR 841, 5/15/12).

The Proposed Acquisition

The most significant of the three orders involves the Industrial and Commercial Bank of China Limited (“ICBC”), China Investment Corporation (“CIC”), and Central Huijin Investment Ltd. (“Huijin”) — all of Beijing, and all of which requested approval to become bank holding companies under section 3 of the Bank Holding Company Act of 1956 (“BHC Act”), by acquiring up to 80 percent of the voting shares of The Bank of East Asia, National Association (“BEA-USA”), New York, New York.¹ ICBC engages primarily in retail and commercial banking throughout China. CIC is an investment vehicle organized by the Chinese Government for the purpose of investing the latter's foreign exchange reserves, and controls Huijin, a Chinese Government-owned investment company organized to invest in Chinese financial institutions.² BEA-USA, with total consolidated assets of approximately \$780 million and deposits of approximately \$621 million (as of December 31, 2011), engages in retail and commercial banking in the United States, and operates 13 branches in New York and California.

Decisional Factors

In evaluating an application by a foreign banking organization to acquire a U.S. domestic depository institution, the FRB considers several factors, namely: (1) supervision or regulation on a consolidated basis; (2) competitive considerations; (3) financial, managerial,

¹ FRB Order No. 2012-4 (May 9, 2012).

² CIC also owns a non-controlling interest in Morgan Stanley. See China Investment Corporation, 96 Fed. Res. Bull. B31 (2010).

and other supervisory considerations; (4) convenience and needs considerations; and (5) financial stability.

Supervision or Regulation on a Consolidated Basis

In what is perhaps the most significant aspect of the FRB's BEA-USA acquisition approval, the FRB evaluated whether the Chinese financial regulatory regime meets the "comprehensive, consolidated supervision" or "CCS" standards required for a foreign banking organization to acquire a U.S. domestic depository institution.³

Section 3 of the BHC Act requires the FRB to consider whether the applicants are subject to comprehensive supervision or regulation on a consolidated basis by appropriate authorities in their home country.⁴ The FRB has long held that "the legal systems for supervision and regulation vary from country to country, and comprehensive supervision or regulation on a consolidated basis can be achieved in different ways."⁵ In applying this standard, the FRB has considered the Basel Core Principles for Effective Banking Supervision ("Basel Core Principles"), which are recognized as the international standard for assessing the quality of bank supervisory systems, including with respect to comprehensive, consolidated supervision.

The FRB's Regulation K provides that a foreign bank is subject to consolidated home country supervision if the foreign bank is supervised or regulated in such a manner that its home country supervisor receives sufficient information on the worldwide operations of the foreign bank (including the relationships of the bank to any affiliate) to assess the foreign bank's overall financial condition and compliance with law and regulation.⁶ In assessing this standard under section 211.24 of Regulation K, the FRB considers, among other indicia of comprehensive, consolidated supervision, the extent to which the home country supervisors: (1) ensure that the bank has adequate procedures for monitoring and controlling its activities worldwide; (2) obtain information on the condition of the bank and its subsidiaries and offices through regular examination reports, audit reports, or otherwise; (3) obtain information on the dealings with and relationship between the bank and its affiliates, both foreign and domestic; (4) receive from the bank either financial reports that are consolidated on a worldwide basis or comparable information that permits analysis of the bank's financial condition on a worldwide consolidated basis; and (5) evaluate prudential standards, such as capital adequacy and risk asset exposure, on a worldwide basis.

³ We note that while the FRB has never previously determined that China is subject to CCS status, the FRB has previously approved applications from Chinese banks, including ICBC, to establish U.S. branches under a lower standard than the CCS standard. FRB Order No. 2012-4 n. 26 (May 9, 2012). The other two branch applications approved in association with Order No. 2012-4 were reviewed under this lower standard.

⁴ 12 U.S.C. § 1842(c)(3)(B).

⁵ 57 Fed. Reg. 12992, 12995 (April 15, 1992).

⁶ 12 C.F.R. § 211.24(c)(1)(ii).

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In determining that the enhancements to standards of bank supervision in China warranted a finding that ICBC is subject to CCS, the FRB was particularly persuaded by the following factors:

- The China Banking Regulatory Commission ("CBRC") is the principal supervisory authority of ICBC, including its foreign subsidiaries and affiliates, for all matters other than money laundering, and monitors Chinese banks' consolidated financial condition, compliance with laws and regulations, and internal controls through a combination of on-site examinations, off-site surveillance through the review of required regulatory reports and external audit reports, and interaction with senior management.

- The CBRC has issued guidance in various supervisory areas, including strict prudential requirements for capital, loan-loss allowance coverage, executive compensation, banks' equity investments in insurance companies, and enhanced risk-management requirements for operations, liquidity, derivatives, reputational, and market risk. The guidance is intended to make supervision more risk-focused and to strengthen practices consistent with the Basel Core Principles. Chinese examination ratings are based on the CAMELS rating model and emphasize credit-risk management, the quality of the bank's loan portfolio, internal controls, liability structure, capital adequacy, liquidity, and the adequacy of reserves. Additionally, under the Chinese system, examinations are conducted by local and national officials, similar to the U.S. system of field-office staff and Washington review. Chinese law also establishes single-borrower credit limits. As these points suggest, the modern Chinese bank regulatory system appears to have been modeled on that of the United States.

- The CBRC head office prepares annual examination plans for the largest banks in China, including ICBC.

- Examination findings and areas of concern are discussed with senior management, and corrective actions are monitored by the CBRC.

- Chinese banks are required to report key regulatory indicators to the CBRC periodically on general schedules.

- Banks must report to the CBRC their unconsolidated capital adequacy ratios quarterly and their consolidated ratios semiannually.

- China's bank capital rules are based on the Basel capital rules, and the CBRC supports the Basel III framework and its implementation schedule.

- Large banks in China are required to be audited annually by an external accounting firm that meets the standards of the Chinese authorities.

■ China's accounting standards are basically compatible with IFRS with full conversion anticipated in 2012.

■ Chinese law imposes various prudential limitations on banks, including limits on transactions with affiliates and on large exposures.

■ The definition of affiliate appears to be much more encompassing under Chinese law than in the United States.

■ The CBRC is authorized to require any bank to provide information and to impose sanctions for failure to comply with such requests.

■ Authorities in China have increased cooperation with international groups and supervisory authorities in other countries regarding bank supervision. These include the Basel Committee on Banking Supervision, the Financial Action Task Force, and the Financial Stability Board, among others.

■ The IMF recently completed a financial system stability assessment of China, as well as China's compliance with the Basel Core Principles. The conclusions were that China's overall regulatory and supervisory framework adheres to international standards, and that the consolidated supervisions of banks and their direct subsidiaries and branches on the mainland and offshore is of high quality.

■ The government of China has adopted a statutory regime regarding anti-money laundering ("AML") and suspicious activity reporting, and has criminalized money-laundering activities and other financial crimes. China's central bank, the Peoples' Bank of China, is the supervising authority regarding anti-money laundering.

Beyond the above specific factors supporting approval of CCS status, the FRB noted the Chinese Government's structural commitment to overseeing the activities of the CBRC, while according the CBRC autonomy in carrying out its obligations. Under the Chinese governmental system, the CBRC derives its authority from the State Council, a senior governmental body with members appointed by the Chinese President or the National Peoples' Congress.⁷ Under the Chinese system, the State Council may alter or annul a rule or guideline of the CBRC only if the rule or guideline violates applicable law.⁸ The FRB noted its understanding that the State Council has never altered or annulled the rules and guidelines issued by the CBRC. The FRB also noted that Chinese authorities represented that the State Council has supported the CBRC in undertaking banking regulation and supervision, and that the CBRC has upgraded the number and quality of its staff over time.⁹

Competitive Considerations

Section 3 of the BHC Act prohibits the FRB from approving a proposal that would result in a monopoly or

would be in furtherance of any attempt to monopolize the business of banking in any relevant banking market. The FRB is also prohibited from approving a proposal that would substantially lessen competition in any relevant banking market, unless the anticompetitive effects of the proposal clearly are outweighed by countervailing public policy considerations.¹⁰ In considering this factor, the FRB was particularly focused on the number of competitors that would remain in the banking market, the relative shares of total deposits in depository institutions in the market controlled by relevant institutions, and the concentration level of market deposits and the increase in that level as measured by the Herfindahl-Hirschman Index ("HHI"). Based on market conditions, and input and non-objections from the Justice Department, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation, the FRB determined that the proposed investment would not have a significantly adverse effect on competition in the relevant markets.

Financial, Managerial, and Other Supervisory Considerations

Section 3 of the BHC Act requires the FRB to consider the financial and managerial resources and future prospects of the companies and depository institutions involved in the proposal, as well as the effectiveness of these companies in combating money-laundering activities. Section 3 of the BHC Act also requires the Board to determine that an applicant has provided adequate assurances that it will make available to the FRB such information on its operations and activities and those of its affiliates that the FRB deems appropriate to determine and enforce compliance with the BHC Act.¹¹

This willingness of a major U.S. regulator to accept transparency assurances from the Chinese Government, which is viewed by some in the international community as lacking a strong, long-term track record of openness and transparency in other international relations issues, coupled with the fact that the Chinese Government has significant ownership interests in the applicants, represents a certain leap of faith on the part of the FRB as to the ability of the FRB to sustain a strong cooperative relationship with the applicants and the CBRC.

Two notable qualitative determinations of the FRB in considering this factor are the financial stability and re-

⁷ The US-China Business Council, available at: https://www.uschina.org/public/china/govstructure/govstructure_part6/cbrc.html ("CBRC was established in March 2003 to oversee the banking sector as an independent, ministry-level supervisory office that reports directly to the State Council."). For additional information on the CBRC, see the CBRC's website at: <http://www.cbrc.gov.cn/showyjhhjindex.do>.

⁸ FRB Order No. 2012-4, *18 n. 38 (May 9, 2012).

⁹ Id.

¹⁰ 12 U.S.C. § 1842(c)(1); see also, Emigrant Bancorp., Inc. 82 Fed. Res. Bull. 555 (1996).

¹¹ 12 U.S.C. § 1842(c)(3)(A).

sources of the applicant, and the likelihood of transparency. In considering the financial stability and resources of the applicant, the FRB noted that the applicants “are large relative to the size of BEA-USA and have substantial financial resources to consummate the proposal and to provide ongoing financial support to BEA-USA.”¹² As to transparency, the FRB noted that the applicants “have committed that, to the extent not prohibited by applicable law, they will make available to the [FRB] such information on their operations and the operations of their affiliates that the [FRB] deems necessary to determine and enforce compliance with the BHC Act, the International Banking Act, and other applicable federal laws.”¹³ Moreover, the CBRC, the agency with primary responsibility for the supervision and regulation of Chinese banking organizations, “has represented that it would facilitate the [FRB’s] access to information, and it has entered into a statement of cooperation with the [FRB] and other U.S. banking regulators with respect to the sharing of supervisory information.”¹⁴ This willingness of a major U.S. regulator to accept transparency assurances from the Chinese Government, which is viewed by some in the international community as lacking a strong, long-term track record of openness and transparency in other international relations issues, coupled with the fact that the Chinese Government has significant ownership interests in the applicants, represents a certain leap of faith on the part of the FRB as to the ability of the FRB to sustain a strong cooperative relationship with the applicants and the CBRC.

The key financial consideration for the FRB in reviewing the application was the capital strength of ICBC as the FRB has consistently considered capital adequacy to be “especially important.”¹⁵ The FRB noted that the capital levels of ICBC exceeded the minimum levels that would be required under the Basel I Capital Accord and were considered to be equivalent to the capital levels that would be required of a U.S. banking organization seeking to acquire an organization of the size and profile of BEA-USA.¹⁶ In fact, the CBRC requires all large, internationally active banks, such as ICBC, to have minimum capital levels that exceed Basel minimum levels.¹⁷

Convenience and Needs Considerations

In acting on a proposal under section 3 of the BHC Act, the FRB also must consider the effects of the proposal on the convenience and needs of the communities to be served, and must take into account the records of the relevant insured depository institutions under the Community Reinvestment Act (“CRA”).¹⁸ The CRA requires the federal financial supervisory agencies to encourage insured depository institutions to help meet the credit needs of the local communities in which they operate, consistent with their safe and sound operation, and requires the appropriate federal financial supervisory agency to take into account a relevant depository institution’s record of meeting the credit needs of its en-

tire community, including low- and moderate-income neighborhoods, in evaluating bank expansionary proposals.¹⁹

The record that the FRB considered included evaluations of the CRA performance record of BEA-USA, the record of the branch offices of CIC and Huijin, information provided by ICBC and BEA-USA, comments received on the proposal from the general public, and confidential supervisory information. The FRB’s Order notes that “several commenters raised concerns that BEA-USA might exclude African Americans, Hispanics, and Southeast Asians in the provision of its products and services. Other commenters alleged that BEA-USA excludes African Americans and Hispanics with respect to its home mortgage lending.”²⁰ During the comment period, several commenters also requested that the FRB require ICBC “to submit a CRA plan or enter into commitments that will ensure BEA-USA provides service to all underserved and minority communities in its service areas.”²¹ This tactic of special interest groups using the CRA comment process to attempt to extract monetary and non-monetary concessions from financial institutions is not new. In declining to require such commitments or agreements, the FRB stated: “The Board consistently has stated that neither the CRA nor the federal banking agencies’ CRA regulations require depository institutions to make pledges or enter into commitments or agreements with any organization and that the enforceability of any such third-party pledges, initiatives, and agreements are matters outside the CRA.”²² Moreover, the FRB noted that while the BEA-USA HMDA data appeared to suggest some lending disparities among certain racial or ethnic groups, the FRB noted that the data alone provided an insufficient basis to conclude whether or not BEA-USA is excluding or imposing higher costs on any racial or ethnic group on a prohibited basis.

Based on a review of the entire record, the FRB concluded that considerations relating to the convenience and needs factor, and the CRA performance records of the relevant insured depository institutions, are consistent with approval.

Financial Stability

The Dodd-Frank Wall Street Reform and Consumer Protection Act amended section 3 of the BHC Act to require the FRB also to consider “the extent to which a proposed acquisition, merger, or consolidation would result in greater or more concentrated risks to the stability of the United States banking or financial system.”²³ In this application, the FRB found that the proposal would have a *de minimis* impact on the applicants’ systemic footprint because BEA-USA has consolidated assets of approximately \$780 million, and that its acquisition would not meaningfully increase ICBC’s size, and the proposal would not add any significant complexity to the overall operations of ICBC. Given these two key points, and other relevant factors, the FRB concluded that the considerations relating to financial stability are consistent with approval.

¹² FRB Order No. 2012-4, *7 (May 9, 2012).

¹³ *Id.* at *9.

¹⁴ *Id.*

¹⁵ FRB Order No. 2012-4, *7 (May 9, 2012).

¹⁶ *Id.* at *7.

¹⁷ *Id.* at n. 20.

¹⁸ 12 U.S.C. § 2901 *et seq.*; 12 U.S.C. § 1842(c)(2).

¹⁹ 12 U.S.C. § 2903.

²⁰ FRB Order No. 2012-4, *25 (May 9, 2012).

²¹ *Id.* at *25.

²² *Id.* at *25.

²³ Dodd-Frank Act Sec. 604(d), codified at 12 U.S.C. § 1842(c)(7).

This approval, like all initial determinations of CCS status, is precedential in that it will provide a basis for additional Chinese investors to acquire U.S. depository institutions and thereby become bank holding companies.

Of note in its financial stability analysis is the FRB's guidance on its anticipated consideration of the post-transaction condition of the target institution. Specifically, the FRB notes that it "expects that it will generally find a significant adverse effect if the failure of the resulting firm, or its inability to conduct regular-course-of-business transactions, would likely impair financial intermediation or financial market functioning so as to inflict material damage on the broader economy."²⁴ Conversely, the FRB envisions that "a proposal that involves an acquisition of less than \$2 billion in assets, results in a firm with less than \$25 billion in total assets, or represents a corporate reorganization may be presumed not to raise financial stability concerns absent evidence that the transaction would result in a significant increase in interconnectedness, complexity, cross-border activities, or other risk factor."²⁵

Implications

The approval of ICBC to acquire a substantial position in BEA-USA represents a significant development in international banking and U.S. bank supervision:

- This approval, like all initial determinations of CCS status, is precedential in that it will provide a basis for additional Chinese investors to acquire U.S. depository institutions and thereby become bank holding companies. While each CCS determination is nominally transaction-specific, because so much of the analysis of CCS status is based on a macro analysis of the home country regulatory regime, the analysis in the BEA-USA approval will be the basis upon which future applicants – and examiners – can rely.

- Given the sensitive political and national security issues surrounding investments from Chinese institutions, particularly ones with substantial Chinese government involvement, the FRB undertook a detailed analysis in its application of the quantitative and qualitative factors required by the BHC Act, Regulation Y, and FRB precedent. Excluding countries accused of sponsoring or shielding terrorists, the political and eco-

nomics issues raised by a China-based application probably triggered the highest level of supervisory scrutiny at the FRB. Given this supervisory posture, the analysis and considerations in this approval can serve as a valuable model for evaluating the CCS status of other home country regulatory regimes. Moreover, we surmise that if the acquisition had been of a much larger institution, this would probably have triggered a review by the Committee on Foreign Investment in the United States, i.e., a CFIUS review.

- The FRB's consideration of the transparency factors is notable. With China's increasing involvement in international economic, law enforcement, and diplomatic organizations, the FRB's faith in the willingness of the Chinese government-sponsored institutions and the CBRC represents another advance by the world's most populous nation in its goal of becoming one of the world's leading financial centers.

- The unequal treatment of foreign investments in China versus the more open U.S. investment standards is likely to raise some concern going forward. Under U.S. law, there is no limit to the level of ownership that a foreign investor may have in a U.S. depository institution, provided that the investor is willing to become a bank holding company, and provided that the investment does not raise any national security concerns. In China however, a single foreign investor may acquire stock amounting to less than 20 percent of the stock of a Chinese bank, and the aggregate of all foreign investment in that bank may not exceed 25 percent.²⁶ This imbalance or unlevel playing field has raised concerns on Capitol Hill.²⁷ Congressional reaction may influence the FRB's willingness to approve future applications by investors based in China and elsewhere. A possible tactic for the FRB going forward is to include reciprocity as a basis for approval of an application under the BHC Act, or of the finding of CCS status in a country regime.

- The FRB's extensive attention to the similarities between the U.S. and Chinese bank regulatory systems, including not only substantive provisions, but also examination approaches, suggests that the FRB in the future will require such similarities in making CCS determinations.

- With the increasing pressures that financial institutions are facing across the globe to meet Basel III capital requirements, which the FRB's action of June 7 indicates it proposes to incorporate into its capital requirements, financial institutions will be looking to new sources for investment capital (see related report in the Leading the News section). In fact, Fitch Ratings has recently suggested that as of end-December 2011, the world's 29 global systemically important financial institutions ("G-SIFIs"), which as a group represent \$47 trillion in total assets, might need to raise roughly \$566 billion in common equity in order to satisfy new Basel III

²⁴ FRB Order No. 2012-4, *29 (May 9, 2012).

²⁵ Id. at *29. These considerations of the size of the post-acquisition institution and the complexity that might be presented in the event of failure are consistent with past FRB decisions. See, e.g., Michael E. Bleier and Lauren A. Abbott, *Federal Reserve Board Confirms Template for Financial Stability Test: Board's Way or the Highway*, Reed Smith LLP Client Alert No. 2012-056 (February 28, 2012), available at: <http://www.reedsmith.com/Federal-Reserve-Board-Confirms-Template-for-Financial-Stability-Test-Boards-Way-or-the-Highway-02-28-2012/>.

²⁶ Administrative Rules Governing Equity Investments in Chinese Financial Institutions by Overseas Financial Institutions, Articles 8 and 9 (Dec. 8, 2003). See also, "With China's WTO entry requirements winding down, will 2006 become China's 'Year of the Bank?'" *The China Business Review*, available at: www.chinabusinessreview.com/public/0601/letter.html.

²⁷ "Lawmakers stay largely silent over Chinese takeover of U.S. bank branches," *The Hill* (May 13, 2012).

capital rules, which represents a 23 percent increase relative to these institutions' aggregate common equity of \$2.5 trillion.²⁸ This need to raise significant amounts of additional capital will drive SIFIs, as well as smaller

²⁸ "Basel III: Return and Deleveraging Pressures," Fitch Ratings Macro Credit Research (May 17, 2012) (copy on file with the authors) and available with subscription at: <http://www.fitchratings.com/jsp/general/login/LoginController.faces>; (98 BBR 917, 5/22/12).

institutions, to court new investors such as Chinese investors. With China's strong economy, burgeoning investment class, and eagerness to invest in the U.S. financial markets, China represents a very attractive source of new capital that can help U.S. financial institutions to achieve the Basel III targets ahead of schedule. The FRB made its decision fully cognizant of the need for additional capital, and by its action in granting CCS status to China, opened up a new market for capital for U.S. financial institutions.