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The Fed Approves China

The Federal Reserve has made a major decision that allows banks from China to own US banks and opens the door to future approvals for Chinese banks to acquire US banks. The decision was expected but gestated for years. The approval puts Chinese banks on an equal footing with banks from other major countries that own US banks. However, it appears that Chinese banks do not yet have the status to engage in the full range of financial activities that other foreign banks enjoy.

This memorandum summarizes the decision and its background and makes some observations on its implications for Chinese and other foreign banks.

Background

Three Chinese banks were given approvals to expand in the United States by the Board of Governors of the Federal Reserve System (“Federal Reserve”). The major decision by the Federal Reserve was required for the acquisition by Industrial and Commercial Bank of China Limited (“ICBC”) of a majority stake in The Bank of East Asia (U.S.A.) National Association (“BEA-USA”), a national bank located in New York.¹ This was an approval to become a bank holding company pursuant to Section 3 of the Bank Holding Company Act of 1956, as amended (“BHCA”), traditionally the type of application that is most strictly reviewed.

The other two banks were approved to establish branches. Bank of China Limited, which already has branches in New York and Los Angeles, was approved to establish a branch in Chicago, and Agricultural Bank of China Limited, which has a representative office in New York, was approved to upgrade the office to a branch.² These orders were issued under the International Banking Act of 1978, as amended (“IBA”). While approval under the BHCA is not required, any foreign bank

¹ The ICBC order can be found at <http://www.federalreserve.gov/newsevents/press/orders/20120509a.htm> on the Federal Reserve’s website. BEA-USA’s current owner will continue to hold the remaining 20 percent, will continue to be treated as a bank holding company with regard to BEA-USA, and has an option to sell the stake to ICBC beginning 18 months after consummation. See footnote 2 of the order.

² The orders can be found at <http://www.federalreserve.gov/newsevents/press/orders/20120509c.htm> and <http://www.federalreserve.gov/newsevents/press/orders/20120509b.htm>.

with a US branch is subject to most provisions of the BHCA as though it were a bank holding company. As further discussed below, IBA applications are not necessarily subject to the same degree of rigor as are BHCA applications.

Consolidated Supervision

The major decision made by the Federal Reserve in its approval of ICBC was that China meets international standards in its supervision of globally active banks. That is, it practices consolidated supervision on a comprehensive basis (“CCS”) as defined by the Basel Concordat issued by the Basel Committee on Bank Supervision.³ The Federal Reserve had not been required to make this determination for China before; the earlier branch applications were eligible for approval under a lesser standard on supervision available under the IBA.⁴ The home country of a foreign bank that applies to acquire control of a US bank must meet the full CCS standard.

The orders discussing the manner in which China exercises supervision seem clearly intended to address any criticisms that the Federal Reserve was not adhering strictly to its usual requirements. In addition, the Federal Reserve explicitly cited similar findings of a financial system stability assessment of China conducted by the International Monetary Fund (“IMF”), a joint assessment published by the IMF and World Bank, and a decision by the Financial Action Task Force that China is largely compliant with almost all of the recommendations for establishing an effective system to combat money laundering and terrorist financing. Indeed, two of these reports were only issued shortly before the orders, which may account in part for the very extended period of time that the Federal Reserve took to issue them.

It has been known that Federal Reserve staff has been making numerous trips to China for the past several years and has intensively studied the system there. The great amount of detail provided in the orders shows the results of their work.

In the past, the Federal Reserve has looked unfavorably on government ownership of banking organizations. The concern was that having a government as a shareholder gave the bank a competitive advantage over privately-owned banks, and that such ownership generally was contrary to free-market principles. This concern gradually faded away over the years and is now rarely heard, and accordingly it is not surprising that there is no discussion of this point in the orders. Indeed, in light of the US Government’s ownership of US banking organization equity during the financial crisis, such concerns would seem bizarre.

FHC Status?

The orders say nothing about any of the banks being designated as financial holding companies (“FHCs”) for purposes of the BHCA. A bank holding company, or foreign bank subject to the BHCA, must become a FHC in order to engage in the United States in the full range of financial activities authorized by the BHCA amendments in the Gramm-Leach-Bliley Act of 1999,

³ Principles for the Supervision of Banks’ Foreign Establishments (May 1983), available at <http://www.bis.org/publ/bcb312.pdf>. The Concordat has been supplemented by later guidance.

⁴ A 1996 amendment to the IBA authorized the Federal Reserve to approve branch applications under a standard in which the country is found to be actively working toward establishing a supervisory system that meets CCS standards. 12 U.S.C. § 3105(d)(6). The purpose was to allow US entry from such countries but only to engage in a wholesale banking business through a branch, rather than a retail business, which effectively requires a US bank subsidiary.

including underwriting and dealing in securities. Many companies applying to become bank holding companies include a certification that they qualify as FHCs and receive acknowledgement of that status in the BHCA approval order. It is not stated whether any of the banks asked for FHC status.

Other Countries?

In a few cases, banks from other countries have also expressed interest in acquiring a US bank. The question arises whether the approval of China means that the Federal Reserve is prepared to approve applications from other countries' banks. It is not at all clear that China stands as a precedent for other countries. As noted above, Federal Reserve staff has been working with China for years on its supervision arrangements. These efforts were likely provoked by China's growing size and importance and importuning by the Government of China for this step to be taken.⁵ It appears that no other country has been the subject of the same amount of attention. Also, the orders illustrate the great degree of detail that Federal Reserve staff has to assemble and confirm. Especially with all the work being done to implement financial reform, it seems likely that staff will not have the interest or the will to expend as much energy again.

Political Reactions?

The reaction in the United States to the Federal Reserve's determination has not been uniformly favorable. Certain Members of Congress have indicated concern that the Federal Reserve granted these approvals without obtaining agreement by China to be more open to US banks making investments there. Such statements were made at a subcommittee meeting of the Financial Services Committee on May 16.⁶

Such concerns seem very late in the day. The Bank of China has operated two branches engaged in retail banking activities for over 20 years.⁷ And as noted above other Chinese banks were approved to open branches engaged in wholesale operations during the past few years. The Federal Reserve generally has been opposed to reciprocity requirements.

⁵ The fact sheet issued the week prior to the approvals in connection with high-level meetings in Beijing stated that "The United States welcomes foreign investment in all sectors, including the financial sector, and remains committed to apply the same prudential and regulatory standards to applications made by Chinese banks, securities, and fund management companies as they apply to other foreign financial institutions in like circumstances. Pending applications by Chinese banks are under active review and consideration and authorities will endeavor to act expeditiously." Joint U.S.-China Economic Track Fact Sheet-Fourth Meeting of the U.S. China Strategic and Economic Dialogue (S&ED), 5/4/2012, available at <http://www.treasury.gov/press-center/press-releases/Pages/tg1567.aspx>.

⁶ See "GOP lawmakers press for market access after China takeover of US bank branches," On the Money (The Hill's Finance & Economy Blog) (5/16/12).

⁷ Its two New York branches obtained Federal Deposit Insurance Corporation insurance pursuant to authority granted by the IBA in 1978 and were allowed to retain it after the availability of deposit insurance to branches was withdrawn in 1991.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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