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Competitive Inequality: American Banking In The International Arena†

*Marilyn B. Cane**
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INTRODUCTION

Twenty-three years ago, six of the ten largest banks in the world were U.S. banks.¹ By the end of 1988, the largest U.S.

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¹ At the end of 1966, the ten largest banks in the world were as follows:

Table A.

Bank	Deposits*
1. Bank of America (U.S.)	\$16.4
2. Chase Manhattan Bank (U.S.)	\$13.8
3. First National Citibank Bank (U.S.)	\$12.9
4. Manufacturers Hanover Trust (U.S.)	\$ 6.8
5. Barclays Bank (United Kingdom)	\$ 6.6
6. Morgan Guaranty Trust (U.S.)	\$ 6.5
7. Chemical Bank (U.S.)	\$ 6.1
8. Midland Bank (United Kingdom)	\$ 6.0
9. Banque Nationale de Paris (France)	\$ 6.0
10. Royal Bank of Canada	\$ 5.8

*Deposits are in billions of dollars.

Work, *Is Bigger Better in Banking?*, U.S. NEWS & WORLD REPORTS, October 12, 1987, at 52 [hereinafter *Is Bigger Better?*].

bank was only the twenty-seventh largest bank in the world.² Why have U.S. banks lost so much ground in international banking markets in such a short period of time?

One reason that explains the U.S. banks' loss of stature is undoubtedly traceable to the relatively burdensome regulations under which they must operate. As Justice Roberts stated fifty-seven years ago, "[A] regulation valid for one sort of business, or in given circumstances, may be invalid for another sort, or for the same business under other circumstances, because the reasonableness of each regulation depends upon the relevant facts."³ The wisdom of Justice Roberts' statement rings true today more than ever upon consideration of the reasonableness of regulations that govern U.S. banks competing in international markets. While the regulations governing U.S. banks' domestic branches arguably make sense, virtually identical regulations governing branches operating abroad may serve no useful purpose. Such regulations prevent these banks from competing on equal terms in international banking markets.

The wide variety of foreign regulations that U.S. banks face abroad also helps explain their relative decline. Not only must

² By the end of 1988, the largest banks in the world were as follows:

Table B.

Bank	Deposits*
1. Dai-ichi Kangyo Bank (Japan)	\$312.5
2. Sumitomo Bank (Japan)	\$296.0
3. Fuji Bank (Japan)	\$283.6
4. Mitsubishi Bank (Japan)	\$269.4
5. Sanwa Bank (Japan)	\$269.0
6. Industrial Bank of Japan (Japan)	\$215.4
7. Norinchukin Bank (Japan)	\$210.8
8. Mitsubishi Trust & Banking Co. (Japan)	\$185.6
9. Sumitomo Trust & Banking Co. (Japan)	\$177.9
10. Tokai Bank (Japan)	\$175.6

Citibank, the largest United States bank, has \$105.0 billion in deposits, but it is only the twenty-seventh largest bank in the world.

*Deposits in billions of dollars.

The Top 500 Banks in the World, AM. BANKER, July 24, 1989, at 26.

³ *Nebbia v. New York*, 291 U.S. 502, 525 (1933).

U.S. banks struggle to simultaneously comply with the regulations of several host countries, such regulations may preclude U.S. bank branches from providing the same services as host country banks. Admittedly, however, the problem of inconsistent and protectionist regulation affects all international banking and not just U.S. banks.

This Article explores the extent U.S. and foreign regulations hinder the competitiveness of U.S. banks in the global marketplace. Part I of this Article reviews U.S. regulation of foreign branches of U.S. banks in the areas of the creation of foreign branches, capital adequacy, liquidity control, foreign branch lending, foreign exchange risk, permissible business activities, examination and disclosure requirements, liquidity support, and deposit insurance. Parts II through IV review the regulation of U.S. branches by Japan, the United Kingdom, and the Federal Republic of Germany. An appendix to these parts also compares the various regulations U.S. banks face in each of these countries in chart form. Part V considers the formidable impediments U.S. regulations pose to U.S. banks' foreign branches and focuses, in particular, on the Glass-Steagall Act. Part VI considers multilateral attempts to coordinate international banking regulation. This Article concludes that multilateral harmonization of international banking regulation would allow U.S. banks to compete more effectively abroad. This Article further concludes that unilateral repeal of the Glass-Steagall Act would go far towards allowing U.S. banks to regain their former preminent position in the international banking community.

I. U.S. REGULATION OF FOREIGN BRANCHES

A. *Overview of the U.S. Banking System*

The U.S. banking system is largely a result of political and economic events which have occurred throughout the country's history. Politically, dissension between Federalist and anti-Federalist factions eventually led to bank chartering authority at both the state and federal levels.⁴ This dual banking system results in

⁴ See E. SYMONS & J. WHITE, *BANKING LAW* 11-21 (1984) (discussing the political maneuvering between Federalists and anti-Federalists concerning the chartering of the First Bank of the United States in 1791 and the Second Bank of the United States in 1816).

significant confusion that is only compounded by the multiple regulatory authorities it has spawned.⁵

There are four primary bank regulatory authorities in the United States: the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board (FRB), the Federal Deposit Insurance Corporation (FDIC), and the pertinent state banking authority. National banks are both chartered and regulated by the OCC.⁶ Moreover, by virtue of their status, national banks are statutorily required to be members of the Federal Reserve System (FRS) and to possess FDIC deposit insurance.⁷ Consequently, national banks are also subject to regulation by the FRB and FDIC.

Unlike national banks, state-chartered banks have some leeway in deciding their regulatory fate. A state-chartered bank is always subject to regulation by that state's banking authority.⁸ Beyond this point, however, a bank is relatively free to decide who will exercise regulatory authority over it.⁹ A bank may choose to become a member of the FRS, in which case it will be deemed a "member" bank.¹⁰ A bank selecting this option must carry FDIC deposit insurance. Accordingly, the FRB, the FDIC, and the state banking authority will exercise regulatory authority over the bank simultaneously.¹¹

Despite the prestige afforded a "member" bank, many state-chartered banks choose not to join the FRS and instead apply independently for FDIC deposit insurance.¹² If the FDIC approves the bank's application, the state banking regulator will

⁵ This paper discusses only bank regulators. Banks, however, are subject to other laws and regulations including antitrust laws (i.e. section 7 of the Clayton Act and the Sherman Antitrust Act), enforced by the Justice Department, and the securities laws, enforced by the Securities and Exchange Commission, the Commodities Futures Trading Commission, the Municipal Securities Rulemaking Board, and the National Association of Securities Dealers, among others. 15 U.S.C.A. §§ 1-7, 18 (West 1989); see Isaac & Fein, *Facing the Future—Life Without Glass-Steagall*, 37 CATH. U.L. REV. 281, 313-14 (1988).

While the regulatory structure for depository institutions has undergone significant changes as a result of The Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183, *reprinted in* Fed. Banking L. Rep. (CCH Special) No. 1298 (August 18, 1989), the basic structure discussed in this paper has remained intact.

⁶ Friesen, *The Regulation and Supervision of International Lending* (pt. 1), 19 INT'L LAW. 1059, 1069 (1985).

⁷ *Id.*

⁸ *Id.*

⁹ This would be subject to customer demand for such features as deposit insurance.

¹⁰ Friesen, *supra* note 6, at 1070.

¹¹ *Id.*

¹² *Id.* at 1069.

exercise concurrent regulatory authority with the FDIC over the state-chartered bank.¹³ The following chart illustrates the levels of regulation that U. S. banks face:

Table I.

Bank Type	Chartering Authority	Regulatory Authority(s)
National Bank	OCC	OCC, FRB, FDIC
State Member Bank	State	State, FRB, FDIC
State Nonmember Insured Bank	State	State, FDIC
State Nonmember Noninsured Bank	State	State

In addition to political powerplays, congressional responses to economic events have played a major role in shaping today's banking system.¹⁴ Reacting to the 1929 stock market crash and the ensuing Great Depression, Congress passed the Banking Act of 1933.¹⁵ This legislation had two particularly important features. First, it provided for a statutory deposit insurance scheme by creating the FDIC.¹⁶ This was seen as an important step in restoring confidence in the United States' depression-ravaged banking system.¹⁷ Second, and more important in shaping the structure of today's banking system, Congress separated commercial banking and investment banking via the 1933 Act's Glass-Steagall provisions.¹⁸ While the Glass-Steagall Act provided a remedy to cure the banking abuses of the 1920s, there are serious questions concerning its continuing vitality in today's banking

¹³ *Id.*

¹⁴ R. DALE, *THE REGULATION OF INTERNATIONAL BANKING* 129 (1986).

¹⁵ The Banking Act of 1933 is also referred to as the Glass-Steagall Act, being named after its sponsors. See Issac & Fein, *supra* note 5, at 281 n.1

¹⁶ See 12 U.S.C. §§ 1811-1832 (1989).

¹⁷ See F.D. Roosevelt, Radio Address Delivered From the President's Study, March 12, 1933, reprinted in E. SYMONS & J. WHITE, *supra* note 4, at 37-40.

¹⁸ Sections of the Glass-Steagall Act which effectively separate commercial banking from investment banking are codified at 12 U.S.C.A. §§ 24(7) (forbidding banks from underwriting corporate securities), 78 (persons affiliated with investment banks may not serve as officers, directors, or employees of member banks), 377 (member banks may not be affiliated with securities firms), 378 (member banks may not deal in securities) (West 1989). See, e.g., Garten, *Regulatory Growing Pains: A Perspective on Bank Regulation in a Deregulatory Age*, 57 *FORDHAM L. REV.* 501 (1989); Symons, *The "Business of Banking" in Historical Perspective*, 51 *GEO. WASH. L. REV.* 676 (1983) (both articles discussing the evolution of the foregoing provisions).

environment.¹⁹ These questions, as they relate to international banking regulation, are addressed later in this paper.²⁰

Two other statutes which helped forge the banking system's structure merit brief discussion. The Bank Holding Company Act of 1956 restricted a bank holding company's activities to those which were closely related to banking.²¹ One intended effect of this legislation was to insure that bank holding companies did not own domestic investment banking subsidiaries and thereby diminish the Glass-Steagall Act's effect.²²

The McFadden Act of 1927 allowed national banks to branch for the first time.²³ Amendments to the McFadden Act permitted national banks to branch to the same extent as state-chartered banks.²⁴ Unfortunately, restrictive state branching laws caused the U.S. banking system to evolve into a complex web of more than 14,000 banks.²⁵ With this historical perspective in mind, the logic (or illogic) of U.S. regulation of foreign branches is more easily understood.

B. *Creating a Foreign Branch*

Member banks of the FRS with more than \$1,000,000 in capital and surplus may file an application with the Board of Governors of the FRS for permission to establish a foreign branch.²⁶ The

¹⁹ See, e.g., Cane, *Non-Broker Brokers and Other Anomalies in the Regulation of Financial Services*, 11 HARV. J.L. & PUB. POL'Y 111 (1988); Ferrara & Buttarazzi, *Set Them Free: Glass-Steagall Restrictions Make U.S. Banks Less Competitive*, L.A. Daily J., May 18, 1988, at 4, col. 3.

²⁰ See *infra* notes 314–320 and accompanying text.

²¹ 12 U.S.C.A. §§ 1841–1850 (West 1989).

²² *Id.* at § 1843. Section 1843 specifies what non-bank subsidiaries a bank holding company may own and which investment banking affiliates are not included in that list. *Id.* Nevertheless, on January 18, 1989, the Federal Reserve Board (FRB) conditionally approved applications made by Bankers Trust New York Corporation; the Chase Manhattan Corporation; Citicorp; J.P. Morgan & Co., Inc.; and Security Pacific Corporation allowing subsidiaries of each bank holding company to engage in the underwriting and dealing of securities. *J.P. Morgan & Co., Incorporated, The Chase Manhattan Corporation, Bankers Trust New York Corporation, Citicorp, and Security Pacific Corporation*, 75 Fed. Res. Bull. 192 (1989) [hereinafter *January 18th Approval*]. Another effect of the Bank Holding Company Act of 1956 was to prohibit bank holding companies from avoiding interstate branching laws established by the McFadden Act. 12 U.S.C.A. § 1842(d) creates this prohibition by including virtually the same language as is contained in the McFadden Act at 12 U.S.C.A. § 36. (West 1989).

²³ 12 U.S.C.A. § 36 (West 1989).

²⁴ *Id.* at § 36(c).

²⁵ R. DALE, *supra* note 14, at 129.

²⁶ 12 U.S.C.A. § 601 (West 1989) (referring only to national banking associations); 12 U.S.C.A. § 321 (West 1989) (causing § 601 to be applied to state-chartered member

application must state the bank's name and capital position, the powers the bank is applying for, and the place(s) where operations will be conducted.²⁷ The Board of Governors may reject any application it deems improper and may also increase or decrease the places where foreign branches can conduct business.²⁸ If the bank is a national banking association, it must file an application with the OCC along with its application to the Board of Governors.²⁹

Once a member bank establishes a foreign branch in one country, it may establish additional branches in that country without notifying the FRB of its intent to do so.³⁰ If the member bank operates branches in at least two foreign countries, it may establish branches in other foreign countries simply by giving the FRB forty-five days notice in advance.³¹

A state nonmember insured bank may establish foreign branches, but such activity is subject to regulations prescribed by the FDIC.³² Before the state nonmember insured bank may establish a foreign branch, it must apply for and obtain the FDIC's prior written consent.³³ The bank will generally obtain the FDIC's consent but not before fulfilling certain requirements. The bank must file the application with the appropriate FDIC regional director not more than thirty days before opening the branch.³⁴ Additionally, such application must state the branch's exact location, any insider involvement, the name and address of the newspaper in which notice of the bank's intent to branch will be published, and the date when that notice will be published.³⁵ The

banks); 12 C.F.R. § 211.2(h) (1989) (defining foreign branch as "an office of an organization (other than a representative office) that is located outside the country under the laws of which the organization is established, at which banking or financing business is conducted").

²⁷ 12 U.S.C.A. § 601 (West 1989).

²⁸ *Id.*

²⁹ 12 C.F.R. § 20.3(a)(1) (1989). The comptroller provides the requisite forms for filing a foreign branch application. 12 C.F.R. § 20.3(b) (1989).

³⁰ 12 C.F.R. § 211.3(a)(2) (1989).

³¹ 12 C.F.R. § 211.3(a)(3) (1989). Prior authority to establish foreign branches expires one year from the earliest date on which the authority could have been exercised unless the FRB expressly extends the period. 12 C.F.R. § 211.3(a)(4) (1989). Any bank which opens, closes, or relocates a foreign branch must report the change to the FRB. 12 C.F.R. § 211.3(a)(5) (1989).

³² 12 U.S.C.A. § 1828(d)(2) (West 1989).

³³ 12 C.F.R. § 347.3(a) (1989).

³⁴ *Id.*

³⁵ *Id.* Section 303.2(a)(2) defines insider involvement as any involvement by "a director, an officer, or a shareholder who directly or indirectly controls 5 or more percent of any class of [the bank's] voting stock . . ." *Id.* at § 303.2(a)(2).

bank must repeat this procedure each time it wishes to open another foreign branch.

C. *Capital Adequacy*

A bank's capital adequacy is monitored regularly as part of the bank examination process in the United States.³⁶ An initial capital requirement for establishing a foreign branch is that the bank, as a consolidated entity, possess \$1,000,000 in capital and surplus.³⁷ Similarly, ongoing capital adequacy is measured on a consolidated basis rather than with respect to an individual branch.³⁸ Therefore, a foreign branch's individual capital position is of nominal importance to U.S. regulators so long as the bank's consolidated capital position is adequate.³⁹ Nevertheless, U.S. regulators' capital adequacy requirements merit brief discussion so the reader can better understand the differences among various countries' regulatory approaches concerning the measurement of capital.

U.S. regulators rate a bank's capital position in relation to its assets. Regulations require banks to maintain primary capital equal to at least 5.5% of total adjusted assets.⁴⁰ Total capital,

³⁶ R. DALE, *supra* note 14, at 130-31.

³⁷ See *supra* note 26 and accompanying text.

³⁸ R. DALE, *supra* note 14, at 131.

³⁹ *Id.* Regulators, however, do consider the fact that foreign branches may engage in riskier activities than domestic branches when evaluating a bank's capital position and are, thus, more apt to closely scrutinize the foreign branches' individual financial position. *Id.*

⁴⁰ Capital adequacy guidelines are set forth in 12 C.F.R. § 3.6 (Office of the Comptroller of the Currency), § 255 App. A (Federal Reserve Board), § 325.3(b) (1989) (Federal Deposit Insurance Corporation). The guidelines between the agencies are extremely similar but not uniform. In computing capital adequacy, the Office of the Comptroller of the Currency (OCC) defines the following terms as: "Adjusted Total Assets" means the average total assets figure required to be computed for and stated in a bank's most recent quarterly . . . (Call report), plus the end-of-quarter allowance for loan and lease losses, minus end-of-quarter intangible assets not included in primary capital . . ." 12 C.F.R. § 3.2(a) (1989). "Primary Capital" means the sum of [the following]:

(1) Common stock, perpetual preferred stock, capital surplus, undivided profits, reserves for contingencies and other capital reserves (excluding accrued dividends on perpetual and limited life preferred stock), net worth certificates issued pursuant to 12 U.S.C. § 1823;

(i) Minority interests in consolidated subsidiaries, and allowances for loan and lease losses; minus intangible assets;

(2) Purchased mortgage servicing rights; and

(3) Mandatory convertible debt to the extent of 20% of the sum of [paragraphs (1) and (2) above].

12 C.F.R. § 3.2(c) (1989).

consisting of secondary capital and primary capital, must equal 6% of total adjusted assets.⁴¹

In determining a bank's capital adequacy, however, regulators also consider more subjective criteria such as its growth history, its plans for future growth, and its management strength.⁴² Finally, regulators analyze recent earning trends and dividend payout ratios to determine whether and to what extent retained earnings will contribute to future capital growth.⁴³

D. *Liquidity Control*

The OCC, FRB, and FDIC evaluate a bank's liquidity position as a normal part of the U.S. bank examination process.⁴⁴ Regulators, however, do not impose standard ratios regulating a bank's liquidity position.⁴⁵ Rather, the regulators view a bank's individual liquidity position with respect to several factors, including deposit volatility, ability to convert assets into cash, management expertise, reliance on interest-sensitive funds, and access to money markets.⁴⁶

As with capital adequacy, U.S. regulators generally consider a bank's liquidity position on a consolidated basis.⁴⁷ If, however, a U.S. bank has a large foreign branch with prior liquidity problems, that branch's operations may be analyzed separately.⁴⁸

E. *Foreign Branch Lending Activities*

Two regulatory issues confront U.S. banks concerning a foreign branch's lending activities—lending limits and country risk exposure. Lending by foreign branches is generally subject to the same restrictions imposed on domestic branches.⁴⁹ Therefore, a

⁴¹ The OCC defines secondary capital as:

"Secondary capital" means the sum of paragraphs (d)(1) and (2) of this section, to the extent that this figure does not exceed 50% of the bank's primary capital: (1) mandatory convertible debt that is not included in primary capital; and (2) limited life preferred stock and subordinated notes and debentures.

¹² C.F.R. § 3.2(d) (1989).

⁴² R. DALE, *supra* note 14, at 131.

⁴³ *Id.*

⁴⁴ Friesen, *supra* note 6, at 1078.

⁴⁵ *Id.*

⁴⁶ *Id.*; see *The Comptroller's Manual for National Bank Examiners* at §§ 203, 301, 405, 503, 600 (1989).

⁴⁷ R. DALE, *supra* note 14, at 132.

⁴⁸ *Id.*

⁴⁹ Corse & Nichols, *United States Regulation of International Lending by American Banks*, in *INTERNATIONAL FINANCIAL LAW* 155 (Euromoney pubs. 1988).

foreign branch may not make a loan to a single borrower which exceeds 15% of its *parent* bank's unimpaired capital and surplus unless a statutory exception applies.⁵⁰ Additionally, because all loans to a single borrower are aggregated for lending limit purposes, the foreign branch must stay apprised of loans the bank has made at other branches to the same borrower so as to not violate lending limits.⁵¹

Furthermore, a U.S. bank must file a Country Exposure Report (CER) if its foreign branch has consolidated claims against foreign residents of any country exceeding \$20,000,000.⁵² Authorities developed the CER as part of an increasing awareness of country risk, precipitated in large part by mounting loan losses in particular countries.⁵³ A bank must file a CER with its primary U.S. regulator within forty-five days of each quarter's end.⁵⁴ The CER must include information on loans, securities, and other assets which operate to give a bank a claim against foreign residents.⁵⁵

F. *Foreign Exchange Risk*

U.S. regulators do not set specific limits on a bank's foreign exchange activities.⁵⁶ Instead, regulators monitor a bank's foreign exchange exposure by analyzing periodic reports submitted by the bank.⁵⁷ For instance, the OCC requires that national banking associations file a consolidated report of foreign exchange activities for any month in which specified foreign exchange transactions exceed \$100,000,000.⁵⁸ A specified foreign exchange transaction consists of a trade involving Canadian dollars, French francs, German marks, Japanese yen, Swiss francs, or British pounds.⁵⁹

⁵⁰ See 12 U.S.C.A. § 84 (West 1989). 12 U.S.C.A. § 324 applies § 84 lending limits to banks which are members of the Federal Reserve System.

⁵¹ Corse & Nichols, *supra* note 49, at 159.

⁵² Friesen, *supra* note 6, at 1080.

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ R. DALE, *supra* note 14, at 132.

⁵⁷ *Id.*

⁵⁸ 12 C.F.R. § 20.5(a), (c) (1989).

⁵⁹ 12 C.F.R. § 20.5(b) (1989).

G. *Permissible Business Activities*

Federal law empowers the Board of Governors of the FRB to issue regulations authorizing a member bank's foreign branch "to exercise such . . . powers as may be usual in connection with the transaction of the business of banking in the places where [the] foreign branch transact[s] business."⁶⁰ These regulations, however, may not go so far as to authorize a foreign branch to produce, distribute, buy, or sell general merchandise.⁶¹ Likewise, the FRB may not "authorize a foreign branch to engage or participate, directly or indirectly, in the business of underwriting, selling, or distributing securities."⁶²

Consistent with its statutory authority, the FRB promulgated Regulation K⁶³ which prescribes the powers a member bank's foreign branch may exercise beyond general banking powers. Currently, a foreign branch may engage in the following activities, if it is a usual activity in the host country's banking industry:

- (1) The foreign branch may guarantee a debt or otherwise agree to make payments on the happening of a readily ascertainable event.⁶⁴ The foreign bank's guarantee or agreement must specify a maximum monetary liability. However, to the extent the guarantee or agreement is not fully secured, its maximum dollar amount may not exceed the lending limits prescribed in 12 U.S.C. § 84.⁶⁵
- (2) The foreign branch may invest in:
 - (i) Securities of the central bank, clearing houses, governmental entities, and government-sponsored development banks of the foreign branch's host country;
 - (ii) Other debt securities which the host country determines are eligible to meet local reserve requirements; and
 - (iii) Shares in organizations like professional societies and schools which are necessary to the branch's business.

⁶⁰ 12 U.S.C.A. § 604a (West 1989).

⁶¹ *Id.* This is an attempt to restrict banks to "the business of banking" as contemplated by 12 U.S.C.A. § 24 (West 1989).

⁶² 12 U.S.C.A. § 604a (West 1989).

⁶³ Regulation K is contained in 12 C.F.R. Part 211 (1989). The OCC did not promulgate a similar section; rather, it chose to rely on the fact that all national banks are members of the Federal Reserve and, as such, are regulated by the rules contained in Regulation K.

⁶⁴ 12 C.F.R. § 211.3(b)(1) n.3 (1989). Section 211.3(b)(1) n.3 states: "[r]eadily ascertainable events' include, but are not limited to, events such as non-payment of taxes, rentals, customs duties, or costs of transport and loss or nonconformance of shipping documents." *Id.*

⁶⁵ Generally, the lending limit is 15% of a bank's unimpaired capital and surplus. *See* 12 U.S.C.A. § 84 (West 1989).

The total investments of the bank's branches in the country (excluding securities held pursuant to 12 U.S.C. § 24(7)),⁶⁶ however, may not exceed 1% of the branch's total deposits in that country on the preceding year end call report date.⁶⁷

(3) The foreign branch may underwrite, distribute, buy, and sell obligations of:

- (i) The host country's national government;
- (ii) An agency or instrumentality of the host country's national government; or
- (iii) A municipal, local, or regional governmental entity.

The bank, however, may not hold or be under commitment to hold any of the foregoing obligations for its own account if the total holdings exceed 10% of the bank's capital and surplus.⁶⁸

(4) The foreign branch may loan a bank officer residing in the foreign branch's country of operations funds to acquire or build a house which the officer will use as his residence while living abroad. The loan must be promptly reported to the foreign branch's home office. If the loan exceeds \$100,000, it must also be promptly reported to the parent bank's board of directors.

(5) The foreign branch may take liens or encumbrances on foreign real estate as security for loans. The liens or encumbrances do not have to be senior, and the real estate may be unimproved.⁶⁹

(6) The foreign branch may act as an insurance agent or broker.

(7) The foreign branch may, as part of an employee benefit plan, pay an employee a higher rate of interest than other depositors receive.

(8) The foreign branch may enter repurchase agreements⁷⁰ involving securities and commodities if the repurchase agreement is functionally equivalent to extending credit.

(9) The foreign branch may establish or invest in wholly owned subsidiaries which engage in permissible member

⁶⁶ Securities which banks may hold pursuant to 12 U.S.C.A. § 24 (West 1989) are generally government securities.

⁶⁷ If the branch, however, was recently acquired from a foreign institution and had no year-end call report, securities held may not exceed 1% of the total deposits as of the acquisition date. 12 C.F.R. § 211.3(b)(2) (1989).

⁶⁸ Cf. 12 U.S.C.A. § 24(7) (West 1989) (10% limit on certain types of investment securities a bank may hold in its portfolio).

⁶⁹ The foreign branch's real estate activities are not subject to the real estate loan provisions contained in 12 U.S.C.A. § 371 (West 1989).

⁷⁰ A repurchase agreement is a contract wherein money is loaned to borrowers who provide high-grade securities as collateral for the loan. See E. SYMONS & J. WHITE, *supra* note 4, at 210.

bank activities, or activities incidental to the banking business in the host country. The FRB must grant prior approval before the foreign branch engages in these activities.

(10) The foreign branch may engage in other activities which are usual to the banking business in the host country, but only with prior approval from the Federal Reserve Board.⁷¹

Similarly, the FDIC has the power to prescribe regulations concerning those activities in which foreign branches of state nonmember insured banks may engage.⁷² The regulations promulgated by the FDIC are generally congruent with the FRB's Regulation K and permit foreign branches of state nonmember insured banks to engage in activities common to the banking business in the host country.⁷³

H. *Bank Examination and Disclosure Requirements*

Bank examinations are the cornerstone of the regulatory process in the United States.⁷⁴ Depending on the parent bank's primary regulatory authority, examiners from the OCC, FRB, or

⁷¹ 12 C.F.R. § 211.3(b) (1989). While foreign branches are prohibited from participating in investment banking activities, subsidiaries of a bank holding company may engage in: [U]nderwriting, distributing, and dealing in debt and equity securities outside the United States, provided that no underwriting commitment by a subsidiary of [a bank holding company] for shares of an issuer may exceed \$2 million or represent 20% of the capital and surplus or voting shares of an issuer unless the underwriter is covered by binding commitments from subunderwriters or other purchasers

12 C.F.R. § 211.5(d)(3) (1989). Thus, subject to certain conditions, subsidiaries of U.S. bank holding companies can engage in a broad spectrum of investment banking activities outside the United States. See *January 18th Approval*, *supra* note 22 at 192; Weberman, *More Freedom, Fatter Profits*, *Forbes*, July 14, 1986, at 35-36. Currently, U.S. banks "maintain securities affiliates in London, Tokyo and other international financial centers and were among the leading underwriters of Eurosecurities in 1986 and 1987." *January 18th Approval*, *supra* note 22, at 198.

Nevertheless, despite their underwriting success of Eurosecurities, investment banking subsidiaries of U.S. bank holding companies remain smaller and less well-capitalized than their foreign branch siblings. See J. HOUP, *INTERNATIONAL TRENDS FOR U.S. BANKS AND BANKING MARKETS* 3 (1988) (Staff Economic Study for Federal Reserve Board). Accordingly, this Article takes the position that foreign branches of U.S. banks should be able to engage in any activities in which banks organized under the laws of the host country are allowed to engage in, including, but not limited to, the underwriting of securities.

⁷² 12 U.S.C.A. § 1828(d) (West 1989).

⁷³ See 12 C.F.R. § 347.3(c) (1989). The 12 U.S.C.A. § 604a (West 1989) prohibition against a bank selling goods and engaging in certain securities activities is contained in 12 C.F.R. § 347.3(d) (1989). The primary distinction between Regulation K and the Federal Deposit Insurance Corporation's (FDIC) regulations is that pursuant to 12 C.F.R. § 347.3(c)(1) (1989), it may also be necessary for the FDIC to consider state law to determine whether the foreign branch's desired activity is permissible.

⁷⁴ R. DALE, *supra* note 14, at 133.

FDIC may regularly conduct examinations of foreign branches.⁷⁵ The examination process focuses on the following five distinct areas: capital adequacy, asset quality, management quality, earnings and profitability, and liquidity.⁷⁶ Foreign branches must conform to the reporting and disclosure requirements which reinforce the on-site examination process.

National banking associations and member banks are required to furnish information concerning the condition of their foreign branches to the OCC and FRB on demand.⁷⁷ While specific reporting requirements have not been established, the foreign branch must have systems in place which provide detailed information concerning the branch's risk assets, liquidity, and management so as to insure that the "high standards of banking and financial prudence" inherent in the U.S. banking system are maintained.⁷⁸ Furthermore, foreign branch operations are segregated from the home office with each foreign branch's profit or loss for a fiscal year calculated separately and transferred to the parent bank's books only at the end of the period.⁷⁹

FDIC reporting requirements for foreign branches are more detailed. The parent bank is required to submit an annual report on each foreign branch's condition to the FDIC.⁸⁰ At a minimum, the report must contain detailed information of the foreign branch's risk assets, liquidity, contingencies, and internal control systems.⁸¹ Furthermore, the FDIC may at any time require the parent to provide special reports containing additional information.⁸²

I. *Liquidity Support*

The FRS provides liquidity support to depository institutions by discounting eligible paper and making advances secured by

⁷⁵ *Id.*; see 12 U.S.C.A. §§ 602, 1828(d) (West 1989). Regulatory authority for examinations is contained in 12 C.F.R. §§ 20.1(b)(3) (OCC), 211.7(b)(1), (3) (FRB), 347.6 (1989) (FDIC).

⁷⁶ R. DALE, *supra* note 14, at 133. The acronym for these five areas is "CAMEL". See Norton, *Capital Adequacy Standards: A Legitimate Regulatory Concern for Prudential Supervision of Banking Activities?*, 49 OHIO ST. J.L. 1299, 1316-21 (1989) (discussing the development of the *Uniform Interagency Bank Rating System* from which the term "CAMEL" emerged).

⁷⁷ 12 U.S.C.A. § 602 (West 1989).

⁷⁸ 12 C.F.R. § 211.7(a) (1989); see also 12 C.F.R. § 211.5(a) (1989).

⁷⁹ 12 U.S.C.A. § 604 (West 1989).

⁸⁰ 12 C.F.R. § 347.6(b) (1989).

⁸¹ 12 C.F.R. § 347.6(a)(1)-(4) (1989).

⁸² 12 C.F.R. § 347.6(c) (1989).

satisfactory collateral.⁸³ This service goes directly to the parent bank of a foreign branch.⁸⁴ The parent bank may, in turn, provide liquidity assistance to its foreign branch by diverting the credit it receives from the FRS to its foreign branch.⁸⁵

Reserve requirements, however, are the *quid pro quo* for the FRS's liquidity assistance.⁸⁶ Uniform reserves are required on all transaction accounts and time deposits held by depository institutions.⁸⁷ Consequently, all foreign branches must maintain reserves on transaction accounts and time deposits equal to those held by domestic branches unless the funds are payable only outside of the United States⁸⁸ or the FRB otherwise promulgates regulations exempting them.⁸⁹

Currently, the following foreign branch deposits are subject to reserve requirements:⁹⁰

1. A deposit of a U.S. resident⁹¹ of less than \$100,000, regardless of where the depositor may demand payment;

⁸³ Friesen, *supra* note 6, at 1082. The Federal Reserve's services can be used by all depository institutions pursuant to the Depository Institutions Deregulation and Monetary Control Act. 12 U.S.C.A. § 461(b)(2), (7) (West 1989).

⁸⁴ Friesen, *supra* note 6, at 1082.

⁸⁵ *Id.*

⁸⁶ The FRB requires banks to hold a certain percentage of their total deposits in the form of cash reserves and, thus, the term reserve requirements. See E. SYMONS & J. WHITE, *supra* note 4, at 50.

⁸⁷ 12 U.S.C.A. § 461(b)(2)(D) (West 1989). Section 461(b)(5) indicates reserve requirements apply to foreign branches of both member and non-member banks. *Id.* at § 461(b)(5).

⁸⁸ 12 U.S.C.A. § 461(b)(6) (West 1989); 12 C.F.R. § 204.1(c)(5) (1989). Deposits payable only outside the United States are defined as:

(1) a deposit of a United States resident that is in a denomination of \$100,000 or more, and as to which the depositor is entitled, under the agreement with the institution, to demand payment only outside the United States or (2) a deposit of a person who is not a United States resident as to which the depositor is entitled, under the agreement with the institution, to demand payment only outside the United States.

12 C.F.R. § 204.2(t) (1989).

⁸⁹ The FRB has exercised its statutory authority and promulgated regulations concerning reserve requirements in 12 C.F.R. Part 204 (1989) (commonly referred to as Regulation D).

⁹⁰ Rules regarding the mechanics of computing reserve requirements are contained in 12 C.F.R. § 204.9 (1989).

⁹¹ "U.S. resident" is defined as:

(1) any individual residing (at the time of the transaction) in the United States; (2) any corporation, partnership, association or other entity organized in the United States ("domestic corporation"); and (3) any branch or office located in the United States of any entity that is not organized in the United States.

12 C.F.R. § 204.2(s) (1989).

2. A deposit of a U.S. resident in an amount greater than \$100,000 if the depositor may demand payment in the United States;

3. A deposit of a non-U.S. resident of any denomination if the depositor may demand payment in the United States.⁹² Furthermore, Eurocurrency liabilities are also subject to uniform reserve requirements.⁹³

J. *Deposit Insurance*

The FDIC provides deposit insurance to all national banking associations and member banks and to state chartered nonmember banks which qualify for coverage. In a typical liquidity crisis, the FDIC would not be involved.⁹⁴ In the event a bank becomes insolvent, however, the FDIC will take action to protect depositors.⁹⁵ Presently, foreign branch deposits are not included in assessing a bank's deposit insurance premium.⁹⁶ Consequently, foreign branch deposits are not insured and do not receive protection in the event of bank failure.⁹⁷

This Article now turns to analagous bank regulations in Japan, the United Kingdom, and West Germany. From this point forward, a foreign country's bank regulations are considered applicable to a foreign branch of a U.S. bank unless otherwise noted.

⁹² 12 C.F.R. § 204.2(t) (1989).

⁹³ See 12 C.F.R. § 204.2(h) (1989) (providing an exhaustive definition of the term "Eurocurrency liabilities").

⁹⁴ Friesen, *supra* note 6, at 1082.

⁹⁵ R. DALE, *supra* note 14, at 153. There are two types of FDIC protection: (1) statutory insurance coverage per deposit of \$100,000; and (2) protection for uninsured deposits which arises from the FDIC's preferred method of dealing with failed banks wherein it purchases and assumes their operations. *Id.*

⁹⁶ 12 U.S.C.A. § 1817(b)(5) (West 1989).

⁹⁷ 12 U.S.C.A. § 1813(m)(1) (West 1989). The deposits may not receive *de jure* protection, but the FDIC guaranteed foreign deposits in the amount of \$16,600,000,000 when it bailed out Continental Illinois National Bank in 1983-84. See Sprague, *The FDIC After Fifty-Two Years: Time for a Tune-Up*, 5 ANN. REV. BANKING L. 141, 143-46 (1986). As a related matter, the U.S. Supreme Court should soon be definitely resolving whether a foreign branch depositor may demand repayment of the deposit at the bank's home office when the foreign branch is unable to repay its depositors by virtue of adverse economic or credit factors. *Wells Fargo Asia Ltd. v. Citibank, N.A.*, 852 F.2d 657 (2d Cir. 1988), *cert. granted*, 110 S. Ct. 537 (1989); see also *Trinh v. Citibank, N.A.*, 850 F.2d 1164 (6th Cir. 1988), *petition for cert. filed*, 57 U.S.L.W. 3455 (Jan. 10, 1989). For a complete discussion of laws affecting international bank deposits, see Smedersman & Lowenfield, *Eurodollars, Multinational Banks, and National Laws*, 64 N.Y.U. L. REV. 733 (1989).

II. JAPAN—REGULATION OF FOREIGN BRANCHES

A. Overview of the Japanese Banking System

The Banking Law of 1927 (Banking Law), as amended in 1981, provides a regulatory framework for the Japanese banking system.⁹⁸ Two bank regulatory authorities anchor this framework—the Bank of Japan (BOJ) and the Ministry of Finance (MOF).

The BOJ is statutorily responsible for implementing monetary policy in the Japanese financial markets.⁹⁹ The BOJ accomplishes this primarily by influencing banks who borrow from its discount window.¹⁰⁰ Whatever regulatory authority the BOJ possesses, it derives this authority from contract, not from statute.¹⁰¹ Pursuant to contracts entered into with client banks, the BOJ conducts biennial examinations of these banks to insure the safety and soundness of the Japanese banking system.¹⁰²

Nonetheless, true regulatory power over Japanese banks resides in the MOF.¹⁰³ The Banking Law of 1927 grants the MOF such broad supervisory powers that its responsibilities have been likened to “those of the Treasury, Internal Revenue Service, Securities and Exchange Commission, state banking commissions and policy-making responsibilities of the FRB.”¹⁰⁴ Within this broad grant of power, the MOF has considerable discretion to tailor its regulations and policies to the needs of individual banks in return for their voluntary cooperation with MOF directives.¹⁰⁵ This regulatory style is called *gyosei-shido*, or administrative guidance.¹⁰⁶

⁹⁸ Japanese Banking Law of 1927, Law No. 21 of 1927, revised in 1981 (Law No. 59), effective Apr. 1, 1982 [hereinafter Japanese Banking Law]; see R. DALE, *supra* note 14, at 113; Friesen, *supra* note 6, at 1108. Other laws affecting the Japanese banking system, include: (1) Bank of Japan Law, Law No. 67 of 1942, as amended, Sept. 1, 1971; (2) Foreign Exchange and Foreign Trade Control Law, Law No. 228 of 1949, as amended, effective Dec. 1, 1980; (3) Long-Term Credit Bank Law, Law No. 187 of 1952, as amended, effective Apr. 1, 1962; (4) Foreign Exchange Bank Law, Law No. 67 of 1954, as amended, effective Apr. 1, 1963; and (5) Securities and Exchange Law. See Friesen, *supra* note 6, at 1108 n.245.

⁹⁹ Friesen, *supra* note 6, at 1108.

¹⁰⁰ *Id.* at 1109.

¹⁰¹ *Id.*

¹⁰² R. DALE, *supra* note 14, at 113; Friesen, *supra* note 6, at 1109.

¹⁰³ R. DALE, *supra* note 14, at 113; Friesen, *supra* note 6, at 1109.

¹⁰⁴ Friesen, *supra* note 6, at 1109 (quoting Bronte, *Inside the Tokyo Ministry of Finance: The Most Powerful Men in Japan*, EUROMONEY, June 1979, at 24).

¹⁰⁵ E. SYMONS & J. WHITE, *supra* note 4, at 769.

¹⁰⁶ The flexibility of this regulatory style has made it difficult for foreign banks to plan

The MOF uses this administrative guidance to effectively segment the Japanese banking market.¹⁰⁷ Four types of banking institutions exist in Japan: commercial city banks, commercial regional banks, long-term credit banks, and trust banks.¹⁰⁸ Thirteen commercial city banks operate nationwide and are extremely active in international banking markets.¹⁰⁹ Sixty-three commercial regional banks perform operations similar to those of city banks but do so on a smaller scale.¹¹⁰ City banks and regional banks are not allowed to accept time deposits with a maturity exceeding two years, and they are not allowed to engage in trust activities.¹¹¹

Three banks provide long-term credit in Japan.¹¹² These banks were established in 1952 to assist in the development of Japanese capital markets by issuing debentures and lending funds they receive on a long-term basis.¹¹³ Finally, seven trust banks actively engage in trust activities but offer only limited banking services.¹¹⁴

City banks are the principal competitors of foreign banks wishing to enter Japan.¹¹⁵ Not only do they possess over 50% of all Japanese banking assets,¹¹⁶ but they have extremely close contacts with industrial companies in Japan.¹¹⁷ A city bank which is a firm's largest creditor is known as its main bank.¹¹⁸ This position allows the main bank to exert tremendous control over the firm's policy-

their operations in Japan because they are unable to rely on the substantive provisions contained in Japanese banking statutes. *Id.*

¹⁰⁷ *Id.*

¹⁰⁸ DEP'T OF THE TREASURY, REPORT TO CONGRESS ON FOREIGN GOVERNMENT TREATMENT OF U.S. COMMERCIAL BANKING ORGANIZATIONS: 1984 UPDATE 21 (1984) [hereinafter 1984 UPDATE]; E. SYMONS & J. WHITE, *supra* note 4, at 770.

¹⁰⁹ 1984 UPDATE, *supra* note 108, at 21.

¹¹⁰ *Id.*

¹¹¹ E. SYMONS & J. WHITE, *supra* note 4, at 770.

¹¹² 1984 UPDATE, *supra* note 108, at 21.

¹¹³ Friesen, *supra* note 6, at 1110. These banks can also accept longer-term time deposits. *Id.*

¹¹⁴ 1984 UPDATE, *supra* note 108, at 21.

¹¹⁵ *Id.*

¹¹⁶ *Id.*

¹¹⁷ Friesen, *supra* note 6, at 1110. Prior to World War II, banks were at the center of formal industrial conglomerates called *zaibatsu*. These formal groupings, however, gave way to *keiretsu*, which are informal affiliations between commercial banks and their industrial customers. These affiliations resulted in the banks having officers on the industrial company's board of directors and large positions in that company's stock. All city commercial banks, except Fuji Bank, are members of these influential groupings. *See id.* at 1110 & n.262.

¹¹⁸ E. SYMONS & J. WHITE, *supra* note 4, at 770.

making decisions.¹¹⁹ No foreign bank has ever achieved main bank status.¹²⁰

B. *Market Entry*

U.S. banks may enter Japan via representative offices, subsidiaries, or branches.¹²¹ Most banks entering Japan do so through foreign branches.¹²² Irrespective of the entity chosen to enter Japanese banking markets, each entrant must apply to the MOF for a banking license.¹²³ In determining whether to grant the license, the MOF considers the applicant's financial resources, banking expertise, and proposed business plan.¹²⁴ The bank must have initial minimum capital of one billion yen as well as reputable and competent management.¹²⁵ Additionally, foreign branches must satisfy an economic need criterion,¹²⁶ and Japanese banks must be able to establish similar operations in the foreign branch's home country.¹²⁷

¹¹⁹ *Id.* This is bolstered by the fact that they are usually influential shareholders. *Id.*

¹²⁰ *Id.*

¹²¹ DEP'T OF THE TREASURY, REPORT TO CONGRESS ON FOREIGN GOVERNMENT TREATMENT OF U.S. COMMERCIAL BANKING AND SECURITIES ORGANIZATIONS: 1986 UPDATE 73 [hereinafter 1986 UPDATE]. Article 47 of the Japanese Banking Law refers to branches and agent offices of foreign banks but does not refer to subsidiaries.

¹²² This is due, in large part, to the fact that Japan discourages foreign-owned banking subsidiaries. R. DALE, *supra* note 14, at 91.

¹²³ Japanese Banking Law, *supra* note 98, at art. 47 ("[i]f a person performing banking business in a foreign country based on foreign laws . . . intends to perform banking business in Japan by establishing a branch or agent office in Japan, said foreign bank shall . . . obtain the license of the Minister of Finance, for each said branch . . ."); see BD. OF GOVERNORS OF THE FED. RESERVE SYS., REPORT TO CONGRESS ON BANK SUPERVISION IN THE GROUP OF TEN NATIONS AND SWITZERLAND 57 (1984) [hereinafter GROUP OF TEN]; see also R. DALE, *supra* note 14, at 113.

¹²⁴ Article 47(3) of the Japanese Banking Law refers to the licensing standards established in article 4. These standards include:

1. Sufficient financial resources to "soundly and effectively" engage in the banking business (Japanese Banking Law, art. 4(1));

2. Sufficient knowledge, expertise and social credit to "precisely, fairly and effectively" engage in the banking business (Japanese Banking Law, art. 4(2));

3. The bank poses no threat of "throwing financial order into disorder" in view of current economic conditions (Japanese Banking Law, art. 4(3)); and

4. Japanese banks may compete under equal conditions in the foreign bank's home country (Japanese Banking Law, art. 4(4)). Japanese Banking Law, *supra* note 98, at art. 47(3); see R. DALE, *supra* note 14, at 113; GROUP OF TEN, *supra* note 123, at 57-58.

¹²⁵ Japanese Banking Law, *supra* note 98, at art. 5(2).

¹²⁶ Japanese Banking Law, *supra* note 98, at art. 4(4). The Ministry of Finance (MOF) asks whether a new bank is needed given the current state of Japan's economy. See R. DALE, *supra* note 14, at 113; GROUP OF TEN, *supra* note 123, at 57.

¹²⁷ Japanese Banking Law, *supra* note 98, at arts. 4(2), 4(3), 48. Articles 4(2)-(3) and 48

C. *Capital Adequacy*

Beyond the initial minimum capitalization of one billion yen, the MOF does not seek to establish specific capital adequacy requirements.¹²⁸ The MOF, however, has used the powerful tool of administrative guidance to influence banks' capital positions.¹²⁹

To measure capital, the MOF uses a term described as a bank's "own capital" which is the sum of total shareholder equity, loan loss reserves, reserves for retirement allowances, and special reserves.¹³⁰ According to the MOF, a bank's own capital should equal at least 10% of the bank's demand deposits and negotiable certificates of deposits.¹³¹ Additionally, total loans should average no more than 80% of deposits, and fixed assets used in the bank's operations should not exceed 50% of net worth.¹³²

To assist banks in managing capital growth, the MOF also offers administrative guidance concerning dividend payout rates.¹³³ Generally, the MOF limits bank dividends to 15% of the face value of the equity instrument with a maximum dividend payout ratio equal to 40% of after-tax income.¹³⁴ Banks must allocate 20% of their cash dividends to a legal reserves account until legal reserves equal 100% of the face value of the bank's common stock.¹³⁵

D. *Liquidity Control*

The MOF does not put great emphasis on liquidity control.¹³⁶ Nevertheless, when deemed necessary, the MOF is forthcoming

give the MOF broad discretion in making economic need and reciprocity determinations. *Id.*; see GROUP OF TEN, *supra* note 123, at 57.

¹²⁸ See R. DALE, *supra* note 14, at 113; GROUP OF TEN, *supra* note 123, at 59–60; Friesen, *supra* note 6, at 1112–13.

¹²⁹ GROUP OF TEN, *supra* note 123, at 59–60.

¹³⁰ *Id.* at 59.

¹³¹ *Id.*

¹³² *Id.*

¹³³ *Id.* at 60.

¹³⁴ *Id.*; see Friesen, *supra* note 6, at 1113.

¹³⁵ Japanese Banking Law, *supra* note 98, at art. 18 (“[a] bank shall, up to reaching the amount of capital thereof, respectively accumulate as earned surplus reserve the amount of not less than one fifth of the dividend amount in money at each period for settlement of accounts . . .”). See GROUP OF TEN, *supra* note 123, at 60; Friesen, *supra* note 6, at 1113.

¹³⁶ Friesen, *supra* note 6, at 1113. One reason the MOF places such little emphasis on liquidity is because it has already segmented banking markets according to the maturity of their operations, i.e., commercial banks, long-term credit banks, and trust banks. See

with administrative guidance concerning bank liquidity to prevent banks from maturity mismatching.¹³⁷

The MOF defines liquid assets as cash, short-term interbank deposits, bankers' acceptances, and readily marketable securities.¹³⁸ Each bank's annual average of liquid assets must exceed 30% of its annual average of demand deposits coupled with negotiable certificates of deposit.¹³⁹

Additionally, the MOF has set forth special administrative guidance concerning a bank's Eurocurrency operations.¹⁴⁰ After February 1983, banks must fund term Eurocurrency lending exceeding one year with 45% Eurocurrency debt maturing in over one year.¹⁴¹ Likewise, banks must fund Eurocurrency loans exceeding three years in length by at least 15% Eurocurrency debt having a corresponding three year maturity.¹⁴²

E. *Lending Activities*

Prior to 1982, the MOF also determined lending limits through administrative guidance.¹⁴³ In 1982, however, the parliament amended the Japanese Banking Law to codify, at least in part, lending limits applicable to banks.¹⁴⁴ Article 13(1) of the Japanese Banking Law prohibits a bank from lending an amount exceeding "the total amount of [its] capital and reserves"¹⁴⁵ to a single borrower.

A subsequent MOF administrative order substantially limited article 13(1) by stating that city banks and regional banks may not loan to a single borrower an amount exceeding 20% of the

supra notes 107–14 and accompanying text discussing the segmentation of Japanese banking markets.

¹³⁷ Friesen, *supra* note 6, at 1113.

¹³⁸ GROUP OF TEN, *supra* note 123, at 59; Friesen, *supra* note 6, at 1113.

¹³⁹ GROUP OF TEN, *supra* note 123, at 59; Friesen, *supra* note 6, at 1113.

¹⁴⁰ R. DALE, *supra* note 14, at 113; Friesen, *supra* note 6, at 1113.

¹⁴¹ R. DALE, *supra* note 14, at 113; Friesen, *supra* note 6, at 1113.

¹⁴² R. DALE, *supra* note 14, at 113; Friesen, *supra* note 6, at 1113.

¹⁴³ Friesen, *supra* note 6, at 1112.

¹⁴⁴ *Id.*

¹⁴⁵ Japanese Banking Law, *supra* note 98, at art. 13(1). These lending limits, however, do not apply to "the giving of credit to the country or local public bodies, the giving of credit whose [repayment is] guaranteed by the government, or the giving of credit prescribed by Cabinet Order as being similar thereto." Japanese Banking Law, *supra* note 98, at art. 13(2); see Friesen, *supra* note 6, at 1112 (noting a bank's reserves are synonymous with the term "own capital").

bank's "own capital."¹⁴⁶ The effect on foreign branches differs in that the foreign branch's lending limits are calculated in reference to the parent bank's capital and surplus, not the branch's capital and surplus.¹⁴⁷

The MOF and BOJ take no responsibility for creating a country risk evaluation system.¹⁴⁸ Rather, the MOF's International Finance Bureau "assists" a bank in formulating its own country risk evaluation based on information provided by the Japan Center for International Finance.¹⁴⁹ Despite the MOF's alleged disinterest concerning international lending, it nonetheless issued a directive in 1983 requiring banks to:

1. File a semi-annual report detailing their total exposure to major debtor countries;
2. Establish loan loss provisions for loans to financially troubled countries equal to between 1%–5% of the bank's total exposure to each country; and
3. Limit foreign current asset exposure to fifteen times its "own capital" and keep interbank deposit claims and foreign currency call loans to 60% of foreign currency assets.¹⁵⁰

F. *Foreign Exchange Risk*

The MOF has set loose foreign exchange limits which are applied daily to a bank's net spot position and to the aggregate of its spot and forward position.¹⁵¹ Even though the limits are not strictly enforced, banks generally keep their foreign exchange exposure below 10% of their capital.¹⁵²

Historically, foreign branches have had limited access to Japan's retail banking markets making it difficult for them to attract yen deposits.¹⁵³ Consequently, MOF foreign exchange limits do not apply to foreign branch's currency swap limits.¹⁵⁴ This exemption

¹⁴⁶ GROUP OF TEN, *supra* note 123, at 60; Friesen, *supra* note 6, at 1112.

¹⁴⁷ GROUP OF TEN, *supra* note 123, at 60.

¹⁴⁸ Friesen, *supra* note 6, at 1114.

¹⁴⁹ See GROUP OF TEN, *supra* note 123, at 60–61; Friesen, *supra* note 6, at 1114.

¹⁵⁰ GROUP OF TEN, *supra* note 123, at 60–61.

¹⁵¹ R. DALE, *supra* note 14, at 114; GROUP OF TEN, *supra* note 123, at 61; Friesen, *supra* note 6, at 1114.

¹⁵² R. DALE, *supra* note 14, at 114.

¹⁵³ 1986 UPDATE, *supra* note 121, at 67–68, 70.

¹⁵⁴ *Id.* at 71; see Henderson, *An Analysis of Interest Rate and Currency Swaps*, 11 N.C.J. INT'L L. & COM. REG. 497, 498 (1986) (detailing the mechanics of a currency swap transaction).

permits foreign branches to convert foreign currencies into yen and then loan these funds in the Japanese domestic market.¹⁵⁵

G. *Permissible Areas of Business*

The Securities and Exchange Act of 1948 prohibited Japanese banks from underwriting all securities except certain public sector bonds.¹⁵⁶ The Japanese Banking Law of 1981 perpetuates this prohibition by allowing commercial banks to only underwrite and offer government bonds and government guaranteed debentures to subscribers.¹⁵⁷

The MOF permits banks to engage in other activities which, through administrative guidance, it determines are incidental to that bank's business.¹⁵⁸ These activities include real estate dealings, leasing activities, and bank equipment maintenance.¹⁵⁹ Furthermore, banks are permitted to own large amounts of corporate stock in businesses to which they are a major creditor.¹⁶⁰

H. *Bank Examinations and Disclosure Requirements*

Japanese banking authorities conduct three types of on-site bank examinations.¹⁶¹ First, the MOF conducts a surprise on-site examination every two or three years to insure each individual bank is run safely and soundly.¹⁶² Second, the BOJ conducts a scheduled on-site examination every two or three years, but the goal of its examinations is to insure the stability of the Japanese banking industry as a whole.¹⁶³ Finally, the MOF's International

¹⁵⁵ GROUP OF TEN, *supra* note 123, at 61. This special exemption has allowed foreign branches of U.S. banks to capture 45% of the foreign exchange trading market in Japan. Holden, *Look Who's Winning Tokyo's Currency Sweepstakes*, BUS. WK., Apr. 11, 1988, at 71-72.

¹⁵⁶ R. DALE, *supra* note 14, at 114. The 1948 Securities and Exchange Act was modeled after the Glass-Steagall Act. See Tatsuta, *Securities Activities of Japanese Banks*, 4 J. COMP. CORP. L. SEC. REG. 259, 263 (1982).

¹⁵⁷ Japanese Banking Law, *supra* note 98, at arts. 10(2), 11. As of September 1986, eight U.S. banks had been granted dealing licenses. These licenses allow the banks to deal in the full range of maturities in government bonds. 1986 UPDATE, *supra* note 121, at 71.

¹⁵⁸ GROUP OF TEN, *supra* note 123, at 59.

¹⁵⁹ *Id.*

¹⁶⁰ *Id.*; see *supra* note 117 and accompanying text (discussing commercial bank affiliations with industrial companies).

¹⁶¹ R. DALE, *supra* note 14, at 116.

¹⁶² GROUP OF TEN, *supra* note 123, at 61-62. Article 25 of the Japanese Banking Law, which enables the MOF to inspect banks, is entitled "Spot Inspection."

¹⁶³ GROUP OF TEN, *supra* note 123, at 61.

Finance Bureau conducts on-site bank examinations to insure a bank's foreign exchange operations are in order.¹⁶⁴ Foreign branches are subject to examinations by all three groups.¹⁶⁵

The Japanese Banking Law sets forth disclosure requirements for Japanese banks.¹⁶⁶ Article 19 requires banks to give the MOF an interim and final business report for each business year.¹⁶⁷ Additionally, article 22 requires that banks compile and make public balance sheets, income statements, and other explanatory documents within three months after the end of each business year.¹⁶⁸

All banks are subject to the auditing requirements contained in the Japanese Commercial Code.¹⁶⁹ Specifically, a bank must retain at least two auditors and one certified public accountant.¹⁷⁰ The auditors are hired by the bank and are primarily responsible to bank management, whereas the certified public accountant is hired by the shareholders for the express purpose of insuring the accuracy of published financial statements.¹⁷¹

I. *Liquidity Support*

The BOJ provides liquidity support on a short-term basis at the so-called "Bank Rate."¹⁷² For purposes of borrowing from the BOJ, each bank has a discount quota based on the size of its yen assets.¹⁷³ Foreign branches are given a higher quota because of their low holdings of yen assets.¹⁷⁴ While the BOJ is primarily concerned with a liquidity crisis in yen, it will assist a bank or

¹⁶⁴ R. DALE, *supra* note 14, at 116.

¹⁶⁵ GROUP OF TEN, *supra* note 123, at 62.

¹⁶⁶ Japanese Banking Law, *supra* note 98, at arts. 19–23.

¹⁶⁷ *Id.* at art. 19. Article 17 of the Japanese Banking Law requires a uniform bank business year beginning on April 1 and ending on March 31. *Id.* at art. 17.

¹⁶⁸ Japanese Banking Law, *supra* note 98, at arts. 20, 21. Article 22 of the Japanese Banking Law requires that the balance sheet, income statement, and business report conform to the provisions of article 293–6 of the Japanese Commercial Code and any ordinances prescribed by the MOF.

¹⁶⁹ GROUP OF TEN, *supra* note 123, at 62; Friesen, *supra* note 6, at 1111.

¹⁷⁰ GROUP OF TEN, *supra* note 123, at 62; Friesen, *supra* note 6, at 1111.

¹⁷¹ GROUP OF TEN, *supra* note 123, at 62; Friesen, *supra* note 6, at 1111.

¹⁷² R. DALE, *supra* note 14, at 149. This is similar to the Federal Reserve's discount rate. Additionally, the Bank of Japan (BOJ) may provide for longer-term borrowing if adequate collateral is present. *Id.*

¹⁷³ *Id.*

¹⁷⁴ *Id.*

foreign branch experiencing a liquidity crisis in another currency by making yen available for conversion purposes.¹⁷⁵

J. *Deposit Insurance*

Japan's deposit insurance fund, the Deposit Insurance Corporation, was formed in 1971.¹⁷⁶ The fund received initial capitalization from the government, the BOJ, and the banking industry.¹⁷⁷ The fund operates as a going concern by charging each bank a premium of .008% of that bank's total insured deposits.¹⁷⁸ Currently, all deposits at Japanese banks, except interbank deposits, are covered up to three million yen per account.¹⁷⁹ Deposits at foreign branches of U.S. banks are currently not eligible for coverage.¹⁸⁰

K. *Competitive Disadvantages for U.S. Branches*

Japanese commercial city banks have several advantages over U.S. banks' foreign branches operating in Japan. Unlike their U.S. counterparts, Japanese banks deal with one central authority, the MOF, rather than a plethora of regulatory bodies. Not only do banks enjoy the simplicity of a singular regulatory authority, but they benefit from administrative guidance, a regulatory style that is inherently different and likely more efficient than the more formal and confrontational style that characterizes the U.S. financial institution regulatory processes. For example, new financial products and services offered by U.S. banks are subjected to numerous levels of administrative review often resulting in protracted litigation. One cannot help but believe that the Japanese feel our system is perplexing and, perhaps, amusing. They are literally laughing all the way to the Dai-ichi Kangyo Bank, the world's largest.

The MOF has used administrative guidance to encourage the growth of a small number of city banks, which possess a high concentration of all Japanese banking assets. Such a concentration would be unthinkable for U.S. banks by reason of the antitrust

¹⁷⁵ *Id.* For instance, in 1974 the BOJ borrowed dollars at LIBOR to help Japanese banks through a nationwide liquidity crisis. *Id.*

¹⁷⁶ *Id.*; GROUP OF TEN, *supra* note 123, at 63.

¹⁷⁷ R. DALE, *supra* note 14, at 148; GROUP OF TEN, *supra* note 123, at 63.

¹⁷⁸ R. DALE, *supra* note 14, at 148; GROUP OF TEN, *supra* note 123, at 63–64.

¹⁷⁹ R. DALE, *supra* note 14, at 148; GROUP OF TEN, *supra* note 123, at 63.

¹⁸⁰ R. DALE, *supra* note 14, at 148; GROUP OF TEN, *supra* note 123, at 63.

laws and the geographical constraints imposed by the McFadden Act and the Douglas Amendment to the Bank Holding Company Act.

Although Japanese banks are presently constrained from certain securities underwriting activities as a result of their statutory parallel to the Glass-Steagall Act, the Japanese banks, unlike U.S. banks, are permitted to invest in large amounts of the stock of their debtor commercial clients. This equity tie-in appears to give the Japanese banks a competitive advantage unavailable to their U.S. counterparts.

Japanese banks have deposit insurance for accounts, but U.S. branches are not able to obtain such coverage from either the Japanese Deposit Insurance Corporation or the FDIC. This disparity gives the Japanese banks a significant advantage in their ability to attract deposits.

The Japanese banking regulatory system, like many other areas of Japanese commercial enterprise, is characterized by government oversight, planning, and encouragement. In contrast, the U.S. regulatory system is characterized by governmental oversight, reaction, and, at times, populist paranoia. These regulatory characteristics reflect the cultural differences between Japan and the United States.

III. THE UNITED KINGDOM—REGULATION OF FOREIGN BRANCHES

A. *Overview of the British Banking System*

Historically, British banking regulation has been based on tradition and custom rather than on parliamentary grant.¹⁸¹ Britain's primary bank regulator, the Bank of England (BOE), was founded as a private bank in 1694.¹⁸² The BOE acted as a bank regulator during the 1800's and actually became part of the British government when the Bank of England Act of 1946 authorized the H.M. Treasury to purchase the BOE.¹⁸³ Additionally, the Bank of England Act gave the BOE "extensive powers to request information from and make recommendations to banks, and [it] may, with the consent of the H.M. Treasury, issue direc-

¹⁸¹ E. SYMONS & J. WHITE, *supra* note 4, at 765.

¹⁸² *Id.*

¹⁸³ Friesen, *supra* note 6, at 1088.

tions to any bank to effect compliance with such request or recommendation."¹⁸⁴

After 1946, the BOE exercised its regulatory authority without the assistance of statutory guidelines.¹⁸⁵ Realizing that tradition and custom were no longer a sufficient basis from which to regulate banks, Parliament passed the Banking Act of 1979.¹⁸⁶ Not only did the Banking Act of 1979 finally establish a statutory basis for bank regulation, but it also specifically vested the BOE with primary responsibility for such regulation.¹⁸⁷ Furthermore, the act created two types of institutions—recognized banks and licensed deposit takers.¹⁸⁸ This bifurcated system allowed the BOE to maintain its more traditional approach of supervising recognized banks by direct management contact, while implementing a more formal, statutory based approach to regulating licensed deposit takers.¹⁸⁹

¹⁸⁴ *Id.* The H.M. Treasury is not involved in the day-to-day operations of the Bank of England (BOE). Should a widespread banking crisis develop, however, the public would expect the H.M. Treasury to support the BOE in assisting the United Kingdom's banking industry. *Id.*

¹⁸⁵ *Id.*

¹⁸⁶ *Id.* at 1087.

¹⁸⁷ R. DALE, *supra* note 14, at 126.

¹⁸⁸ *Id.* at 126–27. The primary distinction between the two types of entities is the range of activities in which they engage. The Recognized Bank was allowed to engage in more diverse activities but was also subject to greater regulation as the following licensing criteria for each institution demonstrates:

1. Licensed Deposit-Taking Institution —

a. Each director, controller, and manager must be a fit and proper person to hold the position;

b. The business must be directed by a minimum of two managers; and

c. The business must be conducted in a prudent manner, particularly

i. There must be minimum net assets of £250,000 and the financial resources must be maintained in such a manner as to protect the depositors;

ii. There must at all times be adequate liquidity; and

iii. There must be adequate provisions for bad debt.

2. Recognized Bank —

a. The institution must have a high reputation and standing in the financial community;

b. The institution must provide a wide range of banking services, or alternatively it must provide a highly specialized banking service;

c. The business must be directed by at least two managers who conduct the business with integrity, prudence, and professional skill; and

d. The institution must maintain financial resources commensurate with its scale of operations (£5,000,000 minimum net assets for a wide range of banking services and £250,000 minimum net assets for a highly specialized banking service). GROUP OF TEN, *supra* note 123, at 92–93.

¹⁸⁹ *Id.*

The Banking Act of 1979 was superseded by the Banking Act of 1987 (1987 Act).¹⁹⁰ The 1987 Act perpetuates the BOE's regulatory responsibility for the British Banking System.¹⁹¹ The distinction, however, between recognized banks and licensed deposit takers has disappeared to be replaced by the "authori[z]ed institution."¹⁹²

B. *Market Entry*

An overseas institution¹⁹³ wishing to establish a foreign branch in the United Kingdom must notify the BOE at least two months before the branch is to begin operations.¹⁹⁴ Such notice shall include the name the institution proposes to use in connection with its business activities in the United Kingdom.¹⁹⁵ In addition, if the overseas institution "is authori[z]ed to take deposits or conduct banking business in a country or territory outside the United Kingdom by the relevant supervisory authority in that country or territory," the BOE may require it to provide a certified copy of documents from that authority which authorizes it to engage in the banking business.¹⁹⁶

Foreign branches operating in the United Kingdom are not required to meet capital adequacy requirements, like domestic British banks, because they are part of a larger international institution.¹⁹⁷ Consequently, the BOE usually relies on a consoli-

¹⁹⁰ The United Kingdom Banking Act, 1987 [hereinafter Banking Act of 1987] *reprinted in Halsbury's Laws of England* (vol. 4 1987 reissue).

¹⁹¹ *Id.* at § 1(1) ("[t]he Bank of England . . . shall have . . . the duty generally to supervise the institutions authori[z]ed by it in the exercise of those powers"). In addition, the Banking Act of 1987 established the Board of Banking Supervision (Board) which consists of the Governor, the Deputy Governor, the Executive Director of the Bank of England, and six independent members appointed by both the Chancellor of the Exchequer and the Governor of the Bank of England. *Id.* at § 2(2)(a), (b). The Board's primary function is to assist the Governor of the Bank of England in implementing the supervisory provisions of the Banking Act of 1987. *See id.* at § 2, General Note.

¹⁹² *Id.* at § 106(1).

¹⁹³ The Banking Act of 1987 does not refer specifically to foreign banks, instead relying on the more broadly defined term "overseas institution." *See id.* at § 74(1)-(2).

¹⁹⁴ *Id.* at § 75(1).

¹⁹⁵ *Id.* at § 75(1)(a). The BOE reserves the right to disallow the use of any name it believes would be misleading to the public. *Id.* at § 76.

¹⁹⁶ *Id.* at § 79(2)(d).

¹⁹⁷ R. DALE, *supra* note 14, at 127. The H.M. Treasury and the BOE, however, possess statutory authority to prescribe individual regulations for any overseas institution desiring to establish a representative office in the United Kingdom. *See* Banking Act of 1987, *supra* note 190, at § 80(1).

dated assessment of the parent bank’s management and financial soundness by that bank’s primary supervisory authority.¹⁹⁸ The BOE, however, always makes its own determination of the bank’s reputation and standing in the financial community.¹⁹⁹

C. *Capital Adequacy*

The BOE does not attempt to apply capital adequacy ratios uniformly to banking institutions.²⁰⁰ Instead, the BOE has devised two capital ratios which allow it to consider each institution’s consolidated capital position in view of the particular circumstances confronting that institution both in the United Kingdom and abroad.²⁰¹ Common to both ratios is the capital base which consists of share capital, reserves, general bad debt provisions, minority interests, and subordinated debt.²⁰²

One capital ratio, the gearing ratio, relates a bank’s current liabilities to its capital resources.²⁰³ This is accomplished by dividing the adjusted capital base by contingent liabilities.²⁰⁴ Mathe-

Table II.

$$\frac{\text{Adjusted Capital Base}}{\text{Public Liabilities}} = \frac{[(\text{Capital Base}) - (\text{Investments In Other Businesses} + \text{Goodwill} + \text{Bank Premises})]}{[\text{Deposits} + \text{Short Term Non-Contingent Liabilities}]^{205}}$$

The risk-asset ratio is the more traditional measure of capital adequacy because it measures capital in relation to the bank’s potential losses.²⁰⁶ Various assets are weighted according to their

¹⁹⁸ R. DALE, *supra* note 14, at 127; *cf.* Banking Act of 1987, *supra* note 190, at § 79(2)(d). For foreign branches of U.S. banks, this supervisory authority would be the OCC, FRB, or FDIC.

¹⁹⁹ R. DALE, *supra* note 14, at 127. It is unclear whether the relevant financial community is limited to the United Kingdom or consists of world-wide financial markets.

²⁰⁰ R. DALE, *supra* note 14, at 127; GROUP OF TEN, *supra* note 123, at 95; Friesen, *supra* note 6, at 1092.

²⁰¹ R. DALE, *supra* note 14, at 127; GROUP OF TEN, *supra* note 123, at 95; Friesen, *supra* note 6, at 1092.

²⁰² GROUP OF TEN, *supra* note 123, at 95. Only one-third of a bank’s capital base may consist of subordinated debt. Friesen, *supra* note 6, at 1092.

²⁰³ GROUP OF TEN, *supra* note 123, at 95–96.

²⁰⁴ R. DALE, *supra* note 14, at 127; GROUP OF TEN, *supra* note 123, at 95; Friesen, *supra* note 6, at 1092.

²⁰⁵ R. DALE, *supra* note 14, at 127; GROUP OF TEN, *supra* note 123, at 95–96; Friesen, *supra* note 6, at 1092.

²⁰⁶ R. DALE, *supra* note 14, at 127; GROUP OF TEN, *supra* note 123, at 96; Friesen, *supra* note 6, at 1092.

perceived susceptibility to credit risk, interest rate risk, and forced sale risk.²⁰⁷ Commercial loans are the standard by which other assets are measured and are given a risk weight of one.²⁰⁸ Once risk weights are assigned, each balance sheet asset is multiplied by its risk weight, and the resulting total is called adjusted risk assets.²⁰⁹ This total is divided into the adjusted capital base²¹⁰ yielding the institution's risk asset ratio.²¹¹

D. *Liquidity Control*

The BOE is concerned with two types of potential liquidity problems facing financial institutions—funding risk and interest rate mismatch risk.²¹² Funding risk is the chance a bank will not have sufficient cash on-hand to satisfy all obligations falling due on a certain day.²¹³ Interest rate mismatch risk is the risk that a bank will suffer losses due to adverse movements in interest rates.²¹⁴

While the BOE does not impose specific liquidity requirements on banks, it nevertheless closely monitors each institution's liquidity position.²¹⁵ Liquidity is measured on a cash flow basis with

²⁰⁷ R. DALE, *supra* note 14, at 127. Credit risk is the risk a borrower will become unable to make payments on its loan; investment risk is the susceptibility the loan will be affected by adverse movements in interest rates; and forced sale risk is the risk a bank will have to liquidate the asset. F.L. GARCIA & G. MUNN, *ENCYCLOPEDIA OF BANKING AND FINANCE* 233, 396, 494 (8th ed. 1984).

²⁰⁸ R. DALE, *supra* note 14, at 127.

²⁰⁹ *Id.*

²¹⁰ The adjusted capital base is identical to that used in the gearing ratio except that bank premises and equipment are not deducted from the total. GROUP OF TEN, *supra* note 123, at 96.

²¹¹ Risk asset ratio computations would look as follows:

Table C.

Step #1

Asset #1 * Risk Weighting = Risk Adjusted Value

Asset #2 * Risk Weighting = Risk Adjusted Value

Asset #3 * Risk Weighting = $\frac{\text{Risk Adjusted Value}}{\text{Total Risk Adjusted Assets}}$

Step #2

$\frac{\text{Adjusted Capital Base}}{\text{Total Risk Adjusted Assets}} = \text{Risk Asset Ratio}$

²¹² Friesen, *supra* note 6, at 1093.

²¹³ *Id.*

²¹⁴ *Id.*

²¹⁵ R. DALE, *supra* note 14, at 128.

assets and liabilities in all currencies considered together.²¹⁶ Assets and liabilities are inserted into one of five time periods on a maturity ladder.²¹⁷ The sum of all assets from one time period is deducted from the sum of all liabilities in that time period.²¹⁸ The result is a net mismatch position which allows the BOE to assess quantitatively an institution's liquidity.²¹⁹ While the BOE considers each foreign branch's capital adequacy on a consolidated basis with the parent bank, it monitors each foreign branch's liquidity individually placing particular emphasis on the foreign branch's liquidity in British pounds.²²⁰

E. *Lending Activities*

Banks and foreign branches are required to file a quarterly report with the BOE detailing their ten largest outstanding loans and guarantees.²²¹ While the 1987 Act contains no statutory lending limits, the BOE has "suggested" that banks' total exposure to one borrower should not exceed 10% of their capital base.²²² Moreover, if exposure to an individual borrower exceeds the 10% limit, the BOE expects the bank to raise its capital level so that adequate capital ratios are maintained.²²³

The BOE closely monitors country risk through semiannual reports submitted by banks that detail outstanding loans to non-

²¹⁶ *Id.*

²¹⁷ GROUP OF TEN, *supra* note 123, at 96. The maturity periods range from eight-8 days to 6-12 months. *Id.* All assets are subject to a discount for credit risk, investment risk, or forced sale risk. R. DALE, *supra* note 14, at 128; *see supra* note 203 (discussion of these three risks).

²¹⁸ R. DALE, *supra* note 14, at 128; GROUP OF TEN, *supra* note 123, at 96.

²¹⁹ GROUP OF TEN, *supra* note 123, at 96.

²²⁰ R. DALE, *supra* note 14, at 128. To measure a foreign branch's liquidity on a consolidated basis would not be meaningful since the BOE is only concerned with liquidity and its effects on the British banking system.

²²¹ GROUP OF TEN, *supra* note 123, at 97.

²²² *Id.* Total exposure consists of both outstanding loans and guarantees. *Id.* Regulatory concern over large exposures resulted in the enactment of § 38 of the Banking Act of 1987, which provides in part:

(1) An authori[z]ed institution, other than one whose principal place of business is outside the United Kingdom [effectively excluding British branches of U.S. banks], shall make a report to the [BOE] if —

(a) it has entered into a transaction or transactions relating to any one person as a result of which it is exposed to the risk of incurring losses in excess of 10% of its available capital resources

Banking Act of 1987, *supra* note 190, at § 38.

²²³ GROUP OF TEN, *supra* note 123, at 97.

residents.²²⁴ If the BOE believes a bank's total exposure to one country is inappropriate for that country's economic or political climate, it will ask the bank to reduce its exposure by selling or calling in a portion of its loans.²²⁵

F. *Foreign Exchange Risk*

The BOE regularly monitors each bank's foreign exchange exposure and, in so doing, distinguishes between "structural" positions and "dealing" positions.²²⁶ A "structural" position is foreign exchange exposure arising from the presence of long-term foreign currency assets and liabilities on the bank's balance sheet.²²⁷ Conversely, a "dealing" position is foreign exchange exposure inherent in the bank's daily operations.²²⁸ While "structural" positions are factored into a bank's capital adequacy equation, they are excluded from the BOE's foreign exchange guidelines.²²⁹

Generally, the BOE's foreign exchange guidelines for banks experienced in foreign exchange are as follows:

1. A bank's net dealing position in any one currency should not exceed 10% of its capital base; and
2. A bank's aggregate net dealing position for all currencies should not exceed 15% of the bank's capital base.²³⁰

The BOE, however, does not impose the foregoing limits on foreign branches when the parent bank's internal controls, coupled with the monitoring arrangements of the parent bank's supervisory authority, are deemed adequate.²³¹

G. *Permissible Areas of Business*

The BOE imposes no formal restrictions on activities in which a bank may engage.²³² The BOE does, however, expect to receive

²²⁴ *Id.*

²²⁵ *Id.*

²²⁶ R. DALE, *supra* note 14, at 128; Friesen, *supra* note 6, at 1093.

²²⁷ R. DALE, *supra* note 14, at 128; GROUP OF TEN, *supra* note 123, at 98; Friesen, *supra* note 6, at 1093-94.

²²⁸ R. DALE, *supra* note 14, at 128; GROUP OF TEN, *supra* note 123, at 98; Friesen, *supra* note 6, at 1093-94.

²²⁹ R. DALE, *supra* note 14, at 128; Friesen, *supra* note 6, at 1093-94.

²³⁰ R. DALE, *supra* note 14, at 128; Friesen, *supra* note 6, at 1094. As with the British banking system in general, these requirements are extremely adaptable to each bank's circumstances. R. DALE, *supra* note 14, at 128.

²³¹ R. DALE, *supra* note 14, at 129.

²³² *Id.* at 128; GROUP OF TEN, *supra* note 123, at 94.

advance notice concerning any bank's investment of more than 15% in any business.²³³ Furthermore, the BOE only allows investment in a non-banking entity if the proposed investment is financial in nature, of minimal risk, and small in proportion to the bank's asset base.²³⁴

H. *Bank Examinations and Disclosure Requirements*

Generally, the BOE neither conducts on-site bank examinations nor regularly assesses the quality of a bank's loan portfolio.²³⁵ Instead, the BOE constantly reviews statistical data taken from monthly reports submitted by supervised institutions as required.²³⁶ This data becomes the focal point of interviews the BOE regularly conducts with the senior management of a bank or foreign branch to gain an understanding of the institution's financial health and management capabilities.²³⁷

Other than reports given to the BOE, banks are under no special reporting requirements.²³⁸ The Companies Act of 1948 does require all corporations, including banks, to prepare an annual consolidated balance sheet and income statement and to file these reports with the Registrar of Companies.²³⁹ While the statements are normally only available for public inspection at the Registrar's office, the 1987 Act requires all banks to have copies of these reports available for public inspection at every office where deposits are accepted.²⁴⁰

I. *Liquidity Support*

Much like the Federal Reserve, the BOE provides short-term liquidity assistance to banks in the United Kingdom.²⁴¹ Addition-

²³³ R. DALE, *supra* note 14, at 128.

²³⁴ *Id.*

²³⁵ *Id.* at 129; GROUP OF TEN, *supra* note 123, at 98–99. The Banking Act of 1987, however, gives the BOE tremendous power in requesting information and investigating authorized institutions. See Banking Act of 1987, *supra* note 190, at § 39 (giving the BOE power to obtain information and require production of documents), § 40 (giving the BOE power to enter authorized institutions to obtain information and documents), § 41 (giving the BOE power to appoint investigators to examine the workings of an authorized institution).

²³⁶ R. DALE, *supra* note 14, at 129; GROUP OF TEN, *supra* note 123, at 99.

²³⁷ R. DALE, *supra* note 14, at 129; GROUP OF TEN, *supra* note 123, at 99.

²³⁸ Friesen, *supra* note 6, at 1089.

²³⁹ GROUP OF TEN, *supra* note 123, at 100.

²⁴⁰ Banking Act of 1987, *supra* note 190, at § 45(1).

²⁴¹ GROUP OF TEN, *supra* note 123, at 100. Liquidity assistance is provided to facilitate orderly financial markets and to implement monetary policy. *Id.*

ally, the BOE may provide long-term liquidity support to individual banks, but such assistance is generally limited to institutions experiencing severe financial difficulties and whose failure would undermine confidence in the British banking system.²⁴² Foreign branches, however, are viewed as the responsibility of the parent bank's supervisory authority for liquidity purposes and are, therefore, excluded from receiving BOE liquidity support.²⁴³

J. *Deposit Insurance*

Sections 21–33 of the Banking Act of 1979 established the Deposit Protection Board (Board) and the Deposit Protection Fund (Fund).²⁴⁴ The 1987 Act provides for the continuing existence of both.²⁴⁵ The Board is responsible for managing all aspects of the Fund's operation including managing the Fund's assets and applying them to particular situations as needed.²⁴⁶

The 1987 Act provides that 75% of a deposit up to £20,000 will be repaid to a depositor if his depository institution becomes insolvent.²⁴⁷ The Fund is financed by mandatory contributions from authorized institutions.²⁴⁸ Because a foreign branch of a U.S. bank comes within the definition of "authori[z]ed institution" for purposes of the Fund's operation, it must make mandatory contributions to the Fund.²⁴⁹

K. *Competitive Disadvantages for United States Branches*

The chief competitive advantage for British banks over U.S. bank branches operating in the United Kingdom is that British banks are not subject to formal restrictions on the types of activities in which they may engage. By contrast, U.S. banks' foreign branches are constrained from engaging in merchant or invest-

²⁴² *Id.*

²⁴³ Friesen, *supra* note 6, at 1095.

²⁴⁴ R. DALE, *supra* note 14, at 151; Friesen, *supra* note 6, at 1095.

²⁴⁵ Banking Act of 1987, *supra* note 190, at § 50(1).

²⁴⁶ *Id.* at § 50(2).

²⁴⁷ *Id.* at §§ 58(1), 60(1). The depository institution must be an authorized institution as defined in § 106(1) Banking Act of 1987.

²⁴⁸ *Id.* at § 52(1).

²⁴⁹ The term "authori[z]ed institution" defined in § 106(1) of the Banking Act of 1987 encompasses what is commonly referred to as a foreign branch. Because this term is only altered in the Banking Act of 1987 for §§ 74–81 [Overseas Institutions with Representative Offices], foreign branches must contribute a percentage of deposits to the Fund. *Id.* at § 61(1) ("[a]ll authori[z]ed institutions shall be liable to contribute to the Fund . . .").

ment banking activities by virtue (or vice) of the Glass-Steagall Act.

U.S. banks' foreign branches participate in the Fund which means that, in theory, these branches are not disadvantaged in competing for deposits. The U.S. Congress should study the British deposit insurance system as a model for rebuilding the U.S. system. The British system, which insures only up to 75% of certain amounts deposited, has the advantage of imposing market discipline for sound management through depositors as well as from shareholders and regulators. In light of the temperament of Congress, and particularly in face of the thrift debacle, however, adoption of the British deposit insurance model seems unlikely at present.

The competitive advantages of the United Kingdom's participation in the European Community are assessed in part VI of this Article, but it should be noted here that such advantages are likely to be great, at least from a psychological point of view.

IV. THE FEDERAL REPUBLIC OF GERMANY—REGULATION OF FOREIGN BRANCHES

A. *Overview of the Federal Republic of Germany's Banking System*

All commercial banks in the Federal Republic of Germany (FRG) are subject to the provisions of the Banking Act of the Federal Republic of Germany (Banking Act).²⁵⁰ Pursuant to the Banking Act, the Federal Banking Supervisory Office (FBSO) has primary authority to supervise banks.²⁵¹ The FBSO's statutory duties include "counteract[ing] undesirable elements in banking which may endanger the safety of the assets entrusted to banks, adversely affect the orderly conduct of banking business or result in serious disadvantages for the national economy."²⁵² Despite its wide ranging regulatory powers, the FBSO does not have a large staff.²⁵³ Consequently, the FBSO works closely with the Deutsche

²⁵⁰ See Gesetz über das Kreditwesen § 1(1) (defining what acts constitute the "banking business"), § 32(1) (requiring all parties engaged in the "banking business" to receive a banking license which subjects them to the provisions of the German Banking Act), 1985 BCB1.I 1472 (W. Ger.) [hereinafter German Banking Act].

²⁵¹ *Id.* at § 6(1) ("[t]he Federal Banking Supervisory Office exercises supervision over the banks in accordance with the provisions of this Act"); see R. DALE, *supra* note 14, at 134; GROUP OF TEN, *supra* note 123, at 37; Friesen, *supra* note 6, at 1098.

²⁵² German Banking Act, *supra* note 250, at § 6(2).

²⁵³ Friesen, *supra* note 6, at 1100.

Bundesbank (Bundesbank), and it will not issue regulations before obtaining the Bundesbank's full approval.²⁵⁴

The Bundesbank Act of 1957 establishes the Bundesbank's role in relation to the government.²⁵⁵ The Bundesbank is primarily responsible for controlling monetary policy, much like the Federal Reserve does in the United States.²⁵⁶ Furthermore, because the Bundesbank maintains a bank supervision department, it is responsible for collecting and evaluating reports from commercial banks.²⁵⁷ Once the Bundesbank evaluates a report, it is given to the FBSO so that appropriate supervisory action can be taken.²⁵⁸

B. *Market Entry*

All persons wishing to enter the banking industry in the FRG must apply to the FBSO for a banking license.²⁵⁹ The following statutory criteria must be satisfied before the FBSO will grant such a license:

1. The bank must possess initial minimum capital of DM6,000,000;²⁶⁰
2. The bank must be run by a minimum of two managers;
3. The managers must be qualified to run the bank, and must also be trustworthy individuals; and
4. The bank must submit a detailed business plan.²⁶¹

If these statutory criteria are satisfied, the FBSO must grant the license.²⁶² The FBSO has discretion, however, to attach further conditions which must be satisfied before the banking license

²⁵⁴ *Id.* This closeness between the Federal Banking Supervisory Office (FBSO) and Bundesbank is based largely on statute. The German Banking Act at § 7(1) provides:

The Federal Banking Supervisory Office and the Deutsche Bundesbank cooperate as provided in this Act. The Deutsche Bundesbank and the Federal Banking Supervisory Office shall communicate to each other any observations and findings which may be of significance for the performance of their respective functions.

²⁵⁵ Friesen, *supra* note 6, at 1098.

²⁵⁶ *Id.*

²⁵⁷ *Id.* at 1098.

²⁵⁸ See German Banking Act, *supra* note 250, at § 7(1).

²⁵⁹ *Id.* at § 32(1); see R. DALE, *supra* note 14, at 134; GROUP OF TEN, *supra* note 123, at 38.

²⁶⁰ See R. Dale, *supra* note 14, at 134; Group of Ten, *supra* note 123, at 38.

²⁶¹ *Id.* at § 33.

²⁶² R. DALE, *supra* note 14, at 134. The German Banking Act does not mandate the issuance of the license; rather, § 33 of the German Banking Act has a negative control feature stating "[t]he license may be refused only" if the statutory criteria are not satisfied.

is granted.²⁶³ In the case of commercial banks and foreign branches, the FBSO generally requires membership in the Fund as a prerequisite for obtaining a banking license.²⁶⁴

C. *Capital Adequacy*

The Banking Act requires that all commercial banks in the FRG maintain an adequate level of capital.²⁶⁵ The Banking Act defines capital as the sum of paid-in capital, reserves, retained earnings, and participation certificates.²⁶⁶ For the purposes of foreign branches, however, capital is the sum of working capital made available to the branch and operating surpluses less the branch's net intercompany claims.²⁶⁷

Pursuant to enabling authority contained in the Banking Act, FBSO and Bundesbank guidelines establish prudential ratios applicable to banks and foreign branches.²⁶⁸ Principle I of these guidelines establishes a capital adequacy requirement and states that loans and equity participations, exclusive of loan loss provisions, may not exceed eighteen times a bank's capital.²⁶⁹ Moreover, Principle I incorporates a risk adjusting feature in the capital adequacy equation by weighting various groups of assets according to their perceived risk.²⁷⁰ Principle I assigns the following risk weighting factors to various assets that may appear on a bank's balance sheet:²⁷¹

²⁶³ German Banking Act, *supra* note 250, at § 32(2). Pursuant to this section, the Federal Banking Supervisory Office (FBSO) may also limit the license to certain types of banking.

²⁶⁴ R. DALE, *supra* note 14, at 134.

²⁶⁵ German Banking Act, *supra* note 250, at § 10(1).

²⁶⁶ *Id.* at § 10(2). Participation certificates, or *genussscheine*, are equity certificates which give the bearer a right to share in bank profits but not a right to vote at the bank's annual meeting. These participation certificates may not comprise more than 25% of a bank's capital. *Id.* at § 10(5); see Friesen, *supra* note 6, at 1103.

²⁶⁷ R. DALE, *supra* note 14, at 135.

²⁶⁸ German Banking Act, *supra* note 250, at § 10(1).

²⁶⁹ R. DALE, *supra* note 14, at 135; GROUP OF TEN, *supra* note 123, at 40. The eighteen times capital requirement works out to a capital asset ratio of 5.6%. If capital falls below this mark, there is a rebuttable presumption that corrective action is needed. R. DALE, *supra* note 14, at 135.

²⁷⁰ R. DALE, *supra* note 14, at 135. For a complete discussion of Principle I, see DEUTSCHE BUNDESBANK, SPECIAL SERIES NO. 2, BANKING ACT OF THE FEDERAL REPUBLIC OF GERMANY 8 (1986) [hereinafter SPECIAL SERIES].

²⁷¹ R. DALE, *supra* note 14, at 135.

Table III.

Asset	Risk-Weighting
Fully Secured/Guaranteed Loans	50%
Loans To Foreign Banks	50%
Loans To Domestic Banks	20%
Public Sector Loans	0%
Various International Loans	100+ %

D. *Liquidity Control*

The Banking Act also requires that banks and foreign branches located in the FRG be sufficiently liquid at all times.²⁷² Principles II and III, adopted by the FBSO and the Bundesbank, ensure this requirement is met.²⁷³ Both principles attempt to limit maturity mismatching on a bank's balance sheet while recognizing that a higher proportion of short-term liabilities is generally necessary to form a stable funding base.²⁷⁴ Generally, Principle II requires that long-term assets be matched with long-term liabilities, and Principle III establishes ratios for matching medium-term assets to short-term and medium-term liabilities.²⁷⁵ Failure to comply with these ratios carries with it a presumption that corrective action is needed.²⁷⁶

E. *Lending Activities*

The Banking Act also contains detailed rules concerning bank lending activities.²⁷⁷ *Grosskredit* (large loan) is defined as an extension of credit to a single borrower which exceeds 15% of the bank's equity capital.²⁷⁸ There are two separate rules regarding

²⁷² German Banking Act, *supra* note 250, at § 11. As in the United Kingdom, foreign branch liquidity is considered individually for each branch located in Germany. R. DALE, *supra* note 14, at 128, 135; *see supra* note 216 and accompanying text.

²⁷³ R. DALE, *supra* note 14, at 135; GROUP OF TEN, *supra* note 123, at 41; Friesen, *supra* note 6, at 1103; *see* SPECIAL SERIES, *supra* note 270, at 8-9 (detailed discussion of these principles).

²⁷⁴ R. DALE, *supra* note 14, at 135; GROUP OF TEN, *supra* note 123, at 41. Most depositors also have liquidity concerns and, consequently, keep the majority of their deposits in demand accounts or short-term time deposits.

²⁷⁵ GROUP OF TEN, *supra* note 123, at 41; Friesen, *supra* note 6, at 1103.

²⁷⁶ R. DALE, *supra* note 14, at 135; Friesen, *supra* note 6, at 1103.

²⁷⁷ German Banking Act, *supra* note 250, at §§ 13-20.

²⁷⁸ *Id.* at § 13(1); *see* R. DALE, *supra* note 14, at 136; GROUP OF TEN, *supra* note 123, at 42; Friesen, *supra* note 6, at 1101.

Grosskredite. First, no *Grosskredit* may exceed 50% of a bank's capital.²⁷⁹ Second, the sum of all *Grosskredite* may not exceed eight times the bank's capital.²⁸⁰ Additionally, each *Grosskredit* must be promptly reported to the Bundesbank.²⁸¹

Organkredite (insider loans) are also subject to rules contained in the Banking Act.²⁸² *Organkredit* is defined as an extension of credit to any company affiliated with the bank, an employee of an affiliated company, or a bank employee.²⁸³ *Organkredite* must have unanimous approval of both the bank's managers and board of directors prior to releasing the funds.²⁸⁴ Additionally, all *Organkredite* exceeding DM250,000 must be reported to the FBSO and the Bundesbank.²⁸⁵

The FBSO and the Bundesbank do not attempt to compile and provide banks with country risk information concerning international lending.²⁸⁶ Rather, banks must establish and implement their own country risk evaluation system.²⁸⁷ Once the system is in place, the bank must periodically report its country risk information to the FBSO and Bundesbank along with its plans for dealing with these risks.²⁸⁸

F. Foreign Exchange Risk

FRG banking regulators closely monitor foreign exchange activities of each commercial bank and foreign branch located in the FRG. Principle I(a) provides that a bank's net open position, irrespective of due dates, may not exceed 30% of the bank's

²⁷⁹ German Banking Act, *supra* note 250, at § 13(4).

²⁸⁰ *Id.* at § 13(3).

²⁸¹ *Id.* at § 13(1). Pursuant to this section, the FBSO may order banks to annually submit a list of large loans. In addition to the rules regarding *grosskredite*, § 14 of the German Banking Act requires banks to "report to the Deutsche Bundesbank by the fifteenth day of January, April, July and October those borrowers whose indebtedness to them amounted to one million Deutche Mark or more at any time during the three calendar months preceding the reporting date."

²⁸² *Id.* at §§ 15-17.

²⁸³ *Id.* at § 15(1),(2).

²⁸⁴ *Id.* at § 15(1). If *Organkredite* are granted contrary to this section, the bank's managers and members of its supervisory body are jointly and severally liable to the bank for any loss it sustains as a result of the loan being granted. *Id.* at § 17(1).

²⁸⁵ *Id.* at § 16.

²⁸⁶ Friesen, *supra* note 6, at 1104.

²⁸⁷ *Id.*

²⁸⁸ *Id.*

capital at the close of any business day.²⁸⁹ The net open position is calculated by aggregating the assets for each foreign currency and precious metal.²⁹⁰ A net positive position in one foreign currency or precious metal may not be used to offset a net negative position in another.²⁹¹ In addition, Principle I(a) also limits net foreign currency transactions maturing in any one calendar month or half year to 40% of capital.²⁹²

G. *Permissible Business Activities*

The hallmark of the FRG's banking system is the "universal" bank.²⁹³ The word "universal" is particularly descriptive because there are literally no limits upon the activities in which banks of the FRG may engage.²⁹⁴ Banks of the FRG perform a wide range of commercial and investment banking functions including the underwriting and sale of securities.²⁹⁵ Moreover, banks are permitted to, and frequently do, engage in a wide variety of nonfinancial activities including ownership of nonfinancial companies.²⁹⁶

²⁸⁹ R. DALE, *supra* note 14, at 136; GROUP OF TEN, *supra* note 123, at 41; *see* SPECIAL SERIES, *supra* note 270, at 8.

²⁹⁰ R. DALE, *supra* note 14, at 136; GROUP OF TEN, *supra* note 123, at 41.

²⁹¹ GROUP OF TEN, *supra* note 123, at 41. Because long and short positions are aggregated, the effective maximum long or short foreign exchange position is 15%. R. DALE, *supra* note 14, at 136.

²⁹² R. DALE, *supra* note 14, at 136.

²⁹³ R. DALE, *supra* note 14, at 135-36; GROUP OF TEN, *supra* note 123, at 39.

²⁹⁴ Section 3 of the German Banking Act only prohibits banks from engaging in:

1. the conducting of deposit business if the majority of the depositors are persons employed by the enterprise (employee savings banks—*Werksparkassen*), unless other banking business is conducted which exceeds the scale of such deposit business;
2. the acceptance of sums of money if the majority of the lenders have a legal right to loans being granted to them or objects being supplied to them on credit out of these sums of money (savings enterprises for specific purposes—*Zwecksparkunternehmen*); this does not apply to building and loan associations;
3. the conducting of lending business or deposit business if, by agreement or in accordance with business practice, it is impossible or very difficult to withdraw the amount of the loan or the deposits in cash.

²⁹⁵ R. DALE, *supra* note 14, at 136; GROUP OF TEN, *supra* note 123, at 39.

²⁹⁶ GROUP OF TEN, *supra* note 123, at 39-40. The following statement best displays the advantages German banks gain from being able to invest in non-financial entities:

U.S. banks can only stare in envy at the iron bonds between industry and some European banks, such as Deutsche Bank. The West German institution owns . . . more than \$5 billion in a broad range of German industrial firms, including a controlling interest in Daimler-Benz, the nation's largest industrial firm. Deutsche Bank stock, says Solomon Brothers analyst Tom Hanley, "is like a mutual fund of West Germany's leading commercial enterprises." The institution is enormously profitable because it can not only engage in commercial banking but can

H. *Bank Examinations and Disclosure Requirements*

The Banking Act of 1961 permits the FBSO to conduct on-site examinations or to appoint external auditors to conduct examinations of FRG banks and foreign branches.²⁹⁷ Due to its limited staff, the FBSO generally appoints external auditors to examine banks who, in turn, file detailed reports of their findings with the FBSO.²⁹⁸ In addition to the auditor's report, the FBSO receives numerous other reports from banks which it uses for supervisory and statistical purposes.²⁹⁹

FRG banks are also required to prepare an annual balance sheet and income statement.³⁰⁰ Banks must compile a preliminary balance sheet and income statement within three months of each fiscal year end and complete a final audited balance sheet and income statement within five months of the fiscal year end.³⁰¹ Copies of both the preliminary and final audited statements must be filed with the FBSO and the Bundesbank.³⁰²

I. *Liquidity Support*

FRG banks and foreign branches in need of liquidity support have two options. The first and primary source of liquidity is the Bundesbank.³⁰³ The Bundesbank acts much like the U.S. Federal Reserve by rediscounting eligible instruments.³⁰⁴ Each institution,

also underwrite and trade securities and is a major player in the Euromoney markets, to which U.S. corporations are increasingly turning.
Work, *supra* note 1, at 53.

²⁹⁷ German Banking Act, *supra* note 250, at § 44.

²⁹⁸ Friesen, *supra* note 6, at 1100. Section 28(1) of the German Banking Act specifically authorizes the FBSO to appoint special auditors. Once appointed, § 29(1) of the German Banking Act empowers the auditors to "examine the financial circumstances of the bank and ascertain whether the bank has complied with the reporting requirements laid down in [the German Banking Act]."

If during the course of the audit, an auditor "learns of facts which might warrant the qualification or refusal of the certificate of audit, endanger the existence of the bank or gravely impair its development, or which indicate that the managers have seriously violated the law, the articles of association or partnership agreement," the auditor is required to immediately report these findings to the FBSO and the Deutsche Bundesbank (Bundesbank). German Banking Act, *supra* note 250, at § 29(2).

²⁹⁹ *Id.* at § 25; see GROUP OF TEN, *supra* note 123, at 43.

³⁰⁰ *Id.*

³⁰¹ German Banking Act, *supra* note 250, at § 26(1) (preliminary balance sheet and income statement within three months), § 27(1) (final audited balance sheet and income statement within five months).

³⁰² *Id.* at § 26(1).

³⁰³ GROUP OF TEN, *supra* note 123, at 45.

³⁰⁴ See *id.*

however, is prescribed a discount quota with the Bundesbank and, generally, may not exceed this quota.³⁰⁵

Because banks are limited in the amount they may borrow from the Bundesbank, the Bundesbank and the domestic banking industry combined in 1974 to form the second option, the Liquidity Consortium Bank (Liko Bank).³⁰⁶ The Liko Bank's function is to assist otherwise solvent banks which are experiencing temporary liquidity difficulties and are unable to borrow further from the Bundesbank.³⁰⁷ Because the Liko Bank's capital base is relatively small, however, it can only assist smaller institutions, and, to date, its facilities have been used very little.³⁰⁸

J. *Deposit Insurance*

The Banking Act does not provide for deposit insurance.³⁰⁹ The Federal Association of German Banks, however, has established the Deposit Guarantee Fund.³¹⁰ This fund protects deposits up to a limit, per depositor, of 30% of the member bank's equity capital.³¹¹ Membership in the fund is voluntary, and each member bank is assessed a membership fee of .003% of insurable deposit liabilities.³¹² Potential payout in the event of bank failure is limited to the size of the fund, and payment of funds is always discretionary.³¹³

K. *Competitive Disadvantage for United States Branches*

The German banking regulatory structure is less complex and, doubtless, more efficient than that existing in the United States. German banks are truly merchant and investment banks and

³⁰⁵ *Id.*

³⁰⁶ R. DALE, *supra* note 14, at 155; GROUP OF TEN, *supra* note 123, at 45; Friesen, *supra* note 6, at 1105. The Bundesbank owns 30% of the Liquidity Consortium Bank (Liko Bank). R. DALE, *supra* note 14, at 155.

³⁰⁷ GROUP OF TEN, *supra* note 123, at 45.

³⁰⁸ *Id.* The Liko Bank has DM250,000,000 paid-in capital and DM750,000,000 capital which is callable from member institutions. *Id.*

³⁰⁹ R. DALE, *supra* note 14, at 155; GROUP OF TEN, *supra* note 123, at 45.

³¹⁰ See SPECIAL SERIES, *supra* note 270, at 12.

³¹¹ R. DALE, *supra* note 14, at 155.

³¹² *Id.*; GROUP OF TEN, *supra* note 123, at 45. Membership is voluntary unless the FBSO makes it a prerequisite to obtaining a banking license pursuant to § 32(2) of the German Banking Act. GROUP OF TEN, *supra* note 123, at 45; see *supra* note 263 and accompanying text (discussing FBSO discretion in this area).

³¹³ R. DALE, *supra* note 14, at 155; GROUP OF TEN, *supra* note 123, at 45.

regularly engage in a broad spectrum of commercial, financial, and non-financial activities. By contrast, U.S. banks' foreign branches are constrained by U.S. law from engaging in many of these activities. The most obvious are the constraints imposed by the Glass-Steagall Act insofar as U.S. banks are forbidden from underwriting equities.

German banks are given latitude to participate in the economic life of Germany to an extent unimaginable for U.S. banks. For example, the Deutsche Bank owns a controlling interest in Daimler Benz, the West German industrial giant. Such arrangements would be inconceivable and certainly unlawful under the present U.S. regulatory structure. Imagine, to your horror or delight, Citicorp owning a controlling interest in General Electric.

German law *per se* does not provide for deposit insurance. As a condition precedent to obtaining a banking license, however, most U.S. banks' foreign branches are required to become members of the privately-created Deposit Guarantee Fund. Consequently, the German deposit insurance scheme provides German banks with no advantage in their ability to attract deposits.

L. *Summary of Foreign Banking Systems*

The sections of this Article which discuss the Japanese, British, and West German banking systems are, by necessity, lengthy in nature. As a result, the reader may at times have difficulty in comparing these systems on a meaningful basis. Accordingly, the table in Appendix I lists each regulatory area by country so the reader can quickly compare and contrast each country's regulation of U.S. branches.

V. RECOMMENDATIONS FOR CHANGE—U.S. REGULATION OF FOREIGN BRANCHES

As the foregoing review indicates, there currently exists little agreement among U.S., Japanese, British, and West German bank supervisory authorities' views toward regulation of banks in general, much less foreign branches of U.S. banks. This lack of regulatory consensus prevents international banking markets from operating at peak efficiency and, in addition, creates advantages for banks chartered by and operating in certain countries. Unfortunately, few, if any, of these advantages accrue to the benefit of U.S. banks' foreign branches. Rather, restrictive U.S. bank regulations act as a governor and prevent U.S. banks' for-

foreign branches from realizing their full competitive potential in international banking markets.

Examples of U.S. bank regulations which negatively affect foreign branches in some manner include reserve requirements on foreign branch deposits and limits on foreign branch lending in the host country. In addition, there is a prevailing fear that expanded foreign branch activity may, in some way, imperil the U.S. deposit insurance system despite the fact that foreign branch deposits are not insured. While changing these regulations and attitudes can be accomplished by the United States, such unilateral action is not prudent. Instead, these changes should be undertaken only after U.S. regulators have discussed them with bank regulators in other countries with a view toward harmonizing the international banking regulatory system. Accordingly, further discussion concerning these types of changes should be deferred until after presentation of recent efforts to coordinate international banking regulation.

There is, however, one regulation that stands alone in placing U.S. banks' foreign branches at a distinct disadvantage in international banking markets—the Glass-Steagall Act. The Glass-Steagall Act separates commercial banking from investment banking and effectively precludes foreign branches from offering many services normal to the banking business in the host country. The legislation which allows banks to operate foreign branches includes the Glass-Steagall Act's investment banking prohibition and states that the "foreign branch [may not] engage or participate, directly or indirectly, in the business of underwriting, selling, or distributing securities."³¹⁴ Because prohibitions similar to the Glass-Steagall Act are incident to the banking systems of very few countries, the United States should unilaterally repeal the Glass-Steagall Act, at least to the extent it affects foreign branch operations. Recognizing the obsolescence of the Glass-Steagall Act, no less an authority than Alan Greenspan, Chairman of the Board of Governors of the FRS has stated:

The key reform needed . . . is, of course, repeal of the Glass-Steagall separations of commercial and investment banking.

³¹⁴ 12 U.S.C. § 604(a) (1986). U.S. banks are permitted to participate in international investment banking through subsidiaries. 12 C.F.R. § 211.5(d)(13) (1989). Foreign subsidiaries, however, are not as large or as well capitalized as foreign branches making them a less than ideal vehicle from which to conduct investment banking activities. *See supra* notes 22, 71 (discussing the ability of U.S. banks to engage in investment banking activities).

The provision of investment banking services, particularly to corporate clients, is on the cutting edge of the information revolution. Repeal of Glass-Steagall would allow banking organizations to evolve with technology and the market, and would provide real public benefits from increased competition and from possible economies of scale and scope. Maintenance of the current environment, on the other hand, will force us to incur unnecessary costs as the specialized resources of banking organizations are transferred into other activities or businesses—not because of banks' unwillingness to compete or innovate, but simply because of an *inflexible statutory and regulatory structure*.³¹⁵

While repeal of the Glass-Steagall Act, at least in the context of foreign branches, is a viable and enticing thought, the mechanics of such a repeal would be extremely complicated.³¹⁶ Specifically, the parent bank would have to be insulated from the perceived risks resulting from the foreign branch's investment banking activities. Such insulation could be accomplished by requiring the bank to install firewalls between the bank and its foreign branches.³¹⁷ A firewall is essentially a restriction on activities between a bank and any related entity engaged in investment

³¹⁵ Greenspan, *Innovation and Regulation of Banks in the 1990's*, 74 Fed. Res. Bull. 783, 785–86 (1988) (emphasis added); *but see* Cane, *supra* note 19, at 164 (“[i]t’s ironic that all the trumpeting now of these [regulatory] protections stemming from 1929 is being done by the same sources that have been trying to get rid of them and remove all inhibitions on the free markets”) (quoting Silk, *Volker on the Crash*, N.Y. Times, Nov. 8, 1987, [Magazine], at 48, col. 3).

³¹⁶ The political repercussions which would accompany the repeal of Glass-Steagall, however, may not be as great as previously thought. This is due in large part to a recent policy reversal by the Securities Industry Association (SIA). Specifically, on December 1, 1989, the SIA released a proposal for restructuring the financial services industry which would allow “non-federally insured units of U.S. banking organizations [referred to as ‘Investment Banking Financing Companies’] to engage in a broad range of securities and securities-related activities [currently prohibited by the Glass-Steagall Act] . . .” Securities Industry Association, Media Release 1 (Dec. 1, 1989). In return for allowing U.S. banks broader securities powers, the SIA proposal will allow securities firms to have “some access to the Federal Reserve payments system, emergency borrowing, [and] consumer banking rights.” *Id.* For a more complete discussion of the SIA proposal, see *SIA Offers Glass-Steagall Compromise; BHC Group Suggests Meeting With SIA*, 21 Sec. Reg. & L. Rep. (BNA) No. 48, at 1797 (Dec. 8, 1989).

³¹⁷ See SENATE COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, REP. ON THE FINANCIAL MODERNIZATION ACT OF 1988, S. REP. NO. 305, 100th Cong., 2d. Sess. (1988), *reprinted in* [1988] Fed. Sec. L. Rep. (CCH) (April 6, 1988) [hereinafter *Modernization Act*].

While the Financial Modernization Act of 1988 (*Modernization Act*) was overwhelmingly approved by the Senate, it met with substantial resistance in the House of Representatives. See *Inaction by Congress on Financial Reform Laws Is Draining Economy, Proxmire Warns*, [July-Dec.] 51 Banking Rep. (BNA) No. 17, at 738 (Oct. 31, 1988).

banking activities.³¹⁸ The purpose of a firewall is threefold: to require the bank to make impartial credit decisions, to prevent the affiliate engaged in investment banking activities from obtaining a funding advantage due to the availability of deposit insurance to the bank's creditors, and to prevent the extension of deposit insurance coverage to investment banking activities.³¹⁹ The types of regulations that amount to firewalls which satisfy these purposes include:

1. No extension of credit from the parent bank to the foreign branch for the purpose of funding the foreign branch's investment activity;
2. No extension of credit from the parent bank to any individual or business entity when the funds are to be used for repayment of interest or principal, or for paying dividends on any securities underwritten by that bank's foreign branch;
3. No extension of credit from the parent bank to any individual or business entity when the funds are to be used for purchasing securities underwritten by that bank's foreign branch;
4. No extension of credit from the parent bank to an issuer of securities or any entity affiliated with the issuer when such securities have been or are being underwritten by the bank's foreign branch;
5. The parent bank may not purchase securities in which its bank has acted as underwriter, either for its own account or as trustee, until at least 60 days have passed since the underwriting period ended;
6. The parent bank may not offer any investment advice or opinion concerning any securities underwritten by its foreign branch until at least 60 days have passed since the underwriting period ended;
7. The foreign branch must prominently display on all securities transactions that such transactions are not covered by any United States-sponsored insurance program, including, but not limited to, the Federal Deposit Insurance Corporation and the Security Investor Protection Program; and
8. No foreign branch shall be allowed to engage in any investment banking activity if the consolidated capital position of the parent bank or bank holding company is below the risk-based capital guidelines then in force.³²⁰

³¹⁸ See Modernization Act, *supra* note 317, at 17.

³¹⁹ See *id.*

³²⁰ These firewall provisions are based upon similar provisions in the Modernization Act, *supra* note 317, at 300-02. There are, however, substantive differences in the operation of each set of firewalls.

The Modernization Act employed the "separate-affiliate" concept wherein all permis-

Together, the foregoing firewalls should sufficiently insulate the bank and foreign branch from the majority of perceived risks associated with investment banking activity. They may, however, present other problems for the bank and foreign branch. If the firewalls are seen as highly restrictive of activities between the bank and the foreign branch by the host country bank regulators, the foreign branch may be reclassified as a subsidiary of the bank. Such reclassification may subject the branch to differing regulatory treatment which could offset any gain associated with the branch's newly created investment banking abilities. Moreover, even if the foreign branch is not reclassified by host country regulators as a subsidiary, they may perceive it to be a much greater threat to the competitiveness of their own banks. Consequently, the regulators may restrict the foreign branch's activities to such a point as to render its investment banking freedom moot.

VI. ATTEMPTS TO COORDINATE INTERNATIONAL BANK SUPERVISION

For many years, there existed no group charged with coordinating international banking regulation, and the predictable results are, as U.S. banks' foreign branches know, banking regulations among countries which are difficult, if not impossible, to reconcile. This situation was first addressed in 1974 when the Bank for International Settlements (BIS)³²¹ appointed the Com-

sible bank securities activities would be conducted in non-FDIC insured affiliates, none of which would be allowed to engage in deposit-taking activities. See Isaac & Fein, *supra* note 5, at 300-02. Unlike the Modernization Act, this Article proposes to allow deposit-taking foreign branches to engage in investment banking activities to the same extent as banks organized in the host country or branches in the host country which are organized under the laws of another country; provided, however, that these foreign branches have deposit insurance from the host country.

For a discussion opposing the use of many firewalls advocated herein, see *Those Nasty Firewalls*, 8 BANKING EXP. REP. 16 (Oct. 2, 1989) (arguing that certain types of firewalls are inconsistent with the manner in which the banking and securities industries are regulated outside the United States and that such firewalls "will impair the efficient delivery of corporate financial services are unnecessary to maintain the safety and soundness of banking organization").

³²¹ The Bank for International Settlements (BIS) is located in Basel, Switzerland. It was formed in 1930 as an organization of central banks. The purpose of forming the BIS was twofold: (1) "to promote the co-operation of central banks and to provide additional facilities for financial operations," and (2) "to act as trustee or agent in regard to international financial settlements (i.e. World War I reparations) entrusted to it under agreements with the parties concerned." See REPORT TO CONGRESS BY THE SECRETARY OF THE TREASURY, THE CHAIRMAN OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM,

mittee on Bank Regulation and Supervisory Practices (hereinafter Cooke Committee).³²² The Cooke Committee consists of central bank representatives from the Group of Ten countries.³²³ The Cooke Committee's purpose is to provide a forum where central

AND THE SECRETARY OF STATE ON UNITED STATES MEMBERSHIP IN THE BANK FOR INTERNATIONAL SETTLEMENTS 1 (1984).

The BIS currently operates as a forum where central bankers can meet and discuss issues of common concern and as an international financial institution. It is not, however, an international lender of last resort. Hackney & Shafer, *The Regulation of International Banking: An Assessment of International Institutions*, 11 N.C.J. INT'L L. & COM. REG. 479, 487 (1986).

³²² The committee is referred to as the Cooke Committee because of the significant progress it made during the tenure of its second chairman, Peter Cooke, who was also head of the Bank of England.

³²³ Hackney & Shafer, *supra* note 321, at 487. The Group of Ten consists of the United States, the United Kingdom, Canada, France, West Germany, Italy, the Netherlands, Belgium, Sweden, and Japan. *Id.* at 487 n.51. The following organizations from these twelve countries and the United Nations are members in the Cooke Committee:

Table D.

Country	Representative Organization(s)
Belgium	National Bank of Belgium Banking Commission
Canada	Bank of Canada Office of the Inspector General of Banks
France	Bank of France Banking Commission
Germany	Deutsche Bundesbank Federal Banking Supervisory Office
Italy	Bank of Italy
Japan	Bank of Japan Ministry of Finance
Luxembourg	Luxembourg Monetary Institute
Netherlands	The Netherlands Bank
Sweden	Sveriges Riksbank Royal Swedish Banking Inspectorate
Switzerland	Swiss National Bank Swiss Federal Banking Commission
United Kingdom	Bank of England
United States	Federal Reserve Board Federal Reserve Bank of New York Office of the Comptroller of the Currency Federal Deposit Insurance Corporation
Secretariat	Bank for International Settlements

bankers can meet and discuss policy issues which affect domestic supervision of international lending.³²⁴ The Cooke Committee's first meeting in 1975 produced the seminal document which attempted to coordinate international banking supervisory efforts—the Basle Concordat.

A. *The Basle Concordat*

The Basle Concordat (Concordat) establishes broad guidelines within which international supervisory authorities should function.³²⁵ The Concordat's objectives are simple and straightforward: no foreign financial institution should escape supervision, and whatever supervision it receives "should be adequate."³²⁶ To accomplish these objectives, the Concordat set forth the following five principles:

- (1) The supervision of foreign banking establishments should be the joint responsibility of host and parent authorities;

The Cooke Committee was formed largely as a response to the 1974 failure of West Germany's largest private bank, I.D. Herstatt, as well as the failure of two state banks, Hessische Landesbank Girozentrale and Westdeutsche Landesbank Girozentrale. All three failures were primarily caused by the banks' international operations. See J. BAKER, INTERNATIONAL BANK REGULATION 15 (1978); Norton, *supra* note 76, at 1336.

³²⁴ Friesen, *The Regulation and Supervision of International Lending* (Pt. 2), 20 INT'L LAW. 153, 205 (1986). Specifically, the Cooke Committee has three objectives: (1) to provide a forum where central bankers can meet and develop closer communication leading to mutual cooperation; (2) to formulate consistent guidelines for supervising banks' foreign offices/activities; and (3) to objectively examine risks arising from international banking. GENERAL ACCOUNTING OFFICE, INTERNATIONAL COORDINATION OF BANK SUPERVISION: THE RECORD TO DATE 2, 15 (1986). In accomplishing the foregoing objectives, the Cooke Committee's approach has been characterized in the following manner:

The committee does not undertake a formal supernational supervisory role; its conclusions do not have, and were never intended to have, legal force. Rather, it formulates and recommends broad supervisory principles and guidelines of the best practices in the hope and expectation that individual authorities will take steps to implement them through detailed arrangements—statutory or otherwise—which are best suited to their own national systems. In this way the committee encourages some gradual convergence towards a common approach and common standards without attempting far reaching harmonization of members countries [sic] supervisory techniques.

Norton, *supra* note 76, at 1337 (quoting W. COOKE, BASEL SUPERVISORS COMMITTEE 1 [1984]).

³²⁵ Hackney & Shafer, *supra* note 321, at 489.

³²⁶ *Id.*

(2) No foreign banking institution should escape supervision, each country should ensure that foreign banking establishments are supervised, and supervision should be adequate as judged by both the host and parent authorities;

(3) The supervision of liquidity should be the primary responsibility of host authorities since foreign establishments generally have to conform to local practices for their liquidity management and must comply with local regulations;

(4) The supervision of solvency of foreign branches should be essentially a matter for the parent authority. In the case of subsidiaries, while primary responsibility lies with the host authority, parent authorities should take account of the exposure of their domestic banks' moral commitment in this regard; and

(5) Practical cooperation would be facilitated by transfers of information between host and parent authorities and by granting of permission for inspections by or on behalf of parent authorities on the territory of the host authority. Every effort should be made to remove any legal restraints (particularly in the field of professional secrecy or national sovereignty) which might hinder these forms of cooperation.³²⁷

The Concordat represents a crucial step toward the coordination of international banking supervision. Soon after its release, however, several of the Concordat's shortcomings became readily apparent. For instance, the Concordat's proposal that host authorities should have primary responsibility for regulating a foreign subsidiary's solvency conflicted with a 1978 recommendation by the Group of Ten that supervision of international banking institutions should be performed on a consolidated basis.³²⁸ Furthermore, the Concordat failed to address problems posed by each country's differing level of supervisory standards as well as to define what constituted "adequate" supervision.³²⁹ Consequently, the Cooke Committee met in 1983 to revise the original Concordat.

B. *The Revised Concordat*

The revised Concordat attempts to address problems inherent in the original Concordat without contradicting the original doc-

³²⁷ Cooke, *Evolving Techniques for Cooperation Among Supervisory Authorities*, 3 J. COMP. L. & SEC. REG. 46, 48 (1981).

³²⁸ R. DALE, *supra* note 14, at 173.

³²⁹ *Id.*

ument's guidelines and principles.³³⁰ In so doing, the revised Concordat differs from the original Concordat in three ways:

First, [the revised Concordat] incorporates the principles of consolidated supervision. Supervisors cannot be assured of an individual bank's soundness without knowing that the banking group, comprised of the parent, branches, and subsidiaries, has not assumed total commitments and risks that are disproportionate to the group's capital base. The consolidated supervision proposed in the revised Concordat applies to country risk exposure as well as capital adequacy. Second, [because] supervisory gaps have resulted from inadequate supervisory standards in certain countries . . . [t]he revised Concordat clarifies that host-country and parent-country central banks jointly share responsibility for supervising branches and subsidiaries with respect to liquidity; however, regarding solvency, parent central banks supervise, while joint parent-host supervision is required for subsidiaries. Third, the revised Concordat explicitly states what was implicit earlier: the central banks will not necessarily act as lenders of last resort.³³¹

Clearly, the revised Concordat improved and strengthened the original agreement by delineating the parent country and host country supervisory responsibilities. It did not, however, establish any standardized bases from which to regulate international banking. The necessity of such a standard and concern about declining levels of capital in international banks led the Cooke Committee in 1987 to announce an agreement by central bank governors from twelve industrialized nations proposing an international risk-based capital system of banking regulation.³³²

C. *Risk-Based Capital Proposal*

The risk-based capital proposal is designed to accomplish two objectives the Cooke Committee believes are of the utmost importance in order to stabilize global financial markets.³³³ First, the proposal seeks to strengthen the financial position of international banks by requiring them to maintain higher levels of

³³⁰ Note, *The Proposed Risk-Based Capital Framework: A Model of International Banking Cooperation?*, 11 *FORDHAM INT'L L.J.* 777, 781-82 n.31 (1988).

³³¹ Hackney & Shafer, *supra* note 321, at 489-90.

³³² Note, *supra* note 330, at 777-78. The twelve industrialized nations include the Group of Ten Nations, Switzerland, and Luxembourg. *Id.*; see *supra* note 323 for a list of the Group of Ten Nations.

³³³ See Note, *supra* note 330, at 783.

capital.³³⁴ Second, the proposal attempts to put international banks in *pari passu* by removing existing differences in various national regulatory schemes.³³⁵ In so doing, the proposal contains a uniform definition of capital, a risk-based capital ratio, and a common minimum capital adequacy ratio.³³⁶

1. Uniform Definition of Capital

Currently, there is no consensus among nations as to what constitutes capital.³³⁷ The proposal corrects this situation by establishing a uniform definition of capital called adjusted primary capital.³³⁸ Adjusted primary capital is determined by utilizing four factors which comprise a bank's capital base: tier 1 capital, tier 2 capital, goodwill, and investments in other financial institutions.³³⁹ The following equation illustrates how adjusted primary capital would be computed:

Table IV.

$$\begin{aligned} \text{Adjusted Primary Capital} = & \\ & [(\text{Tier 1 Capital} - \text{Goodwill}) + \text{Tier 2 Capital}] \\ & \quad - \text{Investing In Other Businesses} \end{aligned}$$

2. Risk-Based Capital Ratio

The risk-based capital ratio measures a bank's risk-weighted asset base in relation to its adjusted primary capital.³⁴⁰ The purpose of this ratio is to quantify various on- and off-balance sheet risks which can affect a bank's level of capital adequacy.³⁴¹ Com-

³³⁴ *Id.*

³³⁵ *Id.*

³³⁶ *Id.*

³³⁷ See *supra* notes 36, 128, 196, 259 and accompanying text.

³³⁸ Note, *supra* note 330, at 784.

³³⁹ *Id.* at 784–85. Tier 1, or core capital, is composed of equity capital and reserves computed from after-tax retained earnings. Tier 1 capital must represent at least 50% of a bank's adjusted primary capital.

Tier 2, or supplementary capital, consists of hidden reserves created by revaluing assets, general loan loss reserves, hybrid debt/equity instruments, and subordinated debt instruments. Certain components of Tier 2 capital may not receive full value in computations for adjusted primary capital.

Goodwill is an intangible asset which is generally created when an asset is purchased at a price exceeding its book value. Outside of certain tax consequences and justifying an asset's purchase price on a balance sheet, goodwill is of little practical value to a company. For an in-depth discussion of adjusted primary capital and its components, see *id.* at 784–85 nn.53–56.

³⁴⁰ *Id.* at 784.

³⁴¹ *Id.* at 785–86.

puting the risk-based capital ratio is a complex process but essentially involves three steps. First, a risk-weighted asset figure is computed by multiplying both on- and off-balance sheet items by a risk-adjusting factor.³⁴² Next, the sum of these risk-weighted assets is adjusted upward for loan and lease loss allowances.³⁴³ This sum is called a bank's risk-weighted asset base.³⁴⁴ Finally, the risk-weighted asset base is divided into adjusted primary capital, and the resulting figure is the bank's risk-based capital ratio.³⁴⁵

3. Common Minimum Capital Adequate Requirement

The third prong of the proposal is a common minimum capital adequacy requirement. Capital adequacy is a minimum amount of capital expressed as a percentage of assets which a bank must maintain to protect it against unforeseen losses.³⁴⁶ The Cooke Committee has determined that by 1992, banks must have a

³⁴² *Id.* at 785. A bank's on-balance sheet items are its assets (including loans, securities, etc.). A bank's off-balance sheet items may include guarantees, floating rate notes, letters of credit, and swaps (both interest rate and currency). A bank's off-balance sheet items are included in its capital adequacy computation because these items expose the bank to tremendous credit and interest rate risk. *Id.*

³⁴³ *Id.* at 786–87. The weighting multiples are based on the perceived risk inherent in each item. The higher the perceived risk of an item, the higher a multiple it receives. This results in the bank having to maintain a proportionately higher level of capital for higher risk items. For instance, cash balances are considered a no-risk item and, accordingly, are afforded a 0% multiple. Conversely, private sector loans are considered a high risk item and receive a 100% multiple. *Id.* at 788 n.75.

³⁴⁴ *Id.*

³⁴⁵ The proposal gives supervisory authorities the latitude to adjust a bank's risk weighted asset base if, in their professional opinion, the bank's capital adequacy is significantly different from what the risk-based capital ratio shows. *See id.*

³⁴⁶ *Id.* at 786–88. Obviously, this is a gross oversimplification of an exceedingly complex process. The calculation of the risk-based capital ratio is succinctly described as follows:

Off-balance sheet items are weighted according to risks through a two-step process. First, they are converted into credit risk equivalents by multiplying principal amount by a credit-risk conversion factor. Off-balance sheet instruments are divided into five broad categories according to credit risk. The category determines which credit-risk conversion factor is to be applied. Second, the on-balance sheet credit-risk equivalents are assigned a risk-weight also according to the degree of credit risk to the obligor. The proposal establishes five broad categories of risk weights: 0%, 10%, 20%, 50%, and 100%. The greater the risk of the asset, the higher the risk weight assigned. On-balance sheet items go through a one-step process that is identical to the second step of the off-balance sheet process . . . [the sum of the risk-adjusted on-balance and off-balance sheet items of the weighted risk-asset base.] The result of dividing adjusted primary capital (the numerator) by the weighted risk-asset base (the denominator) is the so-called risk-based capital ratio

Id. at 786–89.

minimum capital adequacy of 8%, as calculated by the previously discussed risk-based capital ratio.³⁴⁷ Regulators worldwide are currently adopting the proposal with little or no change to its structure.³⁴⁸

D. *The Second Banking Directive*

The most recent legislative attempt to coordinate international banking occurred on December 15, 1989, when the European Community's (Community) finance ministers approved the Second Banking Directive.³⁴⁹ The directive establishes criteria by which a member state can authorize a bank's establishment within its borders.³⁵⁰ Once a bank has received such home country authorization, it can establish additional operations in any member state without having to submit to further registration procedures.³⁵¹ Significantly, the types of operations the bank may es-

³⁴⁷ *Id.* at 789.

³⁴⁸ The phrase "with little or no change to its structure" is meant to indicate that each country's bank regulators must tailor the risk-based capital guidelines to the nuances inherent in that country's financial structure. For instance, certain intangible assets, such as purchased mortgage servicing rights, are a popular bank asset in this country but do not exist in other countries. Consequently, U.S. regulators are given discretion in customizing this country's risk-based capital guidelines to account for this type of difference. *See* Norton, *supra* note 76, at 1346-47.

For an explanation of the final risk-based capital guidelines in the United States, see Risk-Based Capital Guidelines, 54 Fed. Reg. 4168 (1989) (to be codified at 12 C.F.R. Part 3), *Capital; Risk-Based Capital Guidelines*, 4186 (to be codified at 12 C.F.R. Parts 208 and 225), Capital Maintenance; Final Statement of Policy on Risk-Based Capital, 11500 (to be codified at 12 C.F.R. Part 325).

³⁴⁹ 30 O.J. EUR. COMM. (No. L 386) 1 (1989). The European Community (Community) legislates policy changes in two ways—regulations and directives. The distinction between the two methods is as follows:

A *regulation* is binding in its entirety and is directly applicable throughout the Community without any implementing legislation by the member states. By contrast, a *directive* is addressed to member states, which are obligated to ensure that the result set forth in the directive is achieved but have some discretion as to the details of its implementation.

Most of the EC internal market legislation is in the form of directives. Each directive specifies a date by which the member states must conform their national laws to the provisions of the directive; typically the states have two years to do so. Therefore, to complete the internal market by the end of 1992, directives would need to be enacted by the end of 1990.

Key, *Mutual Recognition: Integration of the Financial Sector in the European Community*, 75 Fed. Res. Bull. 591, 594 (1989) (emphasis in original).

³⁵⁰ *Council of Ministers Approves Single Banking License, Minimum Solvency Ratios*, 53 Banking Report (BNA) No. 25, at 994 (Dec. 25, 1989).

³⁵¹ *Id.* The Directive provides that banks chartered in countries which are not members of the Community shall be treated as Community banks if they are authorized to conduct business in a Community country prior to January 1, 1993. After that date, home country

establish in other member states is controlled by the laws of the country which granted home country authorization rather than the state into which expansion is sought.³⁵² Thus, once the directive is implemented, banks which currently engage in investment banking activities only in the United Kingdom or West Germany may engage in these activities throughout the Community. This expansion of investment banking activities will adversely affect U.S. banks' foreign branches in two ways.

Initially, as British and West German banks engage in potentially lucrative investment banking activities across Europe, their ties to the industrial sector will become stronger as will their fiscal position. Meanwhile, unless the previously discussed amendments to the Glass-Steagall Act are adopted, U.S. banks' foreign branches will be unable to participate in these newly-opened markets, and they will become even less competitive in European financial markets.

authorization for a non-Community country bank will be conditioned upon the country in which such bank is chartered meeting certain reciprocity provisions. *Id.*

³⁵² Statement by Manuel H. Johnson, Vice Chairman of the Board of Governors of the Federal Reserve System, before the Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the Committee on Banking, Finance, and Urban Affairs, U.S. House of Representatives (September 26, 1989), *reprinted in* 75 Fed. Res. Bull. 744, 745 (1989) [hereinafter Statement by M. Johnson].

The list of activities subject to mutual recognition by Community countries, however, is limited by the terms of the directive to the following activities:

1. Acceptance of deposits and other repayable funds from the public.
2. Lending (including consumer credit, mortgage credit, factoring, with or without recourse, and financing of commercial transactions).
3. Financial Leasing.
4. Money transmission services.
5. Issuing and administering means of payment (*e.g.*, credit cards, travellers' cheques and bankers' drafts).
6. Guarantees and commitments.
7. Trading for own account or for account of customers in:
 - (a) money market instruments (cheques, bills, CD's, etc.);
 - (b) foreign exchange;
 - (c) financial futures and options;
 - (d) exchange and interest rate instruments;
 - (e) transferable securities.
8. Participation in share issues and the provision of services related to such issues.
9. Advice to undertakings on capital structure, industrial strategy and related questions and advice and services relating to mergers and the purchase of undertakings.
10. Money broking.
11. Portfolio management and advice.
12. Safekeeping and administration of securities.
13. Credit reference services.
14. Safe custody services.

Annex to the Second Banking Directive, 30 O.J. Eur. Comm. (No. L 386) 1, 13 (1989).

This competitive disadvantage will then increase as member states begin to align their banking laws. This process, known as regulatory convergence, will occur in member states whose current banking laws are more restrictive than either the United Kingdom's or West Germany's.³⁵³ As these countries realize that the directive has placed their banks at a disadvantage in relation to British or West German banks, legislators in these countries will quickly take steps to liberalize their banking laws so that such laws more closely resemble those of the United Kingdom and West Germany. The net result of these actions will be increased investment banking activities for banks chartered in member states and a further weakening of U.S. banking presence in Europe.

VII. RECOMMENDATIONS FOR CHANGE—INTERNATIONAL REGULATION OF FOREIGN BRANCHES

The Cooke Committee's risk based capital proposal represents the most significant step ever taken toward coordinating the regulation of international banking on a world-wide basis. Before the end of 1992, there will exist a common denominator in the measurement of banks' fiscal strength in the Group of Ten nations, as well as in Luxembourg and Switzerland, because banks in each country will be subject to relatively uniform capital guidelines. By contrast, the Community's Second Banking Directive only attempts to coordinate the regulation of international banking within Community banking markets. While the directive may ultimately result in uniform banking activities throughout the world, its immediate effect will be to put U.S. banks' foreign branches at a competitive disadvantage when compared to many of their counterparts in the Community. Specifically, the directive will allow British and West German banks to offer investment banking activities throughout the Community while U.S. banks' foreign branches will continue to be hamstrung by the Glass-Steagall Act which forbids them from underwriting, distributing, or selling securities. As previously discussed, this disparity in permissible banking activities cannot be allowed to exist, and the Glass-Steagall Act must be repealed to the extent it applies to U.S. banks' foreign branches.

³⁵³ See Statement by M. Johnson, *supra* note 352, at 747.

In addition, numerous other areas of international banking regulation remain in a state of disarray which negatively affects the competitiveness of U.S. banks' foreign branches. Several steps must be taken to remedy this situation.

A. *Liquidity Control*

First, several of the provisions contained in the Concordat and the revised Concordat should be codified by each country and be enforced by that country's bank regulators. Specifically, because a foreign branch's liquidity is necessarily a local concern affected by local events, supervision of foreign branch liquidity should be performed by regulators in the host country. Once host countries assume supervision of liquidity, it will be unnecessary to subject U.S. banks' foreign branches to U.S. reserve requirements.³⁵⁴ The removal of reserve requirements will immediately lower a U.S. bank's foreign branches' operating costs because it will enable such branch to convert a greater percentage of its deposits into interest earning assets rather than requiring them to sit idle. This will allow the U.S. bank's foreign branches to compete more effectively against host country banks which are not subject to U.S. reserve requirements. Of course, whether this would lower effective reserve requirements in such a manner as to create competitive inequality among the U.S. bank holding companies should first be examined. Similarly, because reserve requirements are a means by which the Board of Governors of the FRS implements monetary policy, potential macroeconomic effects should also be considered.

B. *Examination*

Furthermore, as the Basle Concordat and the revised Concordat stress, the supervision of a foreign branch's solvency should be performed on a consolidated basis by regulators in the bank's parent country. Because the bank's head office and the majority of its corporate records are generally located in the parent country, that country's regulators have easier access to all pertinent records concerning the bank's worldwide activities. Because one regulatory authority can scrutinize all transactions, a higher level of regulatory confidence should exist concerning a bank's true

³⁵⁴ See *supra* notes 83-93 and accompanying text (discussion of reserve requirements).

financial position. There must be open lines of communication between regulators in the parent country and the host country concerning not only the individual banks and branches, but also events within each country which may affect financial markets in general.³⁵⁵ Given the recent events concerning uniform capital adequacy guidelines, such open communication among bank regulators may become a reality in the next few years.

C. *Foreign Branch Lending*

Nevertheless, numerous regulatory areas exist which the Basle Concordat and the revised Concordat do not directly address. Specifically, a foreign branch's lending activities should be supervised by regulators in the parent country. The rationale supporting this position is simple. As previously mentioned, regulators in the parent country would already have responsibility for supervising a foreign branch's solvency. Solvency is directly related to lending activities in which a financial institution engages. Accordingly, in order to meaningfully regulate solvency, it is imperative that the parent country also regulate lending activities. Although lending limits will vary among banks and foreign branches in a particular country, the effect this variance will have on competition will be minimal in relation to the benefits which accrue by allowing the parent country to regulate both solvency and lending activities on a consolidated basis. Ideally, capital adequacy, solvency, and lending activities will each be uniform among nations.

D. *Foreign Exchange Control*

Unlike lending activities, the foreign exchange activities in which a foreign branch is allowed to engage should be regulated by the branch's host country. As with liquidity controls, foreign exchange activities are determined by forces which are local in nature, especially a host country's monetary policy. Consequently, the host country's regulators are in a much better position to

³⁵⁵ The impact of communication among bank regulators concerning bank solvency can have far-reaching effects. Complete candor among bank regulators can eventually lead to a more harmonized country risk evaluation system for international lending. Furthermore, this communication may eventually lead to better coordinated disclosure requirements enabling banks and foreign branches to generate one set of reports which satisfy multiple regulatory authorities.

analyze and regulate foreign exchange activities not only because of their familiarity with their country's economic policies and forces, but also because of their proximity to where the activities occur.

E. *Deposit Insurance*

Finally, deposit insurance should also be the responsibility of the foreign branch's host country. By requiring host country deposit insurance (to the extent it exists in the host country), no deposit will be uninsured and each country's deposit insurance scheme can statistically account for the perceived risk of the activities allowed in its banking system. For instance, deposits at U.S. banks' foreign branches located in Japan are currently not covered by the FDIC or the Japanese Deposit Insurance Corporation. Requiring host country deposit insurance will rectify this situation and place U.S. banks' foreign branches on more equal footing, both in the eyes of Japanese depositors and in the cost of its deposit insurance. Once this step is taken, however, U.S. regulators must make it clear that deposits at banks or foreign branches not located in the United States will not receive U.S. insurance coverage in the event of bank failure.³⁵⁶

CONCLUSION

Many changes must be made before the regulation of U.S. banks' foreign branches is coordinated and equalized with those of their host country competitors. The majority of these changes are beyond the exclusive control of the United States and its regulators. While changes in regulatory areas such as lending limits, liquidity, reserve requirements, and deposit insurance would be beneficial to the competitiveness of U.S. banks' foreign branches, such changes would be most effective if they were coordinated with foreign banking authorities. The Glass-Steagall Act, the major competitive barrier to U.S. banks' foreign branches, is, however, within the exclusive province of the U.S. regulatory process.

We recommend dismantling the Glass-Steagall Act in the context of foreign branches' securities activities provided that certain

³⁵⁶ See *supra* note 97 (discussing the insurance coverage extended to "non-insured" foreign deposits in the Continental Illinois National Bank failure).

firewalls are installed and maintained. Such a recommendation is prudent not only because it would allow U.S. banks to compete on equal terms overseas, but it is also congruent with current regulatory posture concerning the securities activities of banks and bank holding companies.

Specifically, on January 18, 1989, the Board of Governors of the FRS conditionally approved the applications of five U.S.-based multinational bank holding companies to allow their affiliates (but not the banks or their branches) to engage in limited underwriting of debt and equity securities.³⁵⁷ This approval seems to domesticate the FRB's policy of allowing foreign subsidiaries of U.S. banks and bank holding companies to engage in securities activities overseas.³⁵⁸ Moreover, it fortifies an already clear trend toward greatly expanded bank securities activities. With certain firewalls in place, allowing foreign branches to underwrite debt and equity securities is the logical, and required, next step.

Nevertheless, critics will downplay the effectiveness of the recommended firewalls and will cite increased vulnerability of the federal deposit insurance fund as a rationale for not allowing foreign branches to engage in these securities activities.³⁵⁹ This rationale, however, is flawed in the international context. First, deposits of a U.S. bank's foreign branch are excluded from calculations used to determine the bank's deposit insurance premium.³⁶⁰ Therefore, such deposits are not insured by the FDIC and are unprotected in the event the foreign branch fails.³⁶¹ Accordingly, foreign branch securities activities should not expose our federal insurance deposit fund to any additional risks. Second, foreign branch deposits should be covered by the host country's deposit insurance system as suggested by the Basle Concordat.³⁶² The deposit insurance systems in foreign countries already

³⁵⁷ *January 18th Approval*, *supra* note 22.

³⁵⁸ See 12 C.F.R. § 211.5(d)(3) (1989) (subsidiaries of a bank holding company may engage in the "underwriting, distributing, and dealing in debt and equity securities outside the United States . . ."); see *supra* note 71 (discussing the application of this provision).

³⁵⁹ See, e.g., GENERAL ACCOUNTING OFFICE, *BANK POWERS: INSULATING BANKS FROM THE POTENTIAL RISKS OF EXPANDED ACTIVITIES* (1987). As one commentator has noted, the primary concern of this study "was the potential for increased risks to the federal deposit insurance fund through expanded non-traditional banking activities by *FDIC-insured* banks." Cane, *supra* note 19, at 170 (emphasis added).

³⁶⁰ 12 U.S.C.A. § 1817(b)(5) (West 1989).

³⁶¹ 12 U.S.C.A. § 1813(m)(1) (West 1989).

³⁶² See *supra* note 345 and accompanying text (discussing the benefits of host country deposit insurance).

presumably take into account the risks of underwriting securities as these activities are being undertaken by their domestic banks. If deposits of U.S. banks' foreign branches were routinely insured by the host country, this would also mean that the FDIC would be more effectively insulated from claims arising from foreign branch failure. Although the FDIC is not required to cover foreign deposits, it has done so in the past without receiving insurance premiums.³⁶³ This *ad hoc* approach would no longer be necessary.

U.S. legislators must take the initiative and repeal the Glass-Steagall Act, at least in the context of foreign branch investment banking activity. Only simultaneous repeal of the Glass-Steagall Act and multilateral coordination of banking regulation would allow the United States to regain its preeminence in the international banking arena.

³⁶³ See Sprague, *supra* note 97, at 144-46 (discussing payment to foreign depositors in conjunction with the Continental Illinois National Bank failure).

Appendix I. Regulatory Areas by Country

	Market Entry	Capital Adequacy
Japan	United States banks enter Japan primarily through branches. Potential entrants must apply to the Ministry of Finance (MOF) for a banking license. Criteria the MOF considers for granting such licenses include: financial resources, banking expertise, proposed business plan, economic need, and reciprocity.	No statutory criteria exist for capital adequacy. However, the MOF suggests that: (1) shareholder equity, loan loss reserves, reserves for return allowances, and special reserves should equal 10% of demand deposits; (2) total loans should not exceed 80% of deposits; and (3) the bank's operational fixed assets should not exceed 50% of net worth.
United Kingdom	Entrants must notify the Bank of England (BOE) two months before branch operations are to begin. Entrants are generally not required to meet individual capital adequacy requirements, but the BOE will view a consolidated assessment of the bank's financial soundness and management capability made by the bank's primary supervisory authority.	No statutory criteria exist for capital adequacy. However, the BOE utilizes two ratios, the gearing ratio and the risk asset ratio, to analyze a bank's capital position in light of circumstances unique to that institution.
West Germany	Entrants must apply to the Federal Banking Supervisory Office (FBSO) for banking licenses. Statutory criteria for the granting of such licenses include: initial minimum capital of DM6,000,000, operation of the branch by two experienced managers, and submission of a detailed business plan. The FBSO may require membership in the Deposit Protection Fund before granting the license.	No statutory criteria exist for capital adequacy. However, Principle I of the FBSO regulations provides that loans and equity participations, exclusive of loan loss provisions, may not exceed eighteen times a bank's capital. The loans and equity participations are risk-weighted according to FBSO regulations.

Appendix I. Regulatory Areas by Country (Cont'd.)

	Liquidity Control	Lending Activities
Japan	No statutory criteria exist for determining a bank's liquidity. However, the MOF suggests that a bank's liquid assets should not exceed 30% of its demand deposits and negotiable certificates of deposit. Additional regulations exist concerning the funding of Eurocurrency loans.	The Japanese Banking Law prohibits a bank from lending to a single borrower an amount exceeding its total capital and reserves. An MOF administrative order further restricts a bank's lending to a single borrower to 20% of its capital and reserves. Foreign branch lending limits are calculated with respect to the parent bank's capital and surplus.
United Kingdom	No statutory criteria exist for determining a bank's liquidity. However, the BOE analyzes a bank's liquidity by inserting the bank's assets and liabilities into a maturity ladder. Foreign branch liquidity is considered individually, with particular emphasis placed on liquidity in British pounds.	No statutory criteria exist for determining a bank's lending limits. The BOE suggests that a bank's total exposure to one borrower not exceed 10% of its capital base.
West Germany	No statutory criteria exist for determining a bank's liquidity. FBSO regulations in the form of Principles II and III establish complex ratios for matching assets and liabilities based upon their respective maturities.	The German Banking Act establishes specific criteria concerning a bank's lending activities. Large loans are defined as loans which exceed 15% of the bank's equity capital. With respect to such loans, no single large loan may exceed 50% of a bank's equity capital, and the sum of all large loans may not exceed eight times a bank's equity capital. In addition, loans to insiders are subject to detailed rules contained in the German Banking Act.

Appendix I. Regulatory Areas by Country (Cont'd.)

	Foreign Exchange Risk	Permissible Business Activities
Japan	No statutory criteria exist for a bank's foreign exchange activities. However, the MOF has suggested certain guidelines for banks to follow. Such suggestions do not apply to foreign branches.	The Japanese Banking Law allows commercial banks to underwrite and offer government bonds and government guaranteed debentures. The MOF allows banks to engage in certain real estate activities, leasing activities, and bank equipment maintenance activities. Additionally, banks may own stock in companies to which the bank is a creditor.
United Kingdom	No statutory criteria exist for a bank's foreign exchange activities. However, the BOE has suggested certain guidelines for banks to follow. Such guidelines do not apply to foreign branches if monitoring arrangements used by the parent bank's supervisory authority are deemed adequate.	No formal restrictions placed on banking activities, but the BOE prefers non-banking investments to be financial in nature.
West Germany	No statutory criteria exist for a bank's foreign exchange activities. However, the FBSO has created regulations in the form of Principle I(a) concerning a bank's foreign currency transactions.	No formal restrictions. Banks may engage in virtually any commercial activity.

Appendix I. Regulatory Areas by Country (Cont'd.)

	Bank Examination and Disclosure Requirements	Liquidity Support
Japan	The MOF and the Bank of Japan (BOJ) conduct periodic on-site inspections. The Japanese Banking Law requires interim and final business reports for each business year, and it also requires banks to make public a balance sheet, income statement, and explanatory documents within three months after the end of each business year.	Banks may borrow on a short term basis from the BOJ at the bank rate. Quotas are established based on a percentage of a bank's yen assets. Foreign branches have higher percentage quotas than Japanese banks.
United Kingdom	The BOE does not generally conduct on-site examinations and, instead, relies on statistical data gathered monthly at regular meetings with the banks' senior management. The Companies Act requires banks to annually prepare a consolidated balance sheet and income statement; the Banking Act requires those statements to be available for inspection at each deposit-taking office the bank maintains.	The BOE regularly provides short term and sometimes provides long-term liquidity assistance to British banks. Foreign branches may not borrow from the BOE.
West Germany	The German Banking Act permits the FBSO to conduct on-site inspections. However, the FBSO generally appoints outside auditors to conduct these inspections. Banks must annually prepare a preliminary and final balance sheet and income statement, each of which is filed with the FBSO and the Bundesbank.	Banks and foreign branches may rediscount eligible instruments with the Bundesbank. Each institution is prescribed a quota. Once the quota is reached, any further borrowing must be done through the Liko bank.

Appendix I. Regulatory Areas by Country (Cont'd.)

Deposit Insurance

Japan	All deposits at Japanese banks (except interbank deposits) are covered up to three million yen per account by the Deposit Insurance Corporation. Deposits at foreign branches are not eligible for coverage.
United Kingdom	Seventy-five percent of a deposit at banks and foreign branches up to a maximum of 20,000 pounds is covered by the statutorily created Deposit Protection Fund.
West Germany	The Federal Association of German Banks created the Deposit Guarantee Fund, which protects a portion of depositors' funds, based upon the bank's equity capital. The FBSO generally requires foreign branches to become members of the Deposit Guarantee Fund as a precondition to receiving a banking license.
