



FEDERAL RESERVE APPROVES FIRST CHINESE ACQUISITION OF A U.S. BANK AND PROVIDES ROADMAP FOR INTERNATIONAL ACQUISITIONS

Industrial and Commercial Bank of China Limited (“ICBC”) and its two controlling shareholders, China Investment Corporation (“CIC”) and Central Huijin Investment Limited (“Huijin”), are the first Chinese organizations approved by the Board of Governors of the Federal Reserve System (“Board” or “Federal Reserve”) to acquire a U.S. bank under the Bank Holding Company Act of 1956, as amended (the “BHC Act”).¹ In addition to the normal BHC Act statutory factors considered by the Federal Reserve, it is the first determination by the Federal Reserve that a Chinese bank is subject to “comprehensive supervision on a consolidated basis” (“CCS”) by the People’s Republic of China (“China”) regulators. Previously, the Federal Reserve had determined only that Chinese regulatory authorities were “actively working to establish arrangements for CCS of banks.” The ICBC order is an important development that should facilitate Chinese banks expanding in the United States. It may also encourage Chinese

regulators to reciprocate and permit more activities by United States banks in China.

THE APPLICATION AND ORDER

ICBC applied to acquire The Bank of East Asia (U.S.A.), N.A., New York, New York (“BEA-USA”), a small bank with \$780 million of assets in 13 offices in New York and California. In comparison, ICBC has total assets of about \$2.5 trillion, is the largest bank in China, and operates in 21 countries, including an uninsured branch and a securities broker-dealer in the United States. The government of China owns approximately 70.7 percent of ICBC’s shares, including shares held by CIC and Huijin. Consistent with long-standing policy, the Federal Reserve considers foreign government-owned companies as “companies” subject to the BHC Act.

CIC owns ICBC through Huijin. CIC is a nonoperating sovereign wealth fund that holds investments of foreign exchange reserves on behalf of the Chinese government. It holds up to a 10 percent noncontrolling interest in Morgan Stanley, which was approved by the Federal Reserve on August 31, 2010. Huijin also is a nonoperating investment company, which exclusively holds interests in Chinese financial institutions and which also controls Bank of China Limited and China Construction Bank, the second and third largest banks in China. This cross-ownership was not addressed substantively in the Order, except for antitrust purposes with respect to concentrations of the three Chinese banks in the New York City market.

The Federal Reserve considered the financial factors, especially asset quality, earnings performance, proposed funding for the cash purchase of BEA-USA, and capital adequacy. ICBC engaged in a “relatively traditional set of commercial banking activities,” and the Board stated that its asset quality was consistent with approval. Capital was deemed equivalent to the levels required of a U.S. banking organization seeking to acquire an organization the size and profile of BEA-USA.

The applicants committed, consistent with the BHC Act, Section 3(c)(3)(A), to make available to the Federal Reserve such information on their operations and the operations of their affiliates as the Federal Reserve deems necessary to enforce compliance with the BHC Act, the International Banking Act (“IBA”), and other applicable federal laws “to the extent not prohibited by applicable law.” The applicants also agreed to cooperate with the Federal Reserve to obtain any waivers or exemptions to enable them to make such information available to the Federal Reserve. The China Banking Regulatory Commission (“CBRC”), ICBC’s primary regulator, indicated it would facilitate the Federal Reserve’s access to information and previously had entered into a Memorandum of Understanding dated June 17, 2004 agreeing to cooperate with the Federal Reserve and other U.S. bank regulators. A failure to provide information requested by the Board could result in divestiture or termination of the applicants’ or their affiliates’ activities in the U.S.

Comprehensive Supervision on a Consolidated Basis.

The Federal Reserve traditionally has noted that the legal systems for supervision and regulation vary among countries, and that CCS can be achieved in “different ways.” Federal Reserve Reg. K, § 211.24(c)(1)(ii) sets forth the following standards for determining when foreign banks’ home country supervision has sufficient information on the bank’s and its affiliates’ worldwide operations to assess the bank’s overall financial condition and compliance with laws, including:

- Ensuring the bank has adequate procedures for monitoring and controlling activities worldwide;
- Obtaining information on the condition of the bank and its subsidiaries and offices through regular exam reports, audit reports, and otherwise;
- Obtaining information on the dealings with and relationships between the bank and its foreign and domestic affiliates;
- Receiving financial reports that are consolidated on a worldwide basis or comparable information that permits analysis of the bank’s financial condition on a worldwide consolidated basis; and
- Evaluating prudential standards such as capital adequacy and risk asset exposure on a worldwide basis.

“No single factor is determinative, and other elements may inform the Federal Reserve’s determination.” Order at footnote 22.

The Board determined that Chinese bank regulation met the standards for CCS. The Federal Reserve deems the *Basel Core Principles of Effective Banking Supervision* (1997) (“Core Principles”) as the international standard for evaluating CCS. The Board’s analysis found that China’s authorities have continued to enhance CCS standards applicable to China banks and bring its supervision closer to the Core Principles, including:

- Improved statutory authority, regulations, and guidance;
- Adoption of international standards and best practices;
- Enhancements to the supervisory system reflecting supervisory experiences;

- Upgrades to the CBRC’s organization, technological capacity, staffing, and training;
- Increased coordination between the CBRC and other financial supervisory authorities in China; and
- Stricter prudential capital, allowance for loan loss coverage, executive compensation, insurance company investments, and risk management for operations, liquidity, derivatives, reputational, and market risk.

The Board further noted that:

- The CBRC prepares annual examination plans for the largest Chinese banks, conducts continuous off-site surveillance (including risk profiles and stress tests) and frequent on-site examinations of major areas of operation, including asset quality, liquidity, capital, internal controls, compliance, accounting, and corporate governance.
- Examination ratings are based on the CAMELS rating model and emphasize credit-risk management, the quality of the bank’s loan portfolio, internal controls, liability structure, capital adequacy, liquidity, and the adequacy of reserves.
- Chinese banks must report monthly, quarterly, semiannually, and annually to the CBRC.
- Large Chinese banks are required to be audited annually by an external accounting firm that meets the standards of the CBRC and China’s central bank, the People’s Bank of China (“PBOC”).
- Chinese law imposes various prudential limitations on banks, including transactions with affiliates, large exposure liquidity, and foreign currency exposure.
- Chinese banking law also establishes single-borrower credit limits, although the amount of credit granted to all related parties is high—50 percent of total regulatory capital.
- The CBRC may impose sanctions for failure to comply with such requests.
- The Chinese government has adopted a statutory regime regarding anti-money laundering (“AML”) and suspicious activity reporting, has criminalized money-laundering activities and other financial crimes, and the PBOC actively supervises banks in this area.

- China participates in international groups that address the prevention of money laundering and terrorist financing, as well as capital and other areas of bank regulation and operations.

The Board found support for CCS in China from the following reports evaluating Chinese bank supervision and accounting practices, and the Order quickly followed April’s IMF/World Bank assessment of China’s banking supervision compared to the *Core Principles*.

The International Monetary Fund’s (“IMF”) financial system stability assessment report and the accompanying detailed assessment report of observance with the Basel Core Principles found that “[s]ince 2005, [Chinese Accounting Standards (“CAS”)] have substantially converged with [IFRS] and International Standards on Auditing, respectively.”²

In addition, the *World Bank Report on Observance of Standards and Codes* determined that CAS and IFRS are basically compatible and that the Chinese authorities and the International Accounting Standards Board have established a continuing convergence mechanism designed to achieve full convergence in 2012.³

Anti-Money Laundering. The anti-money laundering programs of the PBOC were examined in depth. China has been a member of the Financial Action Task Force (“FATF”) beginning in June 2007. The FATF considered China fully or largely compliant with almost all FATF recommendations on anti-money laundering and terrorist financing.

Convenience and Needs. The Federal Reserve considered that Bank of China Limited, which is controlled by CIC and Huijin, has two grandfathered, FDIC-insured branches in the U.S., which had received satisfactory ratings on their U.S. Community Reinvestment Act (“CRA”) performance. The target bank, BEA-USA, currently has an “outstanding” CRA rating.

The Federal Reserve further considered BEA-USA’s HMDA data for 2009–2011 and its fair lending record. The Order addresses comments that the HMDA data indicated that BEA-USA engaged in disparate treatment of minority individuals in one- to four-family home mortgage lending. The

Board acknowledged that BEA-USA is predominantly a commercial lender with a limited number of one- to four-family mortgage loans, which depend largely on walk-in traffic at BEA-USA branches located in Asian-American neighborhoods. Less than 35 such loans were made in BEA-USA's combined assessment areas in the relevant years. Although the data might reflect certain disparities in the rates of loan applications, originations, denials, or pricing among members of different racial or ethnic groups in certain local areas, the Federal Reserve believed these provided an insufficient basis on which to conclude whether or not BEA-USA is excluding or imposing higher cost on any racial or ethnic group on a prohibitive basis. Further, the Order states:

The Board recognizes that HMDA data alone, even with the recent addition of pricing information, provide only limited information about the covered loans. HMDA data, therefore, have limitations that make them an inadequate basis, absent other information, for concluding that an institution is engaged in lending discrimination.

This may be useful for domestic as well as other foreign applicants in future transactions.

Financial Stability. As a result of the Dodd-Frank Act, the Federal Reserve is also required to consider the extent to which a proposed acquisition would result in greater or more concentrated risk to the stability of the United States banking or financial system. The Order points out that certain proposals are unlikely to raise concerns about financial stability, including:

- An acquisition of less than \$2 billion in assets;
- A resulting firm with less than \$25 billion in total assets; or
- A corporate reorganization.

Although it is one of the biggest banks in the world, ICBC had relatively simple operations, according to the Federal Reserve, and the acquisition of BEA-USA would not meaningfully increase ICBC's size or add significant complexity. Further, the Basel Committee has not designated ICBC as a "globally systemically important bank." Although BEA-USA would add to the applicants' existing cross-border activities,

BEA-USA operates only in the U.S., and ICBC already engages in operations in the U.S. through its \$1.5 billion-asset U.S. branch office and its U.S. securities broker-dealer subsidiary. Neither ICBC nor BEA-USA is a major provider of any product or service that the Federal Reserve believes potentially critical to the functioning of the U.S. financial system, and the Board held that its interconnectedness and contribution to the complexity of the U.S. financial system are *de minimis*.

Other. Although some commentators argued that the transaction would raise national security and other concerns, the Board rejected these and various other comments as outside the Board's authority under the BHC Act.

CONCLUSIONS

This Order is the first time that a Chinese company has been approved to own and control a bank under the BHC Act in the United States. Although each application requires separate determinations, this precedent may facilitate future applications by Chinese banking organizations to acquire or control banks in the United States and expand their existing branch, agency, or representative office operations. Because of the principles of national treatment and reciprocity, this decision may also facilitate the expansion of U.S. banks and bank holding companies in China.

The Order sets out the basis that other foreign banking organizations seeking to establish or acquire operations in the United States will need to establish to obtain Federal Reserve approval, including a determination of what constitutes adequate "comprehensive consolidated supervision." Compliance with the Basel Committee's *Core Principles* is especially important. Among other things, participation in and compliance with the standards of the Basel Committee and the FATF, and the IMF's and World Bank's assessments of the accounting and supervision of the home country, as well as the use of recognized external auditors, may be important. The Order also confirms that large institutions do not raise financial stability concerns based solely on size.

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ENDNOTES

- 1 Board Order dated May 9, 2012 (the “Order”).
- 2 IMF, *People’s Republic of China, Financial System Stability Assessment* at 57 (June 24, 2011), available at <http://www.imf.org/external/pubs/ft/scr/2011/cr11321.pdf>; and IMF and World Bank, *People’s Republic of China: Detailed Assessment Report of Observance with Basel Core Principles for Effective Banking Supervision* at 9 (April 2012), available at <http://www.imf.org/external/pubs/ft/scr/2012/cr1278.pdf>.
- 3 World Bank, *Report on Observance of Standards and Codes (ROSC) Accounting and Auditing—People’s Republic of China* at Executive Summary and at 12 (October 2009), available at http://www.worldbank.org/ifa/rosc_aa_chn.pdf.

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