

## Federal Reserve's Comprehensive Consolidated Supervision Determination for Chinese Banks Has Broader Implications

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The Federal Reserve's decision this week to confer Comprehensive Consolidated Supervision ("**CCS**") status to three state-owned Chinese banks has been long awaited and paves the way for major Chinese banks to enter retail commercial banking in the United States by acquiring U.S. banks. We view the Federal Reserve's decision, which is the first CCS determination with respect to a major jurisdiction in nearly 10 years, as encouraging for banks from other emerging economies that wish to expand their activities in the United States by acquiring U.S. banks or electing to become financial holding companies ("**FHCs**"). Since many developed economies have attained CCS status, the key markets that might, over time, indirectly benefit from the China CCS determination include Dubai, India, Malaysia, Saudi Arabia, Singapore and South Africa. Brazilian and Mexican banks already benefit from earlier CCS determinations. There are, however, a few lessons to be learned from the Chinese experience, which we take to mean that CCS determinations will require patience and persistence. These lessons are:

- A willingness on the part of the Chinese government and major Chinese banks to make the CCS determination a policy priority across a range of trade, economic and strategic relationships;
- A willingness to invest in smaller U.S. community and regional banks by Chinese banks with a traditional commercial banking profile;
- A strong, reciprocal desire by U.S. financial institutions to enter or expand their presence in the Chinese market;
- A determined effort on the part of the Chinese government and Chinese regulatory authorities to enhance their overall supervisory framework, as well as their anti-money laundering controls; and
- An appreciation that, in today's environment, CCS determinations may be incremental and more likely to be made on a bank-by-bank basis (or at least with respect to similar banks in the same country).

The Federal Reserve's unanimous approvals for the three Chinese banks closely followed high-level meetings between senior U.S. and Chinese government officials as well as the conclusion of the U.S.–China Strategic and Economic Dialogue during which the "United States recognize[d] and welcome[d] the further substantial progress made by China in the area of [CCS]" and committed to "act expeditiously" on pending applications by Chinese banks. China has reciprocally committed to allow foreign investors to hold up to a 49 percent equity stake in securities joint ventures and futures broker joint ventures. The remainder of this memorandum describes the transactions and the Federal Reserve's actions in greater technical detail.

### Background on the Approved Transactions and Applicants

In 2011, Industrial and Commercial Bank of China Limited ("**ICBC**"), the largest Chinese bank with approximately \$2.5 trillion in assets, and its parent companies, China Investment Corporation ("**CIC**") and Central Huijin Investment Ltd. ("**Huijin**"), sought the Federal Reserve's approval to become bank holding companies ("**BHCs**") by acquiring up to 80 percent of the voting shares of The Bank of East Asia (U.S.A.), National Association ("**BEA-USA**"), a U.S. bank with approximately \$780 million in assets. The transaction is a significant legal and political milestone not because of its size, but because it marks the first acquisition of a U.S. insured depository institution by a Chinese bank since the introduction of the CCS requirement. In addition to the ICBC transaction, the Federal Reserve also approved an application by Bank of China Limited ("**BOC**"), China's third-largest bank, to establish a branch in Chicago (BOC

already has other branches in the United States) as well as an application by Agricultural Bank of China Limited (“**ABC**”), China’s fourth-largest bank, to establish a branch in New York.

ICBC, BOC and ABC are owned and controlled by the Chinese government. Huijin, a company formed by the Chinese government to assist in the restructuring of major Chinese banks, owns a majority interest in BOC and, together with the Chinese Ministry of Finance, owns a majority interest in ICBC and ABC. Huijin is owned by CIC, a large Chinese sovereign wealth fund. CIC and Huijin are under the direct supervision and control of the State Council, China’s ruling executive body.

### **Comprehensive Consolidated Supervision**

Under the Bank Holding Company Act (“**BHC Act**”), the Federal Reserve must deny a foreign bank’s application to acquire a controlling interest in a U.S. bank unless the foreign bank applicant is subject to CCS in its home country. A foreign bank is considered to be subject to CCS if the Federal Reserve determines that the foreign bank is supervised or regulated in such a manner that its home country supervisor receives sufficient information on the worldwide operations of the foreign bank, including the relationship of the bank to its affiliates, to assess the foreign bank’s overall financial condition and compliance with laws and regulations. In practice, the terms “comprehensive regulation” and “consolidated basis” are sufficiently broad to leave the Federal Reserve substantial latitude in determining whether to disapprove an application by a foreign bank acquirer under Section 3 of the BHC Act on the basis of an absence of CCS.

The ICBC, BOC and ABC orders mark the first time that the Federal Reserve has made CCS determinations for Chinese banks. The Federal Reserve has previously approved applications from Chinese banks to establish U.S. branches under a lower standard than the CCS standard: beginning with the China Merchants Bank order in 2007, the ICBC and China Construction Bank orders in 2008 and, most recently, the Bank of Communications order in 2011. In these previous orders, the Federal Reserve determined that the Chinese bank applicant’s home country supervisors were actively working to establish arrangements for the consolidated supervision of the bank. While the statute governing branch applications by foreign banks expressly permits reliance on the “actively working to establish” standard, the Federal Reserve cannot rely on this lower standard to approve an application by a foreign bank acquirer under Section 3 of the BHC Act. For this reason, the Federal Reserve was required to make a determination that CIC was subject to CCS when it approved CIC’s acquisition of up to 10 percent of the voting shares of Morgan Stanley in 2010. That determination was specific to CIC, but did not extend to any of the three Chinese banks with U.S. branches indirectly controlled by CIC.

ICBC’s application to acquire BEA-USA was therefore dependent on the Federal Reserve’s making a CCS determination with respect to ICBC as well as Huijin, as one of ICBC’s controlling shareholders. In theory, the Federal Reserve could have continued to rely on an “actively working to establish” standard with respect to BOC’s and ABC’s U.S. branch applications, but it chose instead to make CCS determinations with respect to those Chinese banks as well.

### **Factors Considered by the Federal Reserve in Making Its CCS Determinations**

The Federal Reserve’s supporting analysis for its CCS determinations in the ICBC, BOC and ABC orders are very similar. In reaching the conclusion that “the enhancements to standards of bank supervision in China warrant a finding that [ICBC/BOC/ABC] is subject to CCS by its home country supervisors,” the Federal Reserve observed that:

“For a number of years, authorities in China have continued to enhance the standards of consolidated supervision to which banks in China are subject, including through additional or refined statutory authority, regulations, and guidance; adoption of international standards and best practices; enhancements to the supervisory system arising out of supervisory experiences; upgrades to the China Banking Regulatory

Commission (“**CBRC**”), the agency with primary responsibility for the supervision and regulation of Chinese banking organizations, in the areas of organization, technological capacity, staffing, and training; and increased coordination between the CBRC and other financial supervisory authorities in China.”

The supporting analysis also provides an overview of CBRC’s authority, structure, supervisory, examination and enforcement activities as well as the substantive prudential standards to which Chinese banks are subject, including capital, liquidity management, corporate governance, limits on transactions with affiliates and single-borrower credit limits. The Federal Reserve also referred to a recent IMF financial system stability assessment, which determined that China’s overall regulatory and supervisory framework adheres to international standards. The Federal Reserve noted China’s increased cooperation with international groups and supervisory authorities in other countries regarding bank supervision and its support for the Basel III framework.

Lastly, since the People’s Bank of China (“**PBOC**”) rather than the CBRC has supervisory authority over Chinese banks for compliance with anti-money laundering (“**AML**”) laws, the Federal Reserve also assessed the PBOC’s enhanced requirements for Chinese banks’ AML compliance and noted China’s participation in such international AML groups as the Financial Action Task Force and the Eurasian Group. The Federal Reserve concluded that the AML efforts of ICBC, CIC, Huijin and China’s supervisory authorities were all “consistent with approval.”

### Significance of CCS Determination for Subsequent Bank Applications

Strictly speaking, CCS determinations are made on a bank-by-bank basis, not on a country-by-country basis. In the past, however, it has been understood that once a CCS determination has been made with respect to one bank from a particular country, other banks from the same country would soon attain CCS status as well. It is therefore interesting that, in each of the three orders, the Federal Reserve noted that its CCS determination is specific to the Chinese bank applicant and that “differences . . . may exist in the supervisory framework as it is applied by a home country to institutions of different types or sizes.” In a footnote, the Federal Reserve cited to the preamble of a 1993 final rule, which states that “[CCS] is a bank-specific determination that, in general, does not permit blanket approval based on categories of countries or general information on bank supervision.” The preamble, however, goes on to say that “information already reviewed regarding comprehensive supervision in particular countries may be used to make judgments without requiring significant additional input from similar applicants chartered in the same country.” As a result, once the first CCS determination has been made with respect to a bank from a particular country, it generally should be less difficult for another bank from the same country to work through the CCS requirement with the Federal Reserve. The Federal Reserve would likely focus on the extent to which the supervisory system that it has already evaluated applies to the new foreign bank applicant and how, if at all, that system has changed since it was last reviewed by the Federal Reserve. The Federal Reserve’s emphasis on its CCS determinations in the ICBC, BOC and ABC orders being specific to the institutions involved suggests that the Federal Reserve is at least reserving its authority to conclude that a different Chinese bank or controlling entity may not be subject to CCS.

### Significance of CCS Determination for Attaining FHC Status

Not only is a CCS determination necessary for the Federal Reserve to approve a foreign bank’s application to acquire a U.S. bank, such a determination is practically essential for a foreign bank that wishes to become an FHC and thereby engage in a broader range of financial activities in the United States. In order for the Federal Reserve to conclude that a foreign bank is well-capitalized and well-managed (prerequisites for attaining FHC status), the foreign bank must be subject to CCS. In theory, there may be limited situations when an exceptionally strong bank from a country that has not yet fully implemented CCS could be considered for FHC status. However, despite the promise of this alternative

standard, the Federal Reserve has not previously approved an FHC election based on a foreign bank's home country supervisor making "significant progress" toward CCS.

### Continued Availability of Section 4(c)(9) Exemption

The Federal Reserve had previously granted exemptions to CIC and Huijin under Section 4(c)(9) of the BHC Act from many of the restrictions on non-banking activities otherwise applicable to BHCs. Consistent with its 2008 action in simultaneously approving the Section 3 application of UK Financial Investments Limited ("UKFI") in connection with UKFI's acquisition of control over The Royal Bank of Scotland Group plc and its U.S. banking subsidiary and granting UKFI's Section 4(c)(9) exemption, the Federal Reserve noted in the ICBC order that it had granted such an exemption to CIC and Huijin, but that it did not extend to ICBC or any other Chinese banking subsidiary of CIC or Huijin with a branch or agency in the United States. This confirms that sovereign wealth funds or other government-controlled companies that control banks in other markets should similarly be able to obtain or continue to benefit from Section 4(c)(9) exemptions notwithstanding their becoming BHCs as a result of acquisitions of U.S. banks.

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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

#### New York

<b>Luigi L. De Ghenghi</b>	+1 212 450 4296	<a href="mailto:luigi.deghenghi@davispolk.com">luigi.deghenghi@davispolk.com</a>
<b>Randall D. Guynn</b>	+1 212 450 4239	<a href="mailto:randall.guynn@davispolk.com">randall.guynn@davispolk.com</a>
<b>Arthur S. Long</b>	+1 212 450 4742	<a href="mailto:arthur.long@davispolk.com">arthur.long@davispolk.com</a>
<b>Margaret E. Tahyar</b>	+1 212 450 4379	<a href="mailto:margaret.tahyar@davispolk.com">margaret.tahyar@davispolk.com</a>
<b>William L. Taylor</b>	+1 212 450 4133	<a href="mailto:william.taylor@davispolk.com">william.taylor@davispolk.com</a>
<b>Andrew S. Fei</b>	+1 212 450 4063	<a href="mailto:andrew.fe@davispolk.com">andrew.fe@davispolk.com</a>

#### Beijing

<b>Li He</b>	+86 10 8567 5005	<a href="mailto:li.he@davispolk.com">li.he@davispolk.com</a>
<b>Howard Zhang</b>	+86 10 8567 5002	<a href="mailto:howard.zhang@davispolk.com">howard.zhang@davispolk.com</a>

#### Hong Kong

<b>William Barron</b>	+852 2533 3303	<a href="mailto:william.barron@davispolk.com">william.barron@davispolk.com</a>
<b>Kirtee Kapoor</b>	+852 2533 3320	<a href="mailto:kirtee.kapoor@davispolk.com">kirtee.kapoor@davispolk.com</a>

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