

## Federal Reserve “CCS” Determinations Open Door to Chinese Acquisitions of U.S. Banks

The Federal Reserve Board last week approved for the first time a controlling investment by a Chinese bank in a U.S. bank, opening the door for future Chinese acquisitions and investments in the U.S. banking sector. In approving an 80% equity investment by the Industrial and Commercial Bank of China Limited (“ICBC”) in The Bank of East Asia (U.S.A.) N.A., as well as branch openings by the Bank of China Limited (“BOC”) and the Agricultural Bank of China Limited (“ABC”), the Federal Reserve determined that each of the three state-owned Chinese banks is subject to comprehensive consolidated supervision or “CCS”—the first time such determinations have been made with respect to a Chinese bank. Although the CCS determinations are institution-specific, once the Federal Reserve has made a CCS determination with respect to one bank in a country, the approval process for other banks from that jurisdiction has historically been significantly streamlined. As a result, we expect that other Chinese banks may begin exploring options to invest in or acquire U.S. banks and that similarly situated Chinese banks are likely to be able to obtain the required CCS determination.

The Federal Reserve’s orders were issued in the wake of meetings of the U.S. Secretary of State and Treasury Secretary in Beijing, at which China’s “substantial progress” in the area of comprehensive consolidated supervision of Chinese banks was noted and the U.S. committed to “endeavor to act expeditiously” on pending applications by Chinese banks. At the same meetings, the Chinese government agreed to permit foreign investors to acquire up to 49% of securities and futures broker joint ventures in China and to expand opportunities for auto financing companies, including those with foreign investors.

### The CCS Requirement and the Federal Reserve Orders

In order for a foreign bank to establish an office in the United States or acquire a U.S. bank, the Federal Reserve is required to consider whether the foreign bank is subject to CCS by its home country regulator. A foreign bank is considered to be subject to CCS if it is regulated by its home country supervisor in such a way that the supervisor receives sufficient information on the worldwide operations of the foreign bank to assess the foreign bank’s overall financial condition and compliance with law and regulation. The Federal Reserve may approve the establishment of a branch or agency if the home country supervisor is “actively working to establish” arrangements for CCS. In the case of the acquisition of a controlling interest in a U.S. bank (or other applications under Section 3 of

the Bank Holding Company Act (“BHCA”), the Federal Reserve must find that a foreign applicant is in fact subject to CCS. Since the enactment of the CCS standard in 1991, the Federal Reserve has made such “full” CCS determinations with respect to banks from most of the world’s major economies, including Brazil and Korea. Jurisdictions currently limited to “actively working to establish” CCS determinations include India, Peru, Colombia and Egypt. Appendix A to this memorandum lists the years in which jurisdictions first had a bank receive either full or “actively working to establish” CCS determinations.

Beginning in 2007, the Federal Reserve has permitted several Chinese banks, including ICBC, to establish branch offices in the United States pursuant to an “actively working to establish” CCS determination. In 2010, the Federal Reserve made a full CCS determination with respect to the Chinese sovereign wealth fund China Investment Corp. (“CIC”), which is subject to BHCA limitations due to its indirect control of three Chinese banks with U.S. operations,<sup>1</sup> in approving CIC’s acquisition of up to 10% of Morgan Stanley. In reaching that determination, however, the Federal Reserve specifically noted the non-controlling nature of the investment and the “unique nature and structure” of CIC.<sup>2</sup> The CCS determination was made for CIC only for purposes of that application, and the order noted that any proposal by Huijin or any of the Chinese banks owned indirectly by CIC to acquire a U.S. bank would require a CCS finding for that entity. Last week’s orders are the first unqualified “full” CCS determinations for Chinese banks.

The most significant of last week’s orders authorized ICBC to acquire an 80% interest in The Bank of East Asia (U.S.A.) N.A., a retail and commercial bank with branches in New York and California and approximately \$780 million in total assets. ICBC is the largest bank in China, with approximately \$2.5 trillion in assets. The Chinese government owns approximately 70% of ICBC through CIC, Huijin, and interests held directly by the Chinese finance ministry. Because CIC and Huijin control ICBC for BHCA purposes and will therefore become bank holding companies following ICBC’s acquisition, the ICBC order included a full CCS determination with respect to both ICBC and Huijin and affirmed the CCS determination with respect to CIC. The order marked the first time that the Federal Reserve has allowed a Chinese bank to acquire a controlling interest in a U.S. banking organization.

The other orders released on May 9 authorized the establishment of U.S. branch offices by two other state-controlled Chinese banks—the Bank of China Limited, China’s third-largest bank, and the Agricultural Bank of China Limited, China’s fourth largest bank. Although these branch approvals would only have required an “actively working to

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<sup>1</sup> CIC controls Central Huijin Investment Ltd (“Huijin”), another state-controlled investment company, which holds controlling interests in three Chinese banks with U.S. banking offices: ICBC, BOC and China Construction Bank.

<sup>2</sup> Board Letter, dated Aug. 31, 2010, 96 Fed. Res. Bull. B31 (2010).

establish” CCS determination, the Federal Reserve made full CCS determinations in the approvals.

### **Key Issues and Implications**

- *Future Chinese Expansions and Acquisitions.* Although last week’s CCS determinations are limited to specific institutions, the orders set precedents that should ease the entry of other Chinese banks into the United States and facilitate Chinese investments in U.S. banks. Evidence from other recent Chinese investment activity suggests that Chinese banks often focus on coordinating investments in foreign financial institutions with China’s non-financial global activities, including developing overseas financing capabilities to service Chinese companies operating internationally, particularly those in the energy and mining industries.<sup>3</sup> Accordingly, in the near term we expect to see Chinese banks look for opportunities for U.S. investments that would provide such synergies and the enhanced ability to serve their mainly domestic clientele.
- *Federal Reserve Evaluation of Future Acquisition Proposals.* Every foreign bank acquisition of a U.S. bank requires the approval of the Federal Reserve under Section 3 of the BHCA, which requires the Federal Reserve to consider factors such as the competitive effects of the transaction, managerial resources, and financial characteristics of the acquiring company and the resulting entity, including whether the acquirer has capital comparable to that of a well-capitalized U.S. bank. Chinese banks looking for strategic acquisitions in the United States will need to consider how the profiles of both of the U.S target and the acquiring Chinese bank may influence the prospects for regulatory approval.
- *Political Considerations.* Political considerations—both with respect to the overall U.S.-China relationship and with respect to U.S. domestic politics—are also likely to play a factor in the timing and outcome of future Chinese bids to acquire U.S. banks. In the days immediately following last week’s orders, political and policy concerns were raised on Capitol Hill. In a letter to Federal Reserve Chairman Ben Bernanke, Senator Bob Casey expressed concern that having Chinese state-owned banks play a larger role in the U.S. banking system might undermine competition in the U.S. financial services markets, and questioned to what extent U.S. regulators will have the necessary and appropriate access to relevant Chinese financial data to ensure financial transparency. Sensitivity to such political and policy concerns will be important when Chinese

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<sup>3</sup> For example, ICBC has recently made investments—each under \$600 million—in the Argentine operations of Standard Bank, Bank of East Asia’s Canadian unit and a small Thai lender, ACL Bank.

banks pursue future acquisitions, particularly in connection with any attempt to acquire or make a large investment in a systemically important U.S. bank.

- *Cross-Border Transparency and Access to Information.* The concerns expressed by Senator Casey regarding access to financial data are likely to be a continuing point of sensitivity. Currently both the U.S. Securities and Exchange Commission and the Public Company Accounting Oversight Board are involved in disputes regarding the extent to which Chinese law permits foreign inspection of the operations and audit papers of the Chinese subsidiaries of auditing firms. In order to approve a controlling investment in a U.S. banking organization (or other application under Section 3 of the BHCA), the Federal Reserve must determine that it has received adequate assurances that the applicant will make available to the Federal Reserve information that it deems necessary to determine and enforce compliance with the BHCA. In the ICBC order, the Federal Reserve indicated that ICBC, CIC and Huijin made the standard commitment to make such information available to the extent permitted by applicable law. In addition, the Federal Reserve noted that it had consulted with the China Banking Regulatory Commission (the “CBRC”), which represented that it would facilitate access to information.<sup>4</sup> The ICBC order noted in its conclusion that if restrictions on access to information impair the Federal Reserve’s ability to obtain necessary information, the Federal Reserve could require termination or divestiture of the applicant’s U.S. activities. Similar statements have been included in some, but not all, CCS determinations for banks in other jurisdictions.
- *Sovereign Wealth Funds.* The ICBC order’s determination that Huijin is subject to CCS and confirmation of the CCS determination with respect to CIC in the context of a controlling investment in a U.S. bank affirmed that sovereign wealth funds are eligible for CCS determinations. The order also confirmed that CIC and Huijin would continue to be able to rely on exemptions that the Federal Reserve had previously granted under BHCA Section 4(c)(9) to permit CIC and Huijin to make investments without regard to the nonbanking restrictions of the BHCA (subject to certain limitations). This confirms that other sovereign wealth funds that have similar exemptions could expect to continue to benefit from those exemptions even after acquiring control of a U.S. bank. The exemptions do not extend to ICBC or any other banking subsidiary of CIC or Huijin that operates a branch or agency in the United States.
- *Financial Holding Company Status for Chinese Banks.* The determination that a foreign bank is subject to CCS is effectively a precondition for a foreign bank to

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<sup>4</sup> In 2004, the CBRC entered into a Memorandum of Understanding with the Federal Reserve and other U.S. banking regulators regarding the sharing of supervisory information.

elect financial holding company (“FHC”) status, although other factors, including that a foreign bank have capital “comparable” to that of a well-capitalized U.S. bank, must also be satisfied. None of ICBC or the other Chinese banks that obtained CCS determinations has yet elected to become an FHC. By qualifying for FHC status, a foreign bank with U.S. banking operations would be permitted to engage in the United States in a wider range of financial activities than is permissible for a bank holding company that is not an FHC, including securities underwriting and dealing, insurance underwriting and merchant banking activities. Most large U.S. bank holding companies, and most foreign banks with large U.S. banking operations, have elected to become FHCs.

- *Potential for CFIUS Review.* National security concerns could be raised if a Chinese bank proposed to acquire a significant U.S. bank or an important component of the U.S. financial infrastructure. The Committee on Foreign Investment in the United States (“CFIUS”) may review certain foreign investments in U.S. businesses to determine whether they threaten U.S. national security. Financial institutions are considered “critical infrastructure” with a potential impact on national security and, while CFIUS reviews are confidential, we are aware based on public statements and our experience that CFIUS has reviewed prior banking acquisitions. CFIUS reviews of, and concerns regarding, acquisitions of financial institutions appear to be rare, so it is likely that only significant transactions would attract serious scrutiny and potentially lead to delays or denials.
- *Other Jurisdictions to Follow?* Last week’s orders represent the first unqualified “full CCS” determinations for a new jurisdiction in nearly nine years. Now that China has been granted full access to the U.S. banking system, pressure may increase for the Federal Reserve to grant the same status to other jurisdictions, particularly India. Several Indian banks have been permitted to open branches in the United States based on a Federal Reserve determination that India is “actively working to establish” CCS. Indian banks and their regulators may chose to increase the pressure to achieve “full CCS” now that their major regional economic rival has been let through the door.

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If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under “Banking and Financial Institutions” or “Mergers, Acquisitions and Joint Ventures” under the “Practices” section of our website at <http://www.clearygottlieb.com>.

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Appendix A

Federal Reserve Determinations of Comprehensive Consolidated Supervision

Year	Country
1992	Taiwan
1993	Chile
	Hong Kong
	Korea
	Spain
	Switzerland
	United Kingdom
1994	Argentina
	Canada
	The Netherlands
1995	Australia
	Belgium
	France
	Germany
	Ireland
	Japan
	Turkey
	1996
Italy	
Mexico	
1997	Korea*
1998	Puerto Rico
1999	Greece
	Portugal

Year	Country
2000	Egypt*
2001	Colombia*
	Israel
	Peru*
2002	Brazil
	Finland
2003	Hong Kong*†
	Korea
	Norway
2005	Micronesia††
2007	China*
	India*
2010	China‡
2012	China

\* Determination that country was “actively working to establish” CCS.

† Approval for CITIC Ka Wah Bank after 1997 transfer of sovereignty of Hong Kong to China.

†† Approval for The Bank of the Federated States of Micronesia, which is supervised in Micronesia by the FDIC.

‡ Limited determination that China Investment Company was subject to CCS “given its unique nature and structure”, in connection with CIC’s passive non-controlling investment in Morgan Stanley.

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