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CHINESE BANKS CONTROLLED BY SOVEREIGN WEALTH FUNDS RECEIVE KEY APPROVALS FROM FEDERAL RESERVE, HIGHLIGHTING TREATMENT OF SOVEREIGN WEALTH FUNDS UNDER US BANKING LAWS

Sean P. Mahoney
Eric S. Yoon

On May 9, 2012, the Federal Reserve Board (the "FRB") announced the approval of an application filed by Industrial and Commercial Bank of China Limited ("ICBC"), China Investment Corporation ("CIC"), and Central Huijin Investment Ltd. ("Huijin")[1] to become bank holding companies by acquiring up to 80 percent of the voting shares of The Bank of East Asia (U.S.A.) National Association of New York. The FRB simultaneously announced approval of two applications by Bank of China Limited and Agricultural Bank of China, both controlled by CIC and Huijin, to open branches in Chicago and New York City, respectively. The approvals obtained by CIC and Huijin, two Chinese sovereign wealth funds, represent the continuation of a trajectory begun by the FRB in 2008, when it relaxed its then 20-year old, ostensibly-onerous approach to foreign government-controlled entities governed by the Bank Holding Company Act of 1956 ("BHC Act").

To be sure, the FRB has consistently maintained that foreign governments themselves are not "companies" subject to registration and regulation under the BHC Act. However, legal entities established or controlled by foreign governments have been considered "companies" for BHC Act purposes, at least since 1988. Notably, the BHC Act does not carve out an exception with respect to foreign government-controlled entities as it does for entities controlled by the US Federal government or by a state government. In 1982, the FRB, when presented with an application by an Italian bank, Banca Commerciale Italiana ("BCI"), to acquire a US bank, held that BCI's parent, Istituto per la Ricostruzione Industriale ("IRI") – a holding company controlled by the Italian government – was not a "company" for BHC Act purposes.[2]

Six years later, however, the FRB reversed course during its review of a subsequent application by BCI seeking approval to takeover Irving Bank Corporation ("Irving"), declaring

[1] Huijin was established in 2003 to assume ownership of Chinese state-owned banks and, shortly after the formation of CIC in 2007, a controlling interest in Huijin was transferred to CIC.

[2] Banca Commerciale Italiana, 68 Fed. Res. Bul. 423 (1982)

that BCI's parent, IRI, was indeed a "company" that must, within three years, conform its activities to the nonbanking restrictions under the BHC Act.[3] In arriving at this conclusion, the FRB cited policy issues involved in government ownership of multiple banks and commercial-industrial enterprises.[4] The FRB also placed various restrictions on IRI and BCI under the Federal Reserve Act, including a prohibition on credit extensions by Irving's subsidiary banks (including Irving Trust Company) to any company controlled by IRI or the Italian government.[5] These requirements apparently proved unduly restrictive for IRI and BCI, as BCI ultimately withdrew its bid to acquire Irving.

Then, in 2008, the FRB again modified its approach to sovereign-owned entities seeking entry into US banking markets. In a pair of approval orders, subsidiary banks of CIC and Huijin were permitted to establish a branch in New York[6]; and UK Financial Investments Limited ("UKFI"), an entity wholly owned by the UK government, was permitted to takeover The Royal Bank of Scotland Group, a bank holding company that controlled various US banks.[7] The FRB issued individualized approval orders, with limited precedential value, under Section 4(c)(9) of the BHC Act that allowed these transactions to proceed.[8] While the FRB did impose certain limitations on affiliate transactions between CIC/Huijin and UKFI and their respective subsidiaries, on the one hand, and their US banking operations, on the other, these were substantially less restrictive than those imposed on IRI and BCI in their contemplated acquisition of Irving in 1988.

Beyond citing its statutory authority to exempt foreign companies from the BHC Act's restrictions on non-banking activities, the FRB did not differentiate the 2008 CIC/Huijin decision from the earlier BCI application, notwithstanding numerous parallel circumstances. The 2008 CIC/Huijin approval further stated that these entities would need to obtain FRB approval prior to acquiring a controlling interest in a US insured depository institution. This statement was significant as it implied that the FRB would, in fact, entertain such an application. This proved to be the case, and the application was ultimately approved in the FRB's May 9, 2012 order, with CIC/Huijin retaining the 2008 exemption and hence continuing to be permitted to operate free of otherwise applicable restrictions on non-banking activities.

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[3] Letter from the Board of Governors of the Federal Reserve System, dated August 19, 1988, to Patricia S. Skigen and John B. Cairns.

[4] *Id.*

[5] *Id.*

[6] Letter from the Board of Governors of the Federal Reserve System, dated August 5, 2008, to H. Rodgin Cohen.

[7] Letter from the Board of Governors of the Federal Reserve System, dated November 26, 2008, to Arthur S. Long.

[8] In general, the BHC Act limits activities of bank holding companies to those that are "closely related to banking," or, for holding companies that qualify and elect financial holding company status, activities that are "financial in nature." These limitations also apply to affiliates of foreign banks that have branches in the US by virtue of the US International Banking Act of 1978. As banks controlled by CIC and Huijin operated branches in the US, CIC and Huijin were already subject to these restrictions. The BHC Act does, however, allow the Federal Reserve Board to grant exemptions from the restrictions if (a) the party seeking the exemption conducts the greater part of its business outside the US and (b) the FRB determines that the exemption would not be at variance with the BHC Act and would be in the public interest. The FRB granted such an exemption to CIC and Huijin from limitations on activities and certain reporting requirements on August 5, 2008, as noted in footnote 6 above.

The upshot of the May 9, 2012 approval is that CIC and Huijin will now be able to register as bank holding companies. Until this time, other well publicized investments by sovereign wealth funds in foreign banks with US branches, and in US banks, have been specifically structured to avoid "control" of a US bank, thereby avoiding having to register as a bank holding company under the BHC Act. For example, during the height of the financial crisis in 2008, Temasek Holdings (Private) Limited took great pains to structure its investment in Citigroup as non-controlling, thereby avoiding the need to seek FRB approval to become a bank holding company. In contrast, CIC and Huijin actually sought approval from the FRB to become bank holding companies as well as exemptions from limitations on non-banking activities available to foreign entities.

That being said, in many respects the approval orders issued to CIC and Huijin are unremarkable, as they reflect a straight-forward application of long standing principles to the facts presented. For example, each order contains a thorough analysis and determination that the applicants are subject to comprehensive, consolidated supervision by their home country regulators, as required under the BHC Act. The order relative to the application of ICBC, CIC and Huijin to become bank holding companies also sets forth a fairly typical anti-trust analysis. Absent from the orders was any special analysis related to sovereign wealth funds or regulatory concerns regarding a foreign government as a controlling stockholder.

In the final analysis, the significance of these approval orders may be that they serve as confirmation that, at least for the time being, sovereign wealth fund investments in US banking organizations will be analyzed under the same framework applicable to other investors. As with any other ownership structure, regulators will demand transparency as to ownership structure, a standard that CIC and Huijin were apparently able to provide.