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Future Directions in the Financial Services Industry
The International Markets

H. Robert Heller
Member, Board of Governors of the Federal Reserve System

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Future Directions in the Financial Services Industry: The International Markets

International Law and International Business

It is very appropriate that this conference on the "Future Directions in the Financial Services Industry" is co-sponsored by the School of Business Administration and the Law Center. Clearly, there is an active and dynamic relationship between business and the law -- and this is particularly true in the international arena.

The legal system of a nation is one of the most important manifestations of its sovereignty. Consequently, it tends to be unique to a nation. But by its very nature, international business crosses national borders and therefore transcends the legal framework of any one nation. It follows that complex national and international legal problems are often involved in international banking and commerce.

But where there are problems, there are also opportunities. The problems and the opportunities arise because the various national legal systems do not mesh perfectly. Inevitably, there are cracks, fissures, and areas of ambiguity. As a consequence, new and innovative business prospects may present themselves to the entrepreneur with a sharp eye for the unrecognized opportunity.

The situation reminds me somewhat of the rift-zones between the various tectonic plates covering the world and the associated geological phenomena. The risk and uncertainty of life near these rift-zones is undoubtedly greater than in a more tranquil environment. But the vistas of spectacular mountains and valleys generated by the upheavals along the rifts are certainly rewarding. In addition, great riches may be found by the daring explorer of previously undiscovered lodes along the rift-zones.

International bankers have also found that their lives have been at times most rewarding and at times very risky and challenging. I believe that the future will not lack in excitement or opportunity.

The Future of Traditional International Banking

International cross-border banking assets, both in the interbank market and in lending to ultimate borrowers, have roughly doubled since 1980. By this measure, the overall growth of traditional international credit markets has been rather satisfactory. But there have been sharply divergent trends in individual lending and borrowing countries.
It is also noteworthy that the doubling of international

bank lending since 1980 took place against a background of virtually no increase in world trade.

In contrast, prior growth in international banking activity was closely associated with the growth of world trade. In the parlance of bankers, finance has followed trade. Economists who studied the relationship between international finance and trade found one of the tightest correlations on record.

During the eighties, however, many banks saw their traditional trade financing business stagnate as commodity prices fell and developing countries cut their imports to cope with their debt burdens. Furthermore, the sharp rise in the value of the dollar through early 1985 meant that even an increasing amount of trade and trade finance expressed in terms of German marks or Japanese yen might not show any increase at all after conversion into dollars.

Since the turnaround in the external value of the dollar in 1985, world trade has again begun to grow at a rate of well over 10 percent per year as measured in dollar terms. Given the prospects for the world economy, it stands to reason that world trade will continue to expand in the years to come.

We have begun to move forward again, and it is therefore important to contain the current rise in protectionist sentiment. Otherwise, protectionism will kill the golden goose that is about to provide new profit opportunities for international traders and bankers alike and that will benefit consumers by providing them with cheaper goods.

Barring a rise in protectionism, we should see world trade expand more rapidly than domestic production and experience a concomitant upswing in traditional trade finance. In our country, this trend may well be boosted by the new export consciousness of the nation and the drive to enhance our international competitiveness. It may be time to dust off the old letters of credit and to prepare for an increase in traditional export financing opportunities.

I stated earlier that during the 1980s, international finance grew while international trade stagnated. Much of that growth in international banking took place in the interbank market. In addition, banks began to build their international asset portfolios in commercial and industrial lending.

It will not come as a surprise to anybody that Japanese banks were particularly active in this area. For instance, Japanese banks increased their international lending to non-banks from only $18 billion in 1980 to over $85 billion by the end of September 1986 for nearly a five-fold increase. In bank lending since 1980 took place against a background of virtually no increase in world trade.

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On the other hand, what may come as a surprise to many is that Japanese banks funded their international lending activities largely in the international interbank market. At the end of September 1986, Japanese banks had net borrowings amounting to $56 billion in the international interbank market and used these funds to finance two-thirds of their international lending to non-bank borrowers.

In other words, it was not mainly the Japanese savers who provided the funds for the international lending activities of Japanese banks. Instead, Japanese banks obtained two-thirds of the funds that they lent to international non-bank entities in the international interbank market.

There are many possible reasons why Japanese banks were able to out-compete other international banks. But it stands to reason that the lower capital-to-asset ratios permitted by the supervisory authorities in Japan were certainly helpful in that respect.

Capital Adequacy and Competitiveness

That capital-to-asset ratios have something to do with the ability of banks to gain market shares in the fiercely competitive international market is supported by the fact that American multinational banks expanded much more rapidly during the 1970s, when their capital-to-asset ratios were between 3 and 4 percent. In the eighties, when American banks were forced to raise their capital-to-asset ratios to approximately 6 percent, their international growth slowed markedly. As a matter of fact, many American banks cancelled interbank lines of credit because the one-eighth of one percent that could be earned on these advances was simply not enough to produce an adequate return on capital once leverage was reduced.

I am not arguing that we should lower capital adequacy standards for American banks to allow them to grow faster without regard to the risks involved. The tightening of these standards reflected a recognition that the world had become a riskier place in which to do business and a higher capital cushion was called for. I believe that judgment was correct.

However, there is a need to provide for a more level international playing field, so that banks of all nations can compete on an equal footing in the international markets. The proposed agreement between the Bank of England and the U.S. supervisory authorities regarding risk-based capital standards is pathbreaking -- and hopefully trend setting -- in that respect. That agreement is now out for comment prior to final implementation.

Under the terms of that agreement, banks in the United States and the United Kingdom will be subject to similar capital adequacy standards. The playing field between these two important banking nations will therefore become more level. Hopefully, other nations will soon join in that endeavor.

The regulations already in existence in many European countries are not dissimilar in fact and in spirit from the U.S. - U.K. accord. Hence, there should be no major obstacle toward a broader agreement, which would include the European banking system. Hopefully, the Japanese supervisory authorities will also join swiftly in this international effort to provide for equal competition and standards of safety among the banks of the major industrialized countries.

Interstate and International Banking

In discussing American international banking one cannot avoid mentioning the effects of the McFadden Act on American international banking. The United States is perhaps the only nation in the world that does not have an integrated national banking system. Clearly, this has a major impact on the ability of American banks to compete abroad and on their capacity to serve domestic customers active in international trade and finance.

It is no easy task to discern the impact of the prohibition against interstate banking on the level of international activity by U.S. banks. The prohibition against interstate branching has led many money center banks to look toward the international sector for expansion opportunities. For instance, major New York banks have for many decades adopted a distinct international expansion strategy because they could not branch freely across state lines. The same applies to banks based in Chicago, which are not even allowed to branch freely in their headquarter city.

Prevented from serving domestic markets in a comprehensive fashion, international banking became a major avenue of expansion open to these banks. Consequently, these banks became fierce competitors on the international scene.

At the same time, the fragmentation of the American banking system along regional lines results in a situation where many domestic business enterprises can not be served by their local banker both here and abroad. It is true that certain international services can be provided through Edge Act corporations to U.S. companies involved in international trade. But this forces the small entrepreneur to deal with one bank for his local needs and another bank for his international needs. It also stands to reason that the hometown banker does not always look with favor upon his own best customer establishing a liaison with the Edge Act of a large money center bank. For good reason the local banker may be afraid that the large money center bank will succeed in luring away some of his domestic business as well.

Two conclusions can be drawn from these observations: one, small and medium-sized manufacturers in states not served by money center banks may have inadequate access to international banking services and consequently they face additional obstacles in penetrating foreign markets.

Unlike in Japan or Europe, the hometown banker in a small American town cannot provide the local businessman or manufacturer with the necessary financial support to enter and serve foreign markets. The international competitiveness of American industry is thereby reduced. The handicap is particularly strong in unit-banking states.

Second, American banks are more specialized and therefore less diversified than they would be if free interstate banking were permitted. Money center banks focus on wholesale and international business and rural and regional banks focus on domestic business.

We all know that diversification provides the basis for greater financial stability. The removal of the legislative barriers to interstate banking would result not only in a stronger and more diversified American banking system, but would also strengthen the international competitiveness of American industry by providing greater access to international financial services to companies across the nation.

International and Off-shore Banking

Let me now turn to certain aspects of international and off-shore banking that may need some attention in the years to come. I stated at the outset that international banking is often pioneering and pathbreaking because it cuts across national legal systems. Often, banks can engage in a broader range of services abroad than they are permitted to engage in at home.

There is another competitive aspect to international business: it does not involve only businessmen and their ideas, but countries as a place of business. There is a healthy competition among countries to provide an attractive place to conduct business. Obviously, new jobs can be created and profits can be earned if a country is able to provide a superior environment for business.

I believe that international competition among countries is healthy, because it encourages countries to avoid excessive regulatory zeal and legal restrictions. Both the businessman and the consumer may benefit from such competition in providing a less restrictive environment for business and banking.

But we should also recognize that certain limits should be observed in such a laissez-faire environment. One such limit might be termed the <u>Golden Rule of International Business</u>: "Do not do unto other countries what you do not want to have done to your own country". Thus, countries should not serve as a base for international activities that are not permissible within their own borders.

A domestic example of what I have in mind is provided by the so-called "South Dakota Loophole", in which South Dakota law authorizes a South Dakota bank to engage in insurance activities anywhere but in South Dakota. The continued legality of this provision is now being considered by the Congress.

Let me emphasize that this Golden Rule does not call for a restriction of all foreign business activities to those that are permissible in the home country. For instance, German banks are allowed to engage in investment banking activities, and it therefore makes sense to allow American commercial banks to do the same in Germany. That is in accordance with the principle of "national treatment" that puts foreign and domestic enterprises on an equal footing within any one country.

The application of the Golden Rule would suggest that countries should not allow institutions to use their territory as a base for operations in other countries that are not permissible in their own country. It is easy to push the concept of an offshore banking haven to an extreme. Under such a system virtually any activity is permissible in off-shore haven countries or international free banking zones. In some cases, little or no supervisory oversight is provided. Furthermore, the traditional lender of last resort functions may not be available for banks operating in such an environment. I find little to commend in such practices.

Overall, I am proud to say that the United States has led the charge in many areas of deregulation and has therefore become a better place to do business. We provide for national treatment of all foreign banks and financial institutions -- a privilege not accorded to American banks in many foreign countries.

There is also a need to distinguish between the de-facto and the de-jure national treatment of foreign banks in other countries. For instance, while there is no law against foreign ownership of a Japanese bank, the fact is, that not a single Japanese bank is foreign owned. Much more progress in that area needs to be made.

Revising Our Regulatory Framework

In other areas we lag behind some countries, and our own legal and regulatory framework is in urgent need of repair. It has become abundantly clear that our financial system must be overhauled to bring it up to the standard that will be required if we are to remain the leading financial power of the world in the coming years. Where once American banks dominated international banking statistics, we find only a single American bank among the ten largest in the world. Every year, the situation is getting worse instead of better.

Patchwork repair is no longer appropriate. Instead, a comprehensive overhaul of the entire financial system is called for. The debate has now moved beyond criticism of the existing system towards the development of blueprints for the future. This is a most constructive development.

I am also encouraged by the forward-looking attitude of the new Congress in that respect. Not only are key leaders determined to act swiftly on the often postponed clean-up legislation necessary to shore up our current system, but they are also ready to take a fresh look at the long-range future of the financial services industry.

I do not want to recount all that is wrong with our

Balkanized financial system. But there is simply no other advanced industrialized country in which regional and functional barriers to financial business combine with overlapping regulatory authorities in such an insidious fashion. The resulting patchwork quilt defies the comprehension of even the highest paid lawyer.

Given these handicaps, I find it amazing that American business and finance are able to work as efficiently as they do.

The concept of the financial services holding company has much to commend itself, as it allows a bank to exist side by side with other financial services companies without granting the special privileges accorded to banks to the entire financial conglomerate. One may further debate whether such a financial holding company could be owned by a commercial firm.

The financial services holding company concept renders the current debate on broader powers for commercial banks academic as well. The holding company may own both a securities house and a bank, so that both services may be provided to the same customer, subject to safeguards against conflicts of interest. Insured deposits, access to the discount window, and participation in the payments system are privileges that are accorded to banks that in turn accept a framework of supervision and regulation not imposed upon other financial services industries.

Such an institution would also be in a better position to compete internationally, as it would be able to provide a broader spectrum of financial services around the globe. It could be a safer institution because the holding company would be more diversified. The redefined financial services holding company could serve as a source of strength to the bank, which would of course continue to be subject to governmental supervision and regulation and, in turn, would have access to the discount window and the payment systems and would be able to offer government insurance on deposits. This is not to say that the establishment of diversified financial services holding companies will be a panacea for all the difficulties of the banking industry. Management must continue to give attention to bedrock issues of safety and financial prudence in the conduct of all its activities in order that affiliated banks not be harmed by the perceived difficulties of its associated companies.

I believe that it is important to move ahead swiftly with the legislative reforms necessary to provide a world-class financial system in America. Time will not stand still. Not only will business opportunities be lost, but events will move forward that may be difficult to undo later on.

The current applications for broader powers for bank holding companies in the areas of commercial paper, mutual funds, mortgage-backed securities, and municipal bonds are cases in point. By law, the Federal Reserve is forced to act upon these applications within a specified time limit. We have also promised to make our decision by April of this year.

We have to apply the law as it is currently written. Although the world has changed significantly in the half century since the passage of the Glass-Steagall Act, the regulators cannot rewrite the laws or ignore them in an effort to forge a new financial framework better suited for our times. The legal challenges to any such attempt would be swift. It is therefore of the utmost urgency that Congress address these important issues of the future of our financial service industry as quickly as possible.

As I indicated previously, my own preference would be for the implementation of the concept of a financial services holding company within which the bank would hold a special position.

Conclusion

More than ever before, advances in technology serve to integrate global financial markets, and there is no turning back the clock. Instead, we must prepare the system and the institutions for the new environment of around-the-clock, real-time banking.

By its very nature, international banking will continue to be at the cutting edge of technology and innovation. But over time, the competitive advantage of the innovator will be eroded as new techniques are generalized and applied to the mass market. Eventually, the wizardry of yesterday will become the plain-vanilla, standardized product of tomorrow. There are product cycles in the financial service industry just as there are in any other industry.

It is important to realize that money can be made both at the cutting edge of innovation and by providing standardized products for the mass market. In one endeavor, the entrepreneurial and innovative talents are rewarded; in the other, perseverance and attention to cost cutting and detail pay off.

In the future, international banking will be dominated by an increasing reliance on technology and telecommunications. There will be standardization of swap, options, and futures markets. The trend towards securitization and off-balance sheet activity will continue. On the regulatory side, consolidation of balance sheets and internationally comparable risk-based capital adequacy standards will be implemented.