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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

REC'D RECORDS SECTION
APR 18 1969

Office Correspondence

Date April 17, 1969.

To Board of Governors

From Office of the Secretary

Subject:

Attached is a memorandum prepared at the Federal Reserve Bank of New York which was alluded to by Mr. Treiber at the April 1 meeting of the Federal Open Market Committee. The memorandum outlines possible techniques that might be used if it were deemed necessary to limit borrowings of Euro-dollars by head offices of U.S. banks with foreign branches.

Attachment.

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REC'D IN RECORDS SECTION
APR 1 8 1969

CONFIDENTIAL--(F.R.)

SECOND REPORT OF COMMITTEE OF OFFICERS TO STUDY LIABILITIES OF U.S. BANKS TO FOREIGN BRANCHES

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March 27, 1969

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CONFIDENTIAL--(F.R.)

REPORT OF COMMITTEE OF OFFICERS TO STUDY
LIABILITIES OF U.S. BANKS TO FOREIGN BRANCHES

Summary

Our main conclusion is that a convincing case for imposition of controls over borrowing in the Eurodollar market through foreign branches of U.S. banks must be made essentially on the basis of considerations relating to the possible extreme strains imposed by such borrowing on monetary conditions abroad. Such a situation may arise in the near future and the System must be prepared to deal with it. We see no conclusive evidence that the stepped-up borrowing by U.S. banks has produced excessive strains abroad. In particular, there is no evidence at the moment that it has affected the position of sterling. But in view of the delicate situation, and because it is difficult to evaluate the elasticity of a further supply of Eurodollars, such a decision might be required on short notice. We recommend that this issue remain under continuous active review and consideration. We have concluded that in a situation requiring prompt action, further borrowing of Eurodollars for the benefit of head offices could be prevented, or at least restrained by one of the following three means (listed in the order of preference):

(1) imposition of dollar ceilings on lending by foreign branches to head offices;

(2) imposition of very high reserve requirements--perhaps as high as 100 per cent--on such lending; and

(3) a "voluntary" agreement with banks with overseas branches to achieve the same effect.

In each case, the limiting measure would apply to amounts actually outstanding at a cutoff date to be determined. Since any regulatory action keyed to amounts outstanding at an arbitrary date is difficult to justify in the longer run, we would conceive such an action as an emergency action, designed to gain time for a full assessment of longer run needs and possibilities.

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Imposition of limitations on lending to head offices by foreign branches might be considered also if maximum rates on large C/D's under Regulation Q are increased. Presumably, in order to avoid an erroneous interpretation of such a move as an easing of monetary policy, the Board might want to raise simultaneously reserve requirements on demand and/or time deposits. At the same time, introduction of reserve requirements on total lending by branches to head offices might also be considered. While such a move would merely increase the cost of borrowing in the Eurodollar market rather than institute an effective control over the volume of borrowing, such a move could be justified on equity grounds (see below) as well as to establish the principle that access to the Eurodollar market through branches is subject to regulation. Conceivably, imposition of high reserve requirements on marginal amounts could be combined with reserve requirements at a fairly low rate on all lending to the head office.

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Introduction

A committee of officers appointed to study "liabilities of U.S. banks to their foreign branches" submitted its Report on September 11, 1967, with the following conclusion:

> ...on balance, at this time at least, imposition of some kind of reserve requirements on borrowing from branches is not required for reasons of proper conduct of domestic monetary policy, may have disadvantages from the balance of payments point of view, and would probably not help significantly to protect sterling.[1]

However, the committee noted "that the processes into which it has inquired are of fairly recent date and still undergoing important changes", and suggested that its recommendations "be reviewed from time to time in the light of subsequent developments". We have now undertaken such a review.

Since the preparation of the 1967 Report, the volume of borrowings from branches has increased considerably. It is currently approaching $10 billion for the reporting banks, compared with $4 billion at the end of 1966. Channels through which funds flow into the Eurodollar market have multiplied, and this makes imposition of effective limitations exceedingly difficult. Since our Report was submitted, various developments here and abroad have taken place which must be considered when assessing the main question to which this Report is addressed, namely: Is there a need for the Federal Reserve System to impose controls on head office borrowing from branches, in the form of reserve requirements, or otherwise?

The problem of borrowing from branches is exceedingly complex. It has many broad implications for domestic monetary policy, regulatory philosophy, and international monetary cooperation. The more we have examined this problem, the

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1. Report of Committee of Officers to Study Liabilities of U.S. banks to Foreign Branches, p. 14.

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more we are impressed by its complexity. The present Report is designed to provide merely a basis for discussion and to advance a possible solution for preventing, or drastically reducing, further bidding for Eurodollar funds, if and when such limitation should appear desirable. It recognizes that there are other aspects of borrowing from foreign branches, such as the proper accounting treatment of payments involved in such transfers to eliminate practices which improperly reduce deposits subject to reserves, or the problem of "shell branches". Some of these problems are already being dealt with separately, while others need further study.

This Report concentrates on techniques for limiting or preventing further bidding for Eurodollars for the benefit of head offices of banks with foreign branches, because this issue has been under public discussion for several weeks, and since one of the Governors[1] has made extensive public comments on the subject, concluding that "the strong bidding for Eurodollars by the dozen or so large banks with London branches does complicate the problem of monetary management" (p. 6). The main thrust of Governor Brimmer's argument is that "the expansion of business loans tends to be sustained relatively more at the large banks with ready access to Eurodollars during periods of monetary restraint than other banks" (ibid.).

In the interest of brevity, we do not repeat any of the analysis developed in the first Report, and we do not address ourselves to the broader issue of the significance of the Eurodollar market and its future. Neither do we discuss how the whole problem of lending by foreign branches to the head

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1. Andrew F. Brimmer, Eurodollar Flows and the Efficiency of U.S. Monetary Policy, March 8, 1969. Governor Brimmer's speech is supported by an empirical investigation, conducted by members of the Board's staff, which is summarized in several tables attached to his talk.

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office might take on a very different aspect if Regulation Q is abolished (or put on a standby basis) for large C/D's and U.S. banks were no longer restrained by rate ceilings from freely competing for Eurodollar deposits directly. Lifting of interest rate ceilings on large C/D's would possibly meet some of the objections of some European central banks, but any decision on Regulation Q ceilings would have to be made primarily on the basis of considerations of domestic credit policy.

The recent rise in borrowing from branches

The main reason for the recent increase in borrowing from branches is the tightening of credit conditions as ceilings under Regulation Q, established in April 1968, remain unchanged at levels now generally below interest rates available on money market instruments. Banks losing C/D funds attracted earlier have been attempting to replace them with Eurodollars. Current System policy is to maintain steady pressure but to avoid repetition of the "credit crunch". Since mid-December 1968, banks have been coming under increasing pressure.

Money market banks in New York and elsewhere have been resorting to borrowing in the Eurodollar market to replace heavy losses of C/D's. From November 27, 1968 to March 12, 1969, all weekly reporting member banks have lost $4,717 million of large C/D's. During the same period, they have been able to increase their borrowings from overseas branches by $1,899 million, an amount equivalent to about 40 per cent of the C/D's lost. Reporting New York City banks accounted for the bulk ($2,740 million, or about 55 per cent) of the C/D's lost, but they were somewhat more successful in attracting Eurodollars than other banks since their borrowings from foreign branches were equivalent to almost half of the amount of C/D's lost. The inflow of funds has helped to relieve pressure on banks (initially on those which were able to use this mechanism), and improve our balance of payments computed on the official transactions

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basis, while it has tended to raise interest rates in the Eurodollar market, and thus in money markets abroad. Future additional inflows into the Eurodollar market are likely to be of moderate size. However, should head office bidding increase, still higher Eurodollar rates are likely to result and pressure on monetary conditions in some foreign countries might become excessive.

In addition to the avoidance of interest rate ceilings under Regulation Q and of the costs involved in meeting reserve requirements, borrowing from branches provides additional flexibility to banks in managing their money positions.[1] While borrowing from foreign branches enlarges resources available to an individual bank, this borrowing involves, in part, merely a churning of funds already available to U.S. banks. It should also be kept in mind that whenever existing or newly created foreign deposits are transferred to banks with foreign branches, reserve pressures to which they are reacting are transmitted to other banks, so that the impact of the System's tighter credit policy is communicated to the smaller banks more rapidly than would be the case in the absence of borrowing from branches.

The supply of Eurodollars is fed by the U.S. balance of payments deficits. It is also influenced by policy actions of foreign central banks and by the willingness of private holders to convert other currencies into dollars. Some, but not all important central banks have at their disposal various means for coping with undersirable inflows and outflows of Eurodollars, and have used such powers at times.

When the international aspects of borrowing from branches are considered, it should be remembered that the Eurodollar market owes its first

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1. The ability of foreign holders of dollars to obtain a return on maturities shorter than 30 days has been a significant aspect of the attractiveness of the Eurodollar market.

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significant expansion to the endeavor of commercial banks in some European countries (notably Italy) to attract additional resources by paying rates on dollar deposits in excess of ceilings imposed by cartel agreements on domestic currency deposits. This they did by offering higher rates on dollar deposits, since the agreed-upon rates applied to deposits in domestic currency only. Now the Eurodollar market is being used by U.S. banks to achieve a similar purpose, only that the hurdle that it is helping to overcome is not cartel ceilings enjoying central bank blessing, but regulatory ceilings.

Three main aspects of borrowing
in the Eurodollar market

Borrowing from foreign branches may be discussed under three main headings:

(1) The monetary control aspect

One important question is whether borrowing from (or, rather, through) foreign branches constitutes avoidance of monetary controls. The obvious argument is that when funds are shifted to foreign branches and then reappear in bank balance sheets as "owed to branches" (not subject to reserve requirements), reserves are released.

This by itself is not a convincing argument for imposing reserve requirements on such borrowings. As long as week-to-week fluctuations in borrowings from branches are not much larger than in recent months, the maximum potential release of reserves (under the extreme assumption that all funds so obtained substitute for equivalent amounts of C/D's) would be about $30 million a week. This is well within the range of weekly changes (or even errors of estimates) in other reserve factors. The Desk normally would have no difficulty in folding in such changes into its regular operations in order to achieve the desired degree of marginal reserve availability. This does not mean, however,

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that a situation could not arise in which it would be very useful to have at the System's disposal a means of controlling directly exceptionally large swings in funds raised by overseas branches for the benefit of their head offices.

(2) The equity aspect

There are no generally agreed criteria of how the System should deal with the problem of equity when assessing changes resulting from initiatives taken by individual banks or groups of banks. One obvious question is how such actions affect other banks. Another is whether any legal or regulatory provisions which favor certain institutions may be involved. Certainly equity requires equal freedom of access and absence of artifically discriminatory barriers.

In this particular case, the question arises whether those relatively few banks which have established branches abroad enjoy a privileged position for access to the Eurodollar market. Another is related to the fact that borrowing from branches is not subject to reserve requirements. The original exemption of deposits in foreign branches was intended to put these branches on an equal competitive footing with local banks, not to exempt any part of funds lodged in the U.S. banking system from sharing in the burden of monetary controls.

We see little merit in the argument that banks with foreign branches enjoy advantages not available to other banks. Size confers numerous advantages to banks, including ability to enter foreign credit markets, but also involves risks and costs which smaller institutions are unable or unwilling to undertake. There is no reason for singling out direct access to the Eurodollar market as requiring special consideration for reasons of equity. The cost of Eurodollars in recent months has been higher than alternative reserve adjustment costs, after allowing for reserve requirement savings. Furthermore, with the

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demonstrated flexibility of our institutional arrangements and proven inventiveness of market participants, smaller banks are likely to find a way of obtaining access to Eurodollars as they conclude that in the longer run such access offers significant prospects for profits.

In contrast, the other equity argument has considerable validity. Reserve requirements provide a fulcrum for monetary policy; all outside funds attracted by banks, and not only deposits, should be subject to monetary control actions. Furthermore, by having to keep part of their assets in non-income producing balances, member banks share in the burden of monetary controls. An argument can be made that this burden should be shared roughly in proportion to total resources obtained by a bank. Banks with foreign branches derive a part of their resources for use in the United States from funds borrowed through foreign branch intermediation. Such resources, in fact, broaden the lending and investment potential of banks in the same way as deposits; currently, some banks obtain in the Eurodollar market funds equivalent to 15-20 per cent of their deposits. They should not be exempt from determining an individual bank's share in the cost of System membership.

(3) International implications

Since reestablishment of convertibility of the main European currencies, considerable progress has been made in linking more closely money and capital markets of the advanced countries and facilitating flows of funds, including short-term funds, across national borders. This development has been beneficial to all. In particular, it has helped in recent years to finance part of the large deficits in our liquidity balance of payments. Interest rates in various countries have been brought into closer alignment.

Obviously, the Eurodollar market is only one way in which monetary pressures are communicated among countries. In the absence of large-scale

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borrowing from foreign branches, tighter credit conditions and ensuing higher interest rates would spread to various countries through different channels. Foreign central banks have, or should obtain, adequate means for dealing with such situations and they should be expected to deal with them promptly. It is nevertheless true that given the size of funds which move in response to bidding by head offices and the willingness of U.S. banks to pay relatively high rates to meet reserve needs or meet prior loan commitments, sizable pressures in foreign money markets may result. Furthermore, rate developments responding to domestic conditions and prospects in the United States may be transmitted to countries wishing to pursue policies requiring rates significantly different (usually lower) from those in the United States.

A proposal for imposing limitations on lending to the head office by foreign branches

International monetary cooperation requires that all participating countries have adequate tools to deal effectively with destabilizing or other undesirable flows which cannot be reversed by the normal market mechanism. It is clearly desirable to add to the range of monetary controls now available to the System as a means of regulating, when appropriate for reasons of international monetary cooperation, the inflow into the U.S. of private short-term funds. This country has found it desirable to regulate directly the outflow of both short-term and long-term funds to protect its balance of payments after a period of cumulative deficits. A symmetrical argument is that, under certain conditions, inflows may also need to be controlled directly.

We see little, if any, merit in the argument that borrowing in the Eurodollar market significantly weakens effectiveness of monetary policy. Such borrowing is better regarded as a safety valve rather than as an escape mechanism. Borrowing in the Eurodollar market is just one aspect of the growing

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importance of adjusting liabilities in managing bank funds. In the sixties, banks have been quite successful in broadening their lending base by attracting funds other than deposits through a variety of channels. It is true that borrowing from branches escapes the burden of reserve requirements and FDIC payments, but so do other non-deposit resources available to banks. The broad question is whether shifting reserve requirements from liabilities to assets would not serve monetary control better than dealing with each non-deposit source of funds separately.

Imposition of reserve requirements on funds borrowed (net) from overseas branches appears justifiable on grounds of equity. Under existing legislation it can be achieved under Section 25 of the Federal Reserve Act[1] by imposing reserve requirements on funds loaned by branches to the head office. Imposition of such reserve requirements at rates similar (but not necessarily identical) to those applicable to time deposits would not affect competitiveness of overseas branches for local business. It would raise the cost of funds borrowed for the use of the head office, but it would not constitute an effective control over the volume of funds bid for and would most likely result in the shifting of some business from the head office (and domestic branches) to foreign branches.

The practical implementation of the above conclusions would not be simple.

(1) Obtaining funds for the head office is only <u>one</u> of the activities of foreign branches. Controls must be designed in such a way as not to interfere with the regular business of branches and not to worsen their competitive position in the markets in which they operate. Specifically, controls should be confined to funds rechanneled to the head office only.

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1. Since Section 25 provides the basis for regulating activities of foreign branches, any limitation would have to be placed on lending by, rather than borrowing from, foreign branches.

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(2) Since funds "borrowed" by the head office are not always the result of a simple "pass through" transaction, reserve requirements cannot be based on the maturity structure of deposits of foreign branches.

(3) Any new controls tending to increase the cost, or limit the volume of funds borrowed by the branches in the Eurodollar market will automatically result in evasive actions aimed at maintaining, as far as possible, access to the Eurodollar market and reducing the cost of borrowing. Quantitative limitations on lending to the head office by branches in whatever form may be countered by selling to branches foreign and domestic loans, or participations in such loans, and by bidding for Eurodollars through foreign correspondents rather than branches.

(4) An imposition of reserve requirements on borrowing from branches would increase the cost of Eurodollar borrowing and lead to the substitution of other sources of funds (such as Federal funds) at the margin. Unless such reserve requirements are very high, the ensuing increase in the cost of Eurodollars is unlikely to have large quantitative effects on the amounts bid for.

After examining various alternatives, we have concluded that under present conditions the only means of achieving effective control over excessive use of Eurodollars by U.S. banks would be to impose ceilings on the amount of funds lent to head offices. Such ceilings could be imposed, under Section 25, or very high reserve requirements (perhaps as high as 100 per cent) against such lending above a level existing at each bank on a stated cut-off date could be imposed.

In such case, there would be a need to plug up various loopholes now available, and try to anticipate the new ones that might be found by U.S. banks to offset pressure on their reserve positions. Indeed, head offices can obtain Eurodollars through correspondents rather than branches. They can use

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Eurodollars to protect or enlarge their lending power by shifting domestic as well as foreign business to overseas branches. For instance, if the ability of home offices to obtain Eurodollars through branches is limited, they could sell them domestic loans, outright or on a repurchase basis, or let branches make certain loans which otherwise would have been made by the head office.

The proposed approach is designed primarily (1) to deal with specific situations that might arise, requiring a rapid lessening of the impact of the competition for Eurodollars on foreign money markets or (2) to reinforce pressure on bank reserve positions. It would give the System (Board of Governors) an effective means of regulating the ability of head offices to obtain additional funds in the Eurodollar market without interfering with the other activities of foreign branches. It would provide the System with adequate flexibility for coping with a wide range of situations, international as well as domestic, that might arise in the future. Marginal reserve requirements could be imposed temporarily and rescinded or drastically reduced when the need had passed.

Another alternative would be a "voluntary" agreement with the handful of banks with foreign branches to keep their borrowings at or below the level reported for a specific date, but such an agreement might be difficult to negotiate and to enforce (the case of banks which just recently received permission to open "shell branches" in Nassau may present a special problem).

We have also concluded that it is desirable to establish on a permanent basis, essentially on grounds of equity, reserve requirements on the total amount lent by foreign branches to the head office under Section 25 of the Federal Reserve Act.[1] This ratio should be set independently from those applicable to demand and time deposits, perhaps in the range of 4-8 per cent. This

1. Perhaps there will be a need for redefining borrowings from foreign branches as "deposits".

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is not a matter of great urgency and further study by a System committee might be appropriate.

Imposition of ceilings or high marginal reserve requirements would have important consequences for domestic banks as well as for foreign money markets. The Board of Governors has now under consideration an amendment to Regulation D (suggested by this Bank) which would increase the cost of borrowing in the Eurodollar market by removing technical loopholes which confer to the borrowing bank another advantage in reserve accounting. This is an additional reason for careful consideration of the precise timing and scope of any measures designed to limit lending by foreign branches to the home office.

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