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FOR RELEASE UPON DELIVERY PR-64-78 (6-21-78)

Statement on

H. R. 10899, 95th Congress, the "International Banking Act of 1978."

Presented to

Subcommittee on Financial Institutions
Senate Committee on Banking, Housing and Urban Affairs
United States Senate

by

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June 21, 1978

Mr. Chairman, I welcome the opportunity to testify on issues raised in H. R. 10899, the International Banking Act of 1978.

The efforts of the Congress in this area have been timely and appropriate in light of the rapidly growing presence of the operations of foreign banks in the United States. According to statistics provided by the Federal Reserve, from November 1972 to the end of March 1978 the number of U. S. banking institutions owned by foreign banks increased from 104 to 268 and their total U. S. assets quadrupled from $24 billion to $96 billion. Since 1965, there has been more than a twelvefold increase in their assets.

Foreign banks presently operate in the United States through agencies, direct branches, subsidiaries, securities affiliates and commercial lending companies. Currently, these foreign banking organizations are located in ten States plus Puerto Rico and the Virgin Islands. However, 91 percent of all foreign banking offices in the U. S. are concentrated in New York, California and Illinois.

Until quite recently agencies have been the dominant form of foreign banking in the U. S. As of March 31, 1978, 120 agencies with approximately $30 billion in assets were operating in New York, California, Georgia, Florida, and Hawaii. Agencies operate under State licenses and are not permitted to hold deposits but their customers may maintain credit balances which are technically due to the account of the home office.

Direct branches are the most rapidly growing form of foreign banking in the United States. There were 103 branches with assets totalling $45 billion in New York, Illinois, Washington, Oregon, Massachusetts, Puerto Rico and the Virgin Islands on March 31, 1978. Branches are licensed under State law and are permitted to hold both foreign and domestic deposits. These deposits are currently not eligible for Federal deposit insurance.

At the end of March 1978, foreign banks owned 38 State-chartered subsidiaries in New York, California, Illinois and Puerto Rico, with assets of $19 billion. Such subsidiaries may become members of the Federal Reserve System. Five have chosen to do so. Also, foreign banks may apply for national charters for bank subsidiaries; however, the requirement that all national bank directors be U. S. citizens has made this unattractive. Bank subsidiaries of foreign banks are subject to the Bank Holding Company Act of 1956, and must maintain FDIC insurance coverage. Recently, three foreign banking organizations have begun negotiations to acquire all or a substantial portion of the control of three sizeable U. S. banking institutions, the combined assets of which exceed $20 billion.

Five commercial lending companies with $2 billion in assets were licensed to operate in New York. In addition to having a wide range of conventional banking powers, these entities may engage in some investment banking.

Finally, a total of 27 securities affiliates were licensed to operate in the U. S. as of December 31, 1976. These firms are engaged in underwriting and direct sale of securities, activities that are prohibited for domestic banks by the Glass-Steagall Act. Most of these affiliates are located in New York State.

If a foreign bank chooses to operate in this country through a domestically incorporated banking subsidiary, its operations here are generally subject to the same rules under the Bank Holding Company Act that govern the U. S. activities of domestic bank holding companies, with limited exceptions involving nonbanking activities permitted by Federal Reserve regulations issued under Section 4(c)(9) of that Act. However, to the extent that a foreign bank operates domestically through branches, agencies, or commercial lending companies, it is not subject to certain restrictions and requirements applicable to domestic banking organizations -- principally those which forbid operating deposit-taking offices in more than one State and operating affiliated companies engaged in a securities business.

The stated goals of this legislation are twofold: The first is to provide a system of Federal regulation of the domestic activities of foreign banks because of the role these institutions play in domestic financial markets, their impact on the domestic and foreign commerce of the United States and because most foreign banks operate in more than one State. The second goal is national treatment of foreign banks. In other words, to the extent possible or appropriate, foreign and domestic banks operating within the United States should be treated equally.

It seems to me that as a general principle, the goal of "national treatment" or "nondiscrimination" in the regulation of foreign enterprises operating in the United States is highly desirable and should be pursued provided that its implementation is feasible and adherence to it would not interfere with some other important public policy objective. Thus, I am in agreement with the notion that, consistent with our framework of bank supervision, U. S. operations of foreign banks should be subject to appropriate Federal regulation and supervision.

While we support some provisions of the proposed legislation, we have reservations about certain aspects of the bill as drafted and I will set forth our views as to preferable policy choices. In some respects, for example, it seems that the bill deviates from the policy of nondiscrimination without an overriding reason for doing so. In the discussion which follows, I shall outline the FDIC's views with respect to five of the major facets of this legislation.

Provision of a Federal Chartering Option

Section 4 of the bill would authorize the Comptroller to approve the establishment by a foreign bank of its first U. S.

branch or agency in any State where State law does not prohibit the establishment of a branch or agency by a foreign bank. Subsequent Federal branches or agencies of a foreign bank could be authorized in States where the bank had no State branch or agency if expressly permitted by State law. These Federal branches and agencies would be regulated and supervised like national banks to the extent appropriate. In addition, Sections 2 and 3 of the bill would significantly liberalize the National Bank Act and Edge Act requirements that National Bank and Edge Act corporation directors be U. S. citizens and that Edge Corporation stock be owned only by U. S. nationals. Consistent with the principle of nondiscrimination, these provisions would afford foreign institutions the benefits of choice implicit in our dual system. I heartily endorse these changes.

Interstate Banking Operations by Foreign Banks

Section 5(a) of the bill permits interstate branching by foreign banks where permitted by State law. This subsection further provides that establishment of agency or commercial lending company operations outside the home State selected by a foreign bank requires the approval of the State in which it desires to operate.

The thrust of these provisions is, of course, to maintain the status quo with respect to interstate branching by foreign banks rather than to impose branching restrictions of the type applicable to domestic banks. It has been argued by some that foreign banks enjoy a competitive advantage in that they can conduct multi-State deposit banking operations. Frankly, I am not aware of any evidence that interstate banking activity of foreign banks has had an adverse competitive impact on our domestic banks or has impaired their viability.

It should also be noted that foreign banks currently operate banking-type operations in only twelve U. S. States and territories while interstate operations of our large bank holding companies extend into almost every State. These interstate activities include consumer and sales finance, commercial lending, mortgage banking, selling and reinsuring credit related insurance, leasing, computer services and providing venture capital to business. U. S. banks may also establish Edge Act corporations, loan production offices and representative offices in States other than their home State.

Absent some overriding public interest, notions of equity and symmetry would support applying to foreign banks the same branching rules as apply to domestic banks. However, in our judgment there is an overriding public interest which leads us to strenuously oppose application of the principle of national treatment in this context.

If interstate banking operations were to be prohibited for foreign banks, it is unlikely that a foreign bank would want to locate anyplace outside New York, California or Illinois.

As a practical matter, if interstate banking opportunities were foreclosed for foreign banks, other States would find it difficult to attract foreign banks and, hence, would not reap benefits stemming from the activities of these banks -- benefits that may well accrue to the local economy.

One should not minimize the value of foreign banking growth to the banking community as a whole. In an interview published in the June 1977 issue of Euromoney, Paul Volcker, President of the Federal Reserve Bank of New York, stated that --

> Bankers in general -- those of the New York mentality anyway -- hold that additional competition generates additional business. To the extent that it supports the growth of New York as an international banking centre it's going to be good for everybody. More of the world's business will be focused here, and the more effective and efficient this market is, we'll all be able to make some money out of it. Better here than elsewhere.

I see no reasons why other cities in other States should not enjoy the same potential benefits of expanded foreign banking activity. I feel strongly that a State should be permitted to invite a branch of a foreign bank into its banking communities if this is the only realistic way in which foreign bank entry is likely to take place.

Recent patterns of foreign banking expansion in the U. S. support the contention that regional financial centers would be hurt by a ban on interstate operations by foreign banks. Of the 268 foreign agencies, branches, subsidiaries, and commercial lending companies operating in the U. S. as of March 31, 1978, only 25, or nine percent, were located outside the money market centers of New York, Chicago, Los Angeles and San Francisco. These 25 offices are located in Massachusetts, the Virgin Islands, Puerto Rico, Florida, Georgia, Texas, Hawaii, Oregon and Washington. Seventeen of the 25 offices located outside the four principal money market centers are direct branches of foreign banks and six are agencies. This suggests that branches and agencies are the major hope for increased foreign banking involvement outside these centers. Moreover, as indicated in the table, direct branches have been the fastest growing organizational form of foreign banking in the United States, both in number and total assets.

TABLE

Growth in Number of Offices and Size of Foreign Banking Operations in the United States

	March 1978		November 1972	
	Total Assets (billions)	Number	Total Assets (billions)	Number
All foreign institutions	$96	268	$24.3	104
Agencies and agreement corporations	30	122	13.6	50
Branches	45	103	5.3	26
Subsidiaries	19	38	4.1	25
Commercial lending companies	2	5	1.3	3

The 25 foreign institutions outside the banking centers are operated by foreign banking organizations that are part of

14 foreign banking "families" that also have foreign banking offices in the States of New York, California or Illinois. This implies that the tendency is to geographically diversify foreign banking operations once banking operations have already been established in the principal centers. We believe this multi-State diversification should be permitted to continue. We therefore strongly support the provisions of Section 5(a) as passed by the House.

Nonbanking Activities of Foreign Banks

Section 8 of H. R. 10899 subjects foreign banks' domestic agencies, branches, commercial lending companies and their affiliates to the provisions of the Bank Holding Company Act of 1956 as amended in 1970. However, domestic nonbanking activities (including securities activities) which were commenced or acquired prior to May 23, 1977 are grandfathered permanently. Those acquired after that date and which are prohibited for domestically-owned bank holding companies must be divested by December 31, 1985.

Under an earlier version of the bill, different rules would have applied to the securities activities of foreign banks. Divestiture by December 31, 1985 would have been required of all securities activities whether commenced after the grandfather date or not, except that foreign banks' securities affiliates could have continued to engage in securities transactions for individuals and organizations outside U. S. jurisdiction.

During the House consideration of this bill, it was argued that these earlier restrictions on securities activities were both discriminatory and anticompetitive. It was felt that they were unfair to foreign banks, since large U. S. banks engage in substantial securities activities abroad. Moreover, it was feared that such restrictions would prompt retaliation against those U. S. banks which do engage in extensive foreign securities operations. Also, it was argued that by lessening competition in the U. S., the cost of underwriting might be increased and the issuing of new securities made more difficult. Regional stock exchanges felt that they would suffer substantial revenue losses.

I believe it is fairer and less disruptive to grandfather all existing securities operations of foreign banks as the bill presently does. This minimizes any likelihood of retaliation and eliminates the hardship of winding down operations on those institutions which have played by the rules of the game to date. Although this approach may be at odds with the concept of national treatment, the practical effect would be minimal given the limited scope of existing foreign bank securities operations.

Accordingly, I strongly favor the permanent grandfathering of all existing securities activities of foreign banks now contained in Section 8.

Deposit Insurance Coverage

As the FDIC has indicated in previous statements, we have had serious reservations about the necessity and desirability of making deposit insurance coverage available for domestic branches of foreign banks. These reservations arise from a concern that insufficient legal and regulatory controls could be placed on branch operations that are not legally separate from those of the parent bank. At least five problems are involved:

1. Directors of the foreign bank are not usually subject to U. S. jurisdiction, and domestic branch personnel essential to explain certain transactions can be transferred beyond the reach of U. S. authorities. Also, essential records may be difficult to reach if they are kept at the head office or at branches in other countries.
2. The domestic branch may be subjected to requirements under foreign law or to political and economic decisions of a foreign government which conflict with domestic bank regulatory policies.
3. Administrative enforcement proceedings initiated by domestic regulatory authorities against domestic branch personnel may be frustrated or nullified as a result of lack of jurisdiction over the foreign bank's head office and head office personnel.
4. Many foreign banks are permitted under the law of their headquarter's country to engage in business activities abroad which would not be permitted to banks chartered in this country.

Such foreign activities could give rise to antitrust, conflict of interest, and other legal problems under U. S. law.

5. In the event of insolvency of a foreign bank, it is possible that:

    -- assets could be easily and quickly shifted from the U. S. branch and out of U. S. jurisdiction, while deposits could be shifted to the U. S. branch;

    -- legal obstacles and transactions involving other offices of the foreign bank might prevent FDIC from obtaining the usual subrogation of claims it normally gets from depositors in failed U. S. banks before making payment. Even if adequately subrogated, FDIC's aggregate claim in the failed bank's receivership estate might be jeopardized by foreign laws and procedures;

    -- creditors with claims against other offices of the failed bank -- especially banks holding deposits of the U. S. branch -- could attempt offsets against assets in the U. S. or seek preference based on foreign law.

In addition, deposit insurance protection is largely unnecessary insofar as foreign banks' domestic branches engage in "wholesale" international banking activities. Moreover, if foreign banks wish to expand their operations in this country into the "retail" banking business with the benefit of Federal deposit insurance, they presently have an option to do so under existing law through a domestically incorporated banking subsidiary in those States in which State law permits. Of course, in that event most of the problems outlined above are less important.

Notwithstanding our concerns, a number of interested parties, including the Federal Reserve System, have strongly argued that some form of deposit insurance coverage should be available to the U. S. branches of foreign banks. Accordingly, an earlier version of the bill contained a surety bond or pledge of assets method of providing protection similar to, but in lieu of, deposit insurance coverage. In our opinion this solution was less than satisfactory for a number of reasons.

While some of the risks listed above could be mitigated by imposing various conditions and restrictions upon the foreign bank, the value of such requirements depends ultimately upon the ability to physically enforce such requirements by exercising *quasi in rem* jurisdiction over the foreign bank's domestic assets and/or obligors. Short of a dollar-for-dollar pledge of assets to back up 100 percent of the branch's domestic deposits, efforts to impose such requirements as a substitute for deposit insurance could turn out to be of limited value.

In response to the view that some form of deposit insurance coverage is necessary, the FDIC recommended a modified version of the surety bond and pledge of assets approach which would be coupled with the granting of regular deposit insurance for the domestic deposits of U. S. branches of foreign banks. We recommended that such deposit insurance could be made available on an optional basis along the following lines:

> SEC. 6(a) Any branch may become an insured bank under the Federal Deposit Insurance Act (12 U.S.C. 1811-31b) with respect to its domestic deposits, as defined by regulation by the Board of Directors of the Federal Deposit Insurance Corporation, as if such branch were a State nonmember bank. Upon so becoming an insured bank, a Federal branch shall thereafter be treated as if it were a national member bank, and any other branch shall thereafter be treated as if it were a State member bank, for purposes of applying the Federal Deposit Insurance Act to such branch's domestic activities (except that any such branch shall continue to be treated as a State nonmember bank for purposes of the first sentence of Section 8(a) of that Act providing for voluntary termination of insured bank status). Any branch which becomes an insured bank shall maintain with the Federal Deposit Insurance Corporation, or as the Corporation may otherwise direct, a surety bond or a pledge of assets in such amount and subject to such conditions and rules as the Corporation may prescribe for the purpose of providing some additional protection to the deposit insurance fund against the additional risks entailed in insuring the domestic deposits of a foreign bank whose activities, assets and personnel are in large part outside the jurisdiction of the United States. In prescribing such rules, however, the Corporation shall, to the maximum extent it considers appropriate, endeavor to avoid imposing requirements on such branches which would place them at an undue competitive disadvantage vis-a-vis domestically incorporated banks with which they compete.
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> (b) Paragraph (a) of this section shall take effect 180 days after enactment hereof. Within 90 days after enactment and as may be appropriate thereafter, the Corporation shall submit to the Congress its recommendations for amending the Federal Deposit Insurance Act so as to enable the Corporation to implement the provisions of this section in a manner fully consistent with the purposes of that Act.

If foreign banks' domestic branches chose deposit insurance coverage under such a provision, they would become subject to a much less onerous form of surety bond and pledge of assets requirement, which would be designed not to be a substitute for deposit insurance but rather merely to give the Federal deposit insurance fund a measure of protection to compensate for the additional risks to which it would be subjected, as described above, by virtue of providing regular deposit insurance for the domestic deposits of an entity operating for the most part outside of U. S. jurisdiction. Domestic depositors would be fully protected up to $40,000 just as are depositors in domestic insured banks. This approach of providing regular deposit insurance on an <u>optional</u> basis in conjunction with a <u>modified</u> form of the surety bond and pledge of assets requirement seems preferable from the Corporation's standpoint to the <u>mandatory</u> coverage required in Section 6 of H. R. 10899. It would put foreign banks on as nearly an equal basis as possible with domestic banks while at the same time affording appropriate supplemental protection to the deposit insurance fund roughly commensurate with the added degree of risk included in insuring foreign entities.

It will be noted that the provision suggested above would give the FDIC authority to define "domestic deposits" for purposes thereof. It is contemplated that that term would be defined to include deposits of individuals who are citizens or residents of the United States and companies having an appropriate business nexus with this country. It is likely also that such "domestic deposits" would be required to be payable only in the United States, and a requirement might be included that the deposit contract provide that U. S. law govern the depository relationship. Other criteria might also have to be considered from time to time in determining what would be an appropriate insurable "domestic deposit." We would greatly prefer the more flexible approach of defining this term by regulation rather than attempting to do so by statute.

We support optional deposit insurance for foreign banks' U. S. branches because we believe it is preferable to accord such branches, insofar as possible, the same options afforded domestic banks under Federal law. Comparable treatment as to deposit insurance would require permitting foreign banks to operate State-licensed branches in the U. S. without obtaining deposit insurance if such is permitted by State law. Also, from the standpoint of State governments, we believe each State should have the option of permitting foreign banks to operate branches in such State without Federal deposit insurance, subject to such limitations and requirements as State law may provide.

At present, for example, New York is among those States which permit foreign banks to establish domestic branches without obtaining Federal deposit insurance, although such branches are subject to various requirements under State law designed to protect depositors and creditors of such branches. Indeed, there has been no case to our knowledge where any loss has been suffered by depositors or creditors of a U. S. branch of a foreign bank because of the foreign bank's insolvency. Even as to the failure of Intra Bank in October 1966, it is our understanding that all depositors and creditors of Intra Bank's New York branch were paid within three years after the branch was closed. Subsequent to the Intra Bank failure, New York law was amended to give added protection to depositors and creditors of branches of foreign banks operating in New York.

While we have no strong objection to requiring Federal deposit insurance for Federal branches of foreign banks licensed by the Comptroller of the Currency in conjunction with a surety bond/pledge of assets requirement of the type contained in Section 6, we believe that Federal law should not mandate deposit insurance for State-licensed branches of foreign banks. Rather, we believe any requirement that State-licensed branches be federally insured should be left to State law. As you know, California presently imposes such a requirement if such a branch accepts domestic deposits.

One alternative the Congress might want to consider is to require uninsured branches to make that fact known to depositors. This would, of course, be a departure from national treatment since there is no such requirement for domestically chartered banks which do not have deposit insurance.

Such an approach would nevertheless be a possible alternative to mandatory deposit insurance for foreign banks' U. S. branches.

While we would prefer to see Section 6(a) and (b) of the bill modified to make deposit insurance available to domestic branches of foreign banks on an optional rather than a mandatory basis, we have no objection to the lengthy technical revisions in Section 6(c). We have reviewed these provisions at the staff level and worked with House Subcommittee staff in trying to perfect them from the technical standpoint.

If your Subcommittee should not be inclined to take the optional approach to deposit insurance for domestic branches of foreign banks, we would strongly recommend that, at a minimum, language be added to Section 6 which would give the FDIC authority to waive the requirement for FDIC coverage if it determines that the domestic depositors of a foreign bank's U. S. branch would be covered by a foreign deposit insurance or guarantee program, or by an undertaking or agreement of a foreign governmental entity, which in the FDIC's opinion gives protection to U. S. depositors of at least similar quality and extent as would FDIC coverage. If your Subcommittee should so desire, we would be happy to work with you in developing statutory language appropriate for this purpose.

Imposition of Reserve Requirements and Interest Rate Controls

Section 7(a) of H. R. 10899 subjects all branches, agencies and commercial lending companies controlled by foreign banks whose worldwide assets exceed one billion dollars to the reserve requirements and deposit interest rate controls imposed by the Federal Reserve on member banks. Section 7(b) permits the Federal Reserve Board to prescribe rules and regulations governing the access of foreign branches, agencies and commercial lending companies to the clearing, discount and advance facilities of the Federal Reserve System.

While the bill does not require foreign institutions to become members of the Federal Reserve System, these two provisions of Section 7, along with the remaining provisions in the Section, impose upon foreign branches, agencies and commercial lending companies the obligations and benefits of Federal Reserve membership. For all practical purposes, this bill, in effect, requires Federal Reserve membership, even though it is not stated as such.

In my June 20, 1977 testimony before your Subcommittee, I indicated that, although I have an open mind with respect to the question of universal reserve requirements, I do not believe that the issue of reserve requirements for nonmember institutions should be dealt with on a piecemeal basis. Rather, it seems to me that the relationship to the Federal Reserve System of all banking institutions which choose not to join the Federal Reserve System should be studied in a systematic and unified fashion. Such a study is, it seems to me, the most effective way to respond to the Federal Reserve's concern with membership attrition. Applying this to the reserve requirement proposals contained in H. R. 10899 would dictate that the relationship of foreign banks, which choose to operate in the United States in one form or another, to the Federal Reserve System should be dealt with in the context of a broader solution to the question of membership.

The approach I suggest is, of course, consistent with the principle of national treatment or "nondiscrimination." And, conversely, to require, in effect, Federal Reserve membership for only those domestic affiliates of foreign banks having total assets of more than one billion dollars would represent a deviation from that principle.

Yet, I recognize full well that the priniciple of national treatment cannot be viewed as an absolute. As I indicated at the outset, that concept should certainly give way before overriding public policy considerations which arise out of special circumstances. In this regard, the Federal Reserve has argued rather strenuously that the operations of relatively large foreign banking institutions pose just such a case and this mandates a departure from the principle of national treatment.

The Federal Reserve has pointed out that from a monetary control standpoint, the operating characteristics of branches and agencies of foreign banks are noteworthy because these institutions generate a substantial portion of their funds from overseas sources, primarily from the parent or directly related institutions. These funds are not subject to Federal Reserve Regulations D or M. The Federal Reserve fears that this may result in a cost advantage for large foreign institutions vis-a-vis their large U. S. competitors who are members of the Federal Reserve System. More importantly, it is feared that lack of such direct Federal Reserve controls over reserves could impede the effective implementation of monetary policy in the face of massive and precipitous transfers of funds.

Although both these factors represent real concerns, at least two factors suggest that these problems are not sufficiently serious at this time to override the principle of national treatment in this area. It is true that foreign banking activity in the U. S. has grown considerably in recent years; yet its scale remains relatively small. The assets of all foreign banking entities, including State-chartered banking subsidiaries, are less than eight percent of total commercial bank assets as of December 31, 1977. Moreover, the Federal Reserve has stated in previous testimony that foreign banking institutions in the U. S. generally have complied with a Federal Reserve Board request to maintain reserves on increases in net liabilities from abroad which parallel requirements under Regulations D and M.

Although the operations of foreign banks could conceivably pose unique problems for the central banker, we do not believe that these potential problems are yet of sufficient magnitude to pose a real risk to the stability of our economy. At the same time, I recognize fully that the question of whether to depart from the principle of "nondiscrimination" on the matter of reserve requirements is a knotty issue on which reasonable men may differ.

With respect to the matter of deposit interest rate controls, we fully support the notion that foreign branches, agencies, and commercial lending companies should be subjected to such controls. As drafted the legislation would, however, vest all such authority in the hands of the Federal Reserve System. Such an approach is appropriate if the Congress chooses, in effect, to require mandatory membership in the Federal Reserve System. However, if the Congress chooses to maintain the option of nonmembership, then administration of such controls vis-a-vis nonmember foreign banking institutions should be vested in the FDIC as it is presently with respect to nonmember domestic institutions.