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Statement on

S. 958, 94th Congress

The "Foreign Bank Act of 1975"

Presented to

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

by

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I appreciate this opportunity to submit the Corporation's views on S. 958, 94th Congress, the "Foreign Bank Act of 1975."

Presently, foreign banks can operate in the United States through domestically incorporated banking subsidiaries or through direct branches or agencies in a few States (primarily New York, California, Illinois and Massachusetts). To the extent that a foreign bank chooses to operate in this country through domestically incorporated banking subsidiaries, its domestic operations are generally subject to the same rules under the Bank Holding Company Act which govern the U. S. activities of domestic bank holding companies, with limited exceptions not here relevant covering certain 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 or agencies, it may escape certain restrictions and requirements applicable to domestic banking organizations -- mainly in the two areas of operating offices in more than one State and being affiliated with companies engaged in a securities business. This is due, essentially, to the fact that under present law such branches and agencies are not defined as "banks" under the Bank Holding Company Act.

The bill would attempt to remedy this unequal regulatory treatment of foreign and domestic banks by defining "bank" under the Bank Holding Company Act to include "branch," thus subjecting all domestic operations of foreign banks to Federal Reserve jurisdiction under that Act. The bill would also require Federal Reserve membership for all U. S. branches, agencies and subsidiaries of foreign banks having total world-wide bank assets of more than $500 million and would require that the deposits of a domestic branch, agency or subsidiary of a foreign bank be insured by the FDIC.

While the Corporation fully supports the objective of establishing parity of regulatory treatment between the domestic operations of foreign banks and those of domestic banking organizations, we believe the Federal Reserve bill derogates from this principle of equal national treatment by imposing mandatory Federal Reserve membership and mandatory deposit insurance upon foreign banks. There is no comparable requirement under existing law that all domestic banks with assets exceeding $500 million be Federal Reserve members, nor is deposit insurance presently required for domestic nonmember banks unless they are subsidiaries of a bank holding company. Moreover, by requiring deposit insurance for domestic branches and agencies of <u>foreign</u> banks, the bill departs further from the principle of equal national treatment since the FDIC cannot under either existing law or the proposed bill insure the deposits of a branch of a <u>domestic</u> bank separately from those of its head office and other branches of the bank.

The Corporation has serious reservations about the necessity and desirability of making Federal deposit insurance available, even on an optional basis, for domestic branches and agencies of foreign banks. Insofar as these branches and agencies engage in "wholesale" international banking activities, deposit insurance is largely unnecessary. To the extent "wholesale" customers are concerned with Federal insurance of up to $40,000 on their accounts, a requirement that the branches and agencies of foreign banks have such insurance would seem to prefer such foreign bank branches and agencies over

Edge Act corporations owned by U. S. banking organizations which engage in the same type of business and are not covered by deposit insurance. The same requirement would also encourage such branches and agencies to enter or expand their retail banking business in the United States, an option U.S.-owned Edge Act corporations do not have. Furthermore, 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 the option under existing law of doing so through a domestically incorporated banking subsidiary. If equal treatment between foreign and domestic banks is the guiding principle of this proposed legislation, then as to Federal deposit insurance, the present requirements that foreign banks operate through a separately chartered domestic banking subsidiary if they wish to obtain such insurance on their domestic retail deposits should be continued.

Other considerations militate strongly against insuring the deposits of domestic branches and agencies of foreign banks and lead us to the conclusion that the Corporation's supervisory responsibilities could not be administered as effectively, or the trust fund's exposure contained as successfully, with the insurance of such branches and agencies -- even under the most carefully drawn legislation -- as they can be with the insurance granted a domestic banking subsidiary. Some of these considerations are set forth below:

(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 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 headquarters country to engage in business activities which would not be permitted to banks chartered in this country. In addition to potentially increasing the insurance risk, 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 the 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. Either move could substantially increase FDIC's insurance exposure far beyond pre-insolvency estimates.

-- Legal obstacles and transactions involving other offices of the foreign bank might prevent FDIC from obtaining the usual subrogation of deposit claims it normally gets from depositors in failed U. S. banks before making the insurance 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 preferences over FDIC based on foreign law.

Although an elaborate framework of conditions and restrictions might be imposed by statute upon the foreign bank, premised upon its express or implied consent thereto as a result of its being permitted to operate domestically, the value of such requirements depends ultimately upon either (1) the ability of the U. S. Government to physically enforce such requirements by exercising quasi in rem jurisdiction over the foreign bank's domestic assets and/or obligors or (2) the willingness of foreign governments within whose jurisdictions the foreign bank operates to enforce such requirements.

Efforts to impose requirements designed to insure the presence in the United States of adequate assets of the foreign bank to cover its domestic liabilities could turn out to be of little real value. Just when such protection is most needed (e.g., hours, days, or weeks before the foreign bank's demise or the outbreak of war) is precisely when the temptation to violate requirements of that kind could become irresistible. The value of this approach is particularly limited in situations where the chartering foreign government condones the foreign bank's efforts to escape U. S. restrictions. Even more importantly, a sincere attempt to impose meaningful restrictions of this type, such as requiring the domestic branch to maintain a substantial portion of its assets in the custody of a third party or in the form of obligations of domestic obligors or requiring a fidelity bond to guarantee the presence in the U. S. of a stipulated amount of the foreign bank's assets, could prove so onerous or costly for the foreign bank to comply with as to make such restrictions tantamount to a bar against the foreign bank's operating through a domestic branch, if deposit insurance is mandatory, or against opting for insurance, if deposit insurance for branches is optional.

While a substantially greater degree of domestic supervision and regulation might be imposed on domestic branches of foreign banks if deposit insurance is made available to them, to do so might restrict the branches' domestic activities, flexibility, and liquidity, to the point where operating such branches might become wholly impractical for the foreign bank and the expense of supervision disproportionate for domestic regulatory agencies. Even with some grant of extraterritorial power to U. S. examining and supervisory authorities by foreign governments, legal, cultural and economic barriers would certainly arise to the exercise abroad of the type of supervision generally exercised by the Corporation and other bank regulatory agencies in this country over insured domestic banks.

With respect to the willingness of foreign governments to enforce U.S.-imposed restrictions, success in this area could well depend upon the particular foreign government's interest (or that of its nationals) in the assets in question. If such government is essentially a disinterested stakeholder, a prior agreement by the foreign bank to abide by U.S.-imposed rules would presumably carry great weight. In a liquidation or other *in extremis* setting, of course, the FDIC might be required to pursue elusive or illusory assets from one country to another.

Although some of these same problems presently exist in the case of domestically incorporated subsidiaries of foreign banks, the fact of general U.S. jurisdiction over the separately incorporated subsidiary and its assets has been clearly established. Moreover, at least a majority of the domestic subsidiary's board of directors are generally required to be local residents and therefore more readily subjected to domestic civil and criminal sanctions.

In the Corporation's view, there is no certain way of containing the substantial risks to the FDI fund of insuring the domestic branches of foreign banks. A "window dressing" statutory framework could be devised, but we believe that in the final analysis, its protection might well prove illusory and involve the Corporation in financial loss that cannot be estimated in advance. In determining whether to extend deposit insurance to the U. S. branches and agencies of foreign banks, Congress must balance some conflicting considerations. On the one side there is the desirability of increasing the protection afforded to domestic depositors at these branches (many of whom might not be U. S. citizens, and all of whom could be protected under existing law if the foreign bank organized a domestic subsidiary), and of permitting foreign banks the organizational simplicity and risk-taking flexibility of having a branch or agency in this country rather than a separately incorporated domestic subsidiary, thus encouraging a friendly reception in other countries to the operation there of branches and agencies of U. S. banks. On the other side, the Congress must weigh the substantial potential risks of such insurance to the accumulated deposit insurance fund, and the apparent inequity in expecting these risks to be borne primarily by the 15,000 domestic banks which have contributed to that fund over the years since 1933.

One of the principal reasons for subjecting the domestic operations of foreign banks to the Bank Holding Company Act is functionally to limit their domestic nonbanking activities to those permissible for bank holding companies. This purpose could be equally as well accomplished -- without forcing the domestic operations of foreign banks into the Bank Holding Company Act mold and without compromising the goal of equal national treatment between domestic and foreign banks -- by simply prohibiting any foreign bank from engaging in any activity through its domestic branches, agencies and subsidiaries in any manner that would not be permissible if the foreign bank were a bank holding company. These prohibitions could, we believe, be effectively enforced by the appropriate Federal and State banking authorities which regularly examine the foreign bank's domestic branches, agencies and subsidiaries.

In conclusion, it is our view that the Federal Reserve has established no clear need for regulating foreign bank operations in this country differently from those of domestic banks. We therefore believe that, if existing law stays as it is for domestic banks, both Federal Reserve membership and Federal deposit insurance should be made available to foreign banks' domestic operations only on an optional basis and that if a foreign bank wishes to qualify for Federal deposit insurance, it continue to be required, as at present, to establish a separately incorporated domestic subsidiary. Domestic branches and agencies of foreign banks should not be made eligible for Federal deposit insurance without a full appreciation by the Congress of the substantial financial risks this could entail for the Federal deposit insurance fund.

As indicated above, however, we would have no objection to restricting the future nonbank activities of foreign banks to those that would be permissible for domestic banking organizations. Likewise, we would not object to those provisions in the bill which would permit foreign banks to own Edge Act corporations or which would facilitate their ownership of national banks by relaxing certain statutory requirements relating to the citizenship and residence of national bank directors.