For release on delivery

Statement by

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Vice Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Financial Institutions

of the

Committee on Banking, Housing and Urban Affairs

United States Senate

on H.R. 13876

August 31, 1976

I am pleased to appear before this Committee, on behalf of the Federal Reserve Board, to offer the Board's strong support for the enactment of H.R. 13876, the "International Banking Act of 1976," during this session of Congress.

As the Committee is aware, the Board's legislative recommendations for the regulation of foreign banks in the United States were introduced in the Senate as S. 958. In January, Vice Chairman Mitchell testified before this Committee and submitted a comprehensive statement of the Board's objectives and reasons for recommending the enactment of foreign bank legislation.

In supporting the present bill, I would like to discuss certain differences between H.R. 13876 and S. 958 and suggest some ways that H.R. 13876 might be usefully amended.

In recommending legislation to regulate foreign banks operating in the U.S., the Board has been guided by two basic public policy considerations. The first is the adherence by our Federal Government to the principle of national treatment, or nondiscrimination, towards foreign banks operating in this country. The second is the establishment of a system of Federal supervision, regulation and examination of foreign bank operations that is fairly comparable to the regulation of domestic banks.

There are compelling reasons to accomplish these objectives at this time. Foreign banks have grown from a curiosity in U.S. money centers to an increasingly important part of our financial system. Their activities are diverse. No longer can they be characterized as simply wholesale banks dealing principally in international transactions. Our large and powerful economy, the widespread use of the dollar in international financial and commercial transactions, the growing investment by foreigners in U.S. industries, our huge consumer markets for credit and goods and the exceptional breadth and capacity of our capital markets and securities exchanges--all are powerful inducements to foreign banking institutions to establish operations here. The development of foreign banking in the U.S. has grown at a dramatic rate in the last few years as indicated in the Statistical Appendix to my statement, and that development is continuing apace. Reports for the most recent period available indicate that banking assets of foreign banking institutions here have increased almost 10 per cent in the nine months ending June 30, 1976.

I hope this period of rapid expansion has not been based only on the existing lack of Federal regulation because that abnormality has created certain competitive advantages for foreign banks, the consequences of which are sure to be enlarged in time. The U.S. is practically alone among major industrial nations in having no national oversight of foreign banks within its borders, despite the tradition of careful and extensive regulation that we apply to all domestic depository institutions. This is an incongruous situation.

Further, the lack of Federal legislation establishing a national policy towards foreign bank operations creates the disadvantage of uncertainty for these institutions. A fair and coherent national regulatory structure would permit foreign banks here and those that wish to locate here some assurance of stability in which to plan their operations, both now and in the future. It is apparent that Congress considers Federal banking regulation to be a timely and important subject for review. The best approach would be to incorporate foreign banks into the existing regulatory structure so that any future changes that might be made by the Congress would apply to foreign as well as domestic banks. Delays in placing foreign banks on a similar footing nationally with our domestic institutions can only increase the possibility of future disruptions to their operations in this country.

H.R. 13876 would substantially accomplish both of the goals addressed by the Board in its own foreign bank legislation. First, H.R. 13876 implements the principle of national treatment by amending existing banking laws to provide foreign banks with generally the same opportunities in this country that are available to domestic banks. Further, it would subject them generally to the same rules and regulations that apply to the operations of their large domestic bank competitors. Second, H.R. 13876 provides for a Federal presence in the examination, supervision and regulation of foreign banks by permitting the establishment of Federally-approved agencies and branches and by giving the Board the authority to impose monetary and bank supervisory controls on foreign bank operations.

While the Board supports H.R. 13876, there are differences between it and the Board's bill that I would like to bring to the attention of the Committee. These differences concern (a) interstate banking, (b) deposit insurance, (c) monetary policy controls, (d) grandfathering, and (e) Federal economic policy review of foreign bank operations. We have some suggestions in these areas that we hope will be useful to the Committee in its deliberations.

INTERSTATE BANKING

The interstate branching provisions of both H.R. 13876 and of S. 958 are consistent with the principle of national treatment since under each proposal foreign banks would be given no greater branching rights than comparable domestic banking institutions. The Board believes, however, that it would be preferable to use the formulation suggested in S. 958.

Unlike Section 5 of H.R. 13876, the Board's bill does not subject foreign banks to the interstate branching restrictions of the McFadden Act; rather, it provides in Section 3(g) that a foreign bank would be able to establish a branch or agency outside of its home State only if a State bank organized under the laws of its home State could do so. The McFadden Act is, of course, undergoing a thorough study by this Committee. Adoption of the provision in S. 958 would have the advantage of avoiding any apparent prejudgment of the outcome of that study.

I would also like to note that H.R. 13876 does not apply any interstate restrictions to the establishment of agencies by foreign banks because agencies cannot accept deposits. Under S. 958, agencies are treated the same as branches for purposes of interstate restrictions. At present, the activities of agencies measured in terms of both total assets and loans are greater than the activities of branches, as agencies are the preferred form of entry for many foreign banks. Moreover, though agencies do not accept deposits, their credit balance accounts serve many of the same functions as deposits and agencies perform many other commercial banking activities that are carried on by branches, such as the making of commercial loans. In view of the size and scope of their operations, the Board thus believes that Congress should consider subjecting agencies to the same interstate restrictions that would apply to branches.

DEPOSIT INSURANCE

Section 6 of H.R. 13876 requires a surety deposit or pledge of assets by a foreign bank to protect United States depositors in lieu of FDIC insurance. The Board's earlier recommendation in S. 958 contemplated the extension of FDIC insurance to both branches and agencies of foreign banks. Section 6 of H.R. 13876 was adopted in an attempt to meet objections by the FDIC to the extension of deposit insurance to branches and agencies of foreign banks. Since passage of H.R. 13876, questions have been raised about the feasibility and effectiveness of this proposal. Surety deposits or pledges of assets could prove significantly more costly to the covered institutions than the FDIC insurance available to domestic banks. Furthermore, such a system may not assure the same degree of protection to small depositors as that afforded by FDIC insurance.

Our system of deposit insurance is more highly developed, more effective, more actuarially sound and more protective of depositors than those existing in other industrialized countries. The Board believes that it would be unwise not to make use of this insurance system which has effectively protected U.S. depositors over some 40 years. It would seem that the FDIC should be able to propose a plan that would provide both comparable Federal insurance for deposits at foreign bank offices and appropriate safeguards limiting the FDIC fund's exposure.

MONETARY POLICY CONTROLS

A major objective of the Board in submitting its proposal to regulate major foreign banks in the United States was to place this increasingly important segment of domestic banking under the same monetary and supervisory controls that apply to comparable U.S. banks. Section 7 of H.R. 13876 would largely accomplish that objective without requiring formal membership in the Federal Reserve System--a solution that is acceptable to the Board. One concern remains, however, as Section 7 would not subject State-chartered subsidiaries of foreign banks to the Board's monetary controls, even though their parent banks may have worldwide assets greater than a billion dollars. The Board believes that large foreign banks entering our markets should be subject to the same disciplines of the central banking authority that are imposed on comparable domestic banks, no matter which form(s) of organization they may choose for doing business in this country--branch, agency, or subsidiary. By not covering subsidiaries, Section 7 of H.R. 13876 could result in an anomalous situation where part of a foreign bank's operations would be subject to monetary controls and another part would not--for example, a foreign bank that maintains both a non-member subsidiary bank and branches or agencies.

GRANDFATHERING

Section 8 of H.R. 13876 conforms in large measure to the Board's own proposals by granting permanent grandfathered status from the prohibitions of the Bank Holding Company Act to most non-conforming, nonbanking activities engaged in by foreign banks on or before December 3, 1974 (the original date of introduction of the Board's bill). The exception to this position in Section 8 relates to the activities of securities affiliates of foreign banks.

The Board continues to prefer permanent grandfathering of the securities affiliates of foreign banks in this country as the fairest solution and one that minimizes possible retaliation against U.S. banks abroad. As noted in the House Report on this bill, the securities issue is a difficult one involving the balancing of many sensitive national interests. We have concluded that the potential adverse repercussions of divestiture outweigh any potential benefits, and that ample precedents exist for permanent grandfathering.

FOREIGN ECONOMIC POLICY REVIEW OF FOREIGN BANK APPLICATIONS

In comparing the provisions of Section 9 of H.R. 13876 with Section 25 of S. 958, the principal difference is our recommendation that Federal officials charged with the administration of foreign economic policy be given the right to disapprove the entry of a foreign bank if foreign policy or some similar national interest dictates such action. We do not advocate nor see the necessity for screening or detailed guidelines and policy pronouncements. Bank regulators can administer that chartering responsibility. Rather, we believe that there should be some authority in Government (other than the bank regulatory agencies) that would make a determination on national interest factors based on our relations with particular countries. We therefore note this point for the Committee's consideration.

AMENDMENT REGARDING FOREIGN NONBANK OPERATIONS

Finally, I would like to discuss what I believe is a misconception on the part of some foreign banks about the reach of the nonbanking prohibitions of the Bank Holding Company Act. Apparently, some foreign banks believe that the nonbanking prohibitions of the Bank Holding Company Act would seriously interfere with their foreign nonbanking interests. I would note first that section 2(h) of the Bank Holding Company Act specifically exempts the wholly foreign activities and shareholdings of foreign banks from the nonbanking prohibitions of the Act. Next, I would emphasize that even when a foreign company in which a foreign bank has an equity interest does conduct a part of its business in the

United States, the Board has used its discretionary authority under section 4(c)(9) of the Act to prevent the nonbanking prohibitions of the Act from unnecessarily interfering with essentially foreign shareholdings. For example, the Board has adopted a regulation that automatically exempts all noncontrolling investments of foreign bank holding companies in foreign nonbanking companies from the prohibitions of the Act, even if such nonbanking companies are directly or indirectly engaged in business in the United States, as long as such foreign companies derive the majority of their business from outside this country.

The Board has refrained from granting exemptions under section 4(c)(9) only in cases where it was clear that the U.S. nonbanking operations involved would give a foreign bank holding company a significant competitive advantage over domestic banking institutions in this country. In this regard, I think it is important to quote a provision of Chairman Burns' previous testimony on this issue before the Senate Banking Committee in 1970:

> ". . .[W]e believe that bank holding companies that are principally engaged in banking abroad should be allowed to retain interests in foreign-chartered nonbanking companies that are also principally engaged in business outside the United States. We do not believe Congress intended the Act to be applied in such a way as to impose our ideas of banking upon other countries. To do so might invite foreign retaliation against our banks operating abroad, to the detriment of the United States. The provisions of the House-passed bill authorizing the Board to grant exemptions in this area would be most useful in dealing with these problems."

The Board would continue to be guided by these principles in its administration of the Bank Holding Company Act vis-a-vis the foreign banks that would be covered by this proposed legislation.

While the Board believes that it has sufficient regulatory authority under section 4(c)(9) to deal with problems that may occur in this area, we also believe that it would be desirable at this time for the Congress to adopt a more well-defined legislative policy. A great number of foreign banks emanating from a great variety of banking environments would become subject to the nonbanking prohibitions of the Bank Holding Company Act as a result of this proposed legislation. The lack of a statutory policy could initially cause some misunderstanding by foreign banks of the Act's effects on foreign companies with U.S. operations and would make more difficult the task of formulating appropriate general regulations.

Therefore, the Board recommends that H.R. 13876 be amended to make clear that the nonbanking prohibitions of the Bank Holding Company Act are not meant to prevent foreign banks principally engaged in banking abroad from retaining or acquiring interests in foreign-chartered nonbanking companies that are also principally engaged in business outside the United States. We do feel, however, that as a corollary to any such amendment, a domestic office of a foreign bank should be required to deal with the domestic operations of a foreign company in which it may have an equity interest on a strictly arms-length basis so as not to give the firm or bank involved an advantage over their respective U.S. competitors. Legislative language incorporating this proposal is suggested in Appendix B to this statement.

Finally, I would like to emphasize the Board's support for the early passage of H.R. 13876.

Through your hearings on S. 958, the House debates on H.R. 13876 and these proceedings today the principal issues have been identified. Indeed, most responsible objections to the legislation can be and have been met through fair and appropriate amendments. The question is should we not put foreign and domestic banks on a relatively equal footing in the United States now, for surely they should be in time. In fact, this legislation is an essential ingredient in the larger process of modernizing our own banking laws. That work will be fairer and I suggest easier if it is evenly applicable to all banks in our country as it would be if H.R. 13876 is enacted.

The conscientious and excellent work of Congress and this Committee should continue until this bill is passed. The Federal Reserve stands ready to assist you in any way necessary.

Thank you.

Appendix A to Statement by

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Proposed Technical Amendments to H.R. 13876--The International Bank Act of 1976

1. Page 1, line 10 insert "checks are paid, or money is lent" after the word "powers,".

Explanation: The words "checks are paid, or money is lent" were deleted from the definition of "agency" as a result of certain technical amendments adopted during House passage of the bill (see daily ed. Cong. Rec. July 29, 1976 at 7945). It appears from the precise language of the technical amendment adopted by the House of Representatives, that is, deletion of the phrase "and checks are paid or money is lent", that the amendment was intended to apply to the definition of "branch" not "agency" (see discussion infra). Accordingly, it is recommended that the deleted phrase be reinserted.

2. Page 2, lines 7-8, strike the words "and checks are paid or money is lent".

Explanation: In its passage of H.R. 13876, the House of Representatives adopted the following technical amendment without explanation--page 2, line 6 strike the words "and checks are paid or money is lent". The page and line reference was to the definition of "agency"; however, the precise phrase is contained in the definition of "branch". It is believed that the amendment was intended to apply to the definition of "branch" in order to close a potential loophole. Technically, under the existing definition of "branch", if a U.S. office of a foreign bank accepted deposits but did not also lend money or pay checks, it would not be defined as either a "branch" or "agency". By striking "and checks are paid or money is lent" in the "branch" definition, this potential loophole would be closed and it would be made clear that any office receiving deposits would be defined as a branch. If a foreign bank office did not accept deposits but did lend money or pay checks or maintain credit balances, it would be defined as an "agency" and would not otherwise escape the Act's coverage.

3. Page 4, line 3, insert the following new definition:

"(12) 'consolidated' means consolidated in accordance with generally accepted accounting principles in the United States consistently applied."

Explanation: The definition of "foreign bank" in Section 1(7) of the bill and the amount threshold for imposition of monetary controls on foreign banks in Sections 7(a)(2) and (3) of the bill both rely on a "consolidated" test applied to foreign banks. The recommended amendment would make clear that U.S. accounting principles are to be applied in determining whether a foreign bank meets the tests applied by those sections.

4. Page 12, strike lines 22 through 25 and page 13 strike lines 1 through 13 and insert in lieu thereof the following:

"Sec. 5. (a) Except as provided by subsection (b), (1) no foreign bank may operate a Federal branch outside its home State unless the State is one in which it could operate a branch if it were a national bank located in its home State; (2) no foreign bank may operate a State branch outside its home State unless (A) the State is one in which it could operate a branch if it were a national bank located in its home State, and (B) the State branch is approved by the regulatory authority of the State in which such branch is to be located; (3) no foreign bank may operate a State agency and no foreign bank or company of which it is a subsidiary may operate a commercial lending company subsidiary outside of its home State unless such State agency or commercial lending company subsidiary is approved by the regulatory authority of the State in which such agency or commercial lending company is to be located; and (4) no foreign bank may acquire any voting shares of, interest in or substantially all of the assets of a bank located outside of its home State unless such acquisition would be permissible under section 3 of the Bank Holding Company Act of 1956 if the foreign bank were a bank holding company the operations of whose banking subsidiaries were principally conducted in the foreign bank's home State."

Explanation: This recommended amendment is merely an attempt to clarify the application of the interstate banking restrictions of Section 5 to the various forms of foreign bank operations in this country; it effects no substantive change in the section. Specifically, it subdivides the section by the specific forms of organization affected--Federal branches, State branches, State agencies and commercial lending companies, and banks. A provision in the existing Section 5(a) indicating that a Federal branch or agency cannot be established outside of a foreign bank's home State if prohibited by State law is eliminated because it serves merely to duplicate Section 4(a) of H.R. 13876. In addition, the language pertaining to a "bank" operated by a foreign bank outside of its home State has been conformed more closely to the language of section 3(d) of the Bank Holding Company Act.

5. Page 14, line 7, pluralize the word "State".

Explanation: The reference to "State" in subsection (3) of section 5(c) is clearly intended to be a reference to "States".

Appendix B to Statement by

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Proposed Amendment to H.R. 13876 Regarding Foreign Nonbank Operations of Foreign Banks

Section 8 of H.R. 13876 is amended by adding the following new section (e) after line 24 on page 25.

"(e) Section 2(h) of the Bank Holding Company Act of 1956 is amended by striking the proviso to that section and inserting in lieu thereof the following:

> "Provided, however, That the prohibitions of Section 4 of this Act shall not apply to shares of any company organized under the laws of a foreign country (or to shares of any subsidiary of such company principally engaged in activities incidental to the business of the parent) that is principally engaged in business outside the United States if such shares are held or acquired by a bank holding company organized under the laws of a foreign country that is principally engaged in the banking business outside the United States, except that (1) such a company (A) may engage in the business of underwriting, selling or distributing securities in the United States only to the extent that a bank holding company may do so under this Act and under regulations or orders issued by the Board under this Act, and (B) may not engage in the United States in any banking or financial operations or types of activities permitted under section 4(c)(8) of this Act unless it complies with all the conditions specified in section 4(c)(8) or in any order or regulation issued by the Board under such section, and (2) no domestic office or subsidiary of a bank holding company or subsidiary thereof holding shares of such company may extend credit to a domestic office or subsidiary of such company on terms more favorable than those afforded other borrowers in the United States. For purposes of this subsection--(i) a bank holding company may not in any case be considered to be 'principally engaged in the banking business outside the United States' if its principal banking subsidiary is located in the United States; and (ii) 'domestic' means located in the United States or organized under the laws of the United States or any State thereof."

Explanation: The present section 2(h) of the Bank Holding Company Act provides that the nonbanking prohibitions of the Act "shall not apply to shares of any company organized under the laws of a foreign country that does not do any business in the United States, if such shares are held or acquired by a bank holding company that is principally engaged in the banking business outside the United States." Thus, under the current section, a foreign nonbanking company held or acquired by a foreign bank is only eligible for a statutory exemption from the Act's nonbanking prohibitions if it does no business in the United States. This provision thus does little more than recognize the inherent territorial restrictions of the Act.

The proposed amendment would amend section 2(h) of the Act to give foreign bank holding companies principally engaged in banking abroad a statutory exemption under which they could retain and acquire interests in foreign-chartered nonbanking companies that are principally engaged in business outside the United States, even if they have U.S. operations. This would exempt both controlling and minority interests in such companies.

Three important exceptions, however, are made to the exemption. First, no company may qualify for the exemption if it conducts a U.S. securities business that would not be permissible for a domestic bank holding company; this serves to prevent this exemption from being used as a way to avoid Glass-Steagall prohibitions. Secondly, no foreign bank holding company may use this exemption as a means of evading the requirements of § 4(c)(8) of the Act. For example, if a foreign bank owns a foreign leasing company that company may only establish or retain offices in the United States to conduct leasing operations in accordance with the same limitations and procedures that apply to domestic bank holding companies under § 4(c)(8) of the Act and the Board's Regulation Y. Thirdly, it is provided that no domestic office or subsidiary of a foreign bank or subsidiary thereof may extend credit to a domestic office or subsidiary of a foreign nonbanking company qualifying for the exemption on terms more favorable than those afforded other borrowers in the United States. This condition is imposed so as not to give the foreign bank or nonbank firms involved an advantage over their respective U.S. competitors.

In addition, appropriate governing definitions have been proposed in the amendment. For example, in order for a foreign bank holding company to be "principally engaged in the banking business outside the United States" and thus eligible to use the exemption, it is provided that its principal banking subsidiary cannot be located in the United States. This latter definition prevents large U.S. banking organizations from ever being able to use the exemption.

The general purpose of the proposed amendment is to make clear that the Bank Holding Company Act and H.R. 13876 are not meant to apply our ideas of banking to foreign bank operations that derive from and have their primary effects in countries outside the U.S. Since the companies exempted must be principally engaged in business outside the United States and since the foreign bank must be principally engaged in business outside the United States, it is not anticipated that the amendment would have significant effects on the concentration of domestic resources or give foreign banks or their nonbank affiliates significant competitive advantages. The proposed amendment would also be consistent with the U.S. approach of encouraging foreign investment in this country; lack of a statutory exemption may discourage major foreign nonbanking companies from establishing facilities in the U.S. because of a foreign bank shareholder. Finally, the proposed amendment should lessen the possibility of any retaliatory measures being taken abroad against U.S. banks.