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# PUBLIC POLICY ISSUES
# IN U.S. BANKING ABROAD

Remarks by

Robert C. Holland, Member

Board of Governors of the Federal Reserve System

at the

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Bankers' Association for Foreign Trade

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I am pleased to be here with you today to discuss some of the outstanding issues in international banking regulation.

Banks and banking systems the world over have been going through a time of testing. The strains of the past two years--and particularly of last summer--are well-known to everyone here. Under those pressures, the fabric of international banking has in general held up well, and it is important not to lose sight of that fact. However, some banking weaknesses have surfaced. It comes as no surprise, therefore, that issues of bank regulation and modifications of regulatory policy are being actively reviewed in virtually every major country. The problems being faced by bank regulators in these different countries are sufficiently similar to engender a number of efforts to improve cooperation and consultation among the bank supervisory agencies of the major industrial countries. I welcome these developments. Hopefully in the long run these consultations

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I wish to acknowledge the assistance of Mr. Henry S. Terrell, Chief of the International Banking Section in the Board's Division of International Finance, in developing the ideas in this paper. The views herein expressed, however, are my own personal responsibility.

will result in a more nearly harmonized regulatory system. In the meantime, we shall have to deal with banking problems on an essentially national basis, reaching out to achieve coordinated multinational action as we can.

As you know, a little over two years ago the Federal Reserve established a Steering Committee on International Banking Regulation to review the issues confronting the System in this area.

Over the past year that Committee has concentrated much of its attention on designing a comprehensive framework for foreign banks operating in the United States that would place them under essentially the same regulations as their domestic bank counterparts. That effort has produced a legislative proposal which has now been introduced in both Houses of the Congress.

I should like to take this opportunity to reiterate the appreciation of the members of our Committee for the contributions made by the Bankers'

Association for Foreign Trade to the work on this proposal. I should also like to express my personal gratification that the leadership of your Association and so many of your members have indicated their general support for this Federal Reserve bill. Congressional hearings on our proposal will probably be scheduled soon and hopefully definitive legislation will ensue.

The attention attracted by our proposed foreign banking legislation has tended to obscure the other half of our Steering Committee's assignment, namely, to review and propose revisions in the regulations governing the foreign activities of U.S. banks in the light of the substantial changes which have occurred in recent years. It is to this latter task that our Steering Committee is now returning its attentions.

You may recall that in its press release of February 1, 1973, announcing the formation of our

Steering Committee, the Federal Reserve noted that one reason for its creation was the fact that foreign branches of U.S. banks had increased their total assets nearly eight-fold--to about $75 billion--between the end of 1965 and 1972. Since then, the total assets of the foreign branches of U.S. banks have doubled again, to approximately $150 billion. For some of the largest U.S. banks, foreign branch activity now accounts for between one-third and one-half of their total banking activity. And in addition to foreign activity conducted through their foreign branches, U.S. banks engage in international financing activities at their domestic offices as well as through investments in foreign subsidiaries and affiliate corporations. Thus, the sheer magnitude, complexity and rate of growth of the foreign operations of U.S. banks provides an impetus for bank regulators to devote considerable resources to periodically reviewing and updating the relevant regulatory framework.

I cannot tell you today what the shape of the proposed Federal Reserve revisions in the regulation of the operations of U.S. banks abroad may be. I can, however, outline for you four of the key issues on which our studies are focussing and what I regard as some of the more significant related questions. Those issues are:

(1) entry by U.S. banks into foreign countries and the range of their permissible activities,

(2) problems of capital adequacy and where the capital of a multinational banking organization should be located,

(3) the impact of international banking on domestic monetary policies and the related question of who serves as whose lender of last resort, and finally

(4) the proper scope of bank surveillance, reporting and examination in a contemporary international context.

A little over a year ago, our Committee met with representatives of your Association to obtain the benefit of their views in this matter. Hopefully, that dialogue can be renewed and broadened in the coming months to assist us in weighing the appropriate set of regulatory and supervisory policies.

Entry and permissible activities

The first of these issues is entry into foreign jurisdictions and the range of foreign activities in which U.S. banks will be permitted to engage. The most logical point of departure for any revision of U.S. regulations in this area is the principle of "mutual nondiscrimination," the same principle that is embodied in our proposed legislation on foreign bank activity in the United States. Under this principle individual countries would permit foreign-owned banks to perform the same types of financial activities which are permissible to indigenous banks. Adhering to this principle, foreign countries would have essentially one set of rules and regulations for all banks within their jurisdictions, rather than one set for domestic banks and a second and different framework for foreign-owned banks.

It is only realistic to recognize that this guiding principle is likely to be tempered in certain instances by considerations of "national interest." Some countries would be hesitant to permit the preponderance of money and credit flows within their borders to pass through foreign controlled banks. This worry may be especially troublesome for some of the lesser developed countries which do not have strong locally-owned banking institutions. At least within industrial nations, however, it is to be hoped that the extent of any discriminatory restraints would be reduced to a practical minimum. Over the long run the best warranty for such treatment by a foreign host country is the performance of U.S. banks and banks from other countries in that host country; nothing works more effectively to reduce unfair barriers than a demonstrated beneficial impact by foreign banks on the economies of their host countries.

But home as well as host countries can impose constraints. Thus, an important corollary question concerns the range of financial activities which U.S. banks should be permitted to engage in abroad by the U.S. regulatory authorities. Since U.S. banks compete actively with foreign banks outside the United States, and since many foreign banks are permitted to engage in a wider range of activities than is permitted to U.S. banks in their domestic operations, the Federal Reserve generally allows U.S. banks to engage in a wider range of activities in their foreign affiliates than in their purely domestic operations.

How much further it is wise to go in this direction is a very difficult question to answer. To be sure, the ability to compete on even terms in any market is highly prized by a banking organization. Yet the United States has a definite statutory and regulatory view of the limited range of activities in which commercial banks should engage within its own borders. One important aspect of U.S. banking structure, for example, is the separation of banking from commercial and industrial enterprises, a distinction which is not preserved in many countries in continental Europe where commercial banks have large equity interests in commercial and industrial enterprises.

It can be argued that U.S. banks in their operations abroad should be afforded the greatest liberality available under foreign regulations, if and to the extent that such activities are insulated in some way from the "domestic" parent bank. By insulation, I mean shielding the domestic bank from the risks of those foreign operations. That insulation is clearly not possible with respect to the foreign branches of U.S. banks that are legally integral parts of the U.S. institution.

Therefore the question devolves upon the activities permissible to foreign subsidiaries and foreign joint ventures and affiliates in which U.S. banks have invested. This is a much more complicated question. To a very large extent it is analogous to the domestic issue of the degree of insulation of banks from their parent holding companies and nonbanking affiliates. Theoretically, a U.S. bank enjoys a degree of legal insulation from the obligations of both its domestic and foreign subsidiaries. Knowledgeable market participants are aware of this legal distinction with regard to the liabilities of any such subsidiary corporation. However, practical business considerations typically impel a bank to try to stand behind the obligations of its wholly-owned and controlled subsidiaries. This business practice compels U.S. bank supervisors, in turn, to be concerned about the activities of foreign subsidiaries and their potential impact on their parent U.S. banking organizations.

As regards consortium banks and other joint venture enterprises in which a U.S. bank is a minority partner, the U.S. bank has legal insulation and it has a greater degree of practical insulation from the affairs of the affiliate. Precisely how much practical insulation exists probably depends in good part on how prominently the U.S. bank has been associated with the foreign venture. Nevertheless, there is still an issue of the extent to which a U.S. bank could or should walk away from responsibility for an affiliate of this kind.

How properly to reconcile these conflicting considerations of freedom and risk is one of the most difficult tasks facing our Federal Reserve Committee. Among various options, one possible approach would be for insulated foreign affiliates of U.S. banks to be explicitly permitted to engage in a considerably wider range of activities abroad than could integrated affiliates. That permission could be given by a regulation listing either a "positive" list of approved foreign activities or a "negative" list of activities which would not be permissible to U.S. bank affiliates in foreign countries. I am aware that preparing and publishing either type of list, rather than continuing the existing case-by-case approach, might reduce the flexibility of U.S. banks in their foreign investments, since no list could cover the entire range of possible investments. Either type of list might, however, be beneficial to banks in determining their long-range investment plans, since they would have better information on the types of activities which were likely to receive Board approval.

In the case of a "positive" list of approved activities, one way to prevent the loss of flexibility for banks could be to provide a certain amount of leeway for banks to make investments in activities not otherwise permitted, subject to Federal Reserve review. By limiting the leeway for total investments of this sort for any one bank to a small fraction of its total capital, the risk exposure for individual banks could be constrained. The list could be modified as banks and regulatory authorities gained more experience with the activities performed by the banks under this leeway provision.

Banking capital

A second important issue in the regulation of the international activities of U.S. banks is capital adequacy. The Federal Reserve, of course, has been highly concerned with the capital position of U.S. banks, in relation to their exposure both at home and abroad.

In the international area, the question of capital adequacy is particularly complicated. In addition to the normal risks associated with domestic banking, international banking involves risks of exchange market fluctuations, lack of foreign information, adverse political action, and the risks involved in a wider range of financial activities. These additional and different risk elements introduce another dimension to the already thorny capital problem. A first and obvious question is whether the very existence of those elements requires that additional capital provisions be made in banks with significant international operations. The Board has come to no conclusion on this question. One has to admit that there is no persuasive empirical evidence to support such a contention. The data we have bearing on this issue are partial and not completely satisfactory; but they do suggest that actual loss experience in international operations has been no worse than domestic operations and perhaps has been better--so far!

It has also been argued that a bank with extensive international operations is better able to diversify its activities and hence reduce its overall risk exposure. There is merit to the argument, but how much counterbalancing weight it should be given is unclear. Nevertheless, if one cannot answer that question conclusively with respect to traditional banking operations, one is necessarily cautious about permitting banks to extend their overseas activities into nonbanking areas.

Clearly, the level of capital adequacy in international banking ought to be associated with the business risks attaching to the activities of the banks. Accordingly, capital needs might be diminished to some extent by resort to risk-reducing arrangements such as obtaining credit or deposit insurance or denominating more affiliate assets and liabilities in the home currency of the banking organization. Similarly, it is possible that a policy of permitting U.S. banks to engage in a range of riskier activities only through insulated affiliates abroad might require a smaller bank capitalization than if such activities were undertaken in full-fledged branches.

But is it practical to conceive of the development of insulated foreign affiliates? I have already touched on the difficulties of insulating a bank from a foreign subsidiary and hence the potential impact of that subsidiary's activities on the bank's capital. One possible step toward minimizing that impact might be rules encouraging the foreign affiliate to "stand on its own balance sheet." Such rules could aim to keep the foreign subsidiary from being over-leveraged to the extent that it is more than ever dependent on the backing of its parent bank for its funding. There have been several instances in the past year where U.S. banks have been thrown into the necessity of bailing out a foreign subsidiary partly because that subsidiary was so heavily leveraged. In some I think the issues of risk in international banking, the institutional and legal framework in which U.S. banks will operate in their international activities, and the question of capital adequacy for banks with a range of foreign affiliates will have to be rethought carefully in the light of experience, including the sometimes unfortunate experiences of the recent past.

Monetary policies

A third area of concern in international banking regulation involves questions of control by central bankers over conditions in money and credit markets, and the role of central bankers as lenders of last resort. Large banks with multinational operations have access to sources of funds in money markets all over the world. These institutions are able to bid for substantial sources of funds at their offices in one country and transfer the funds through their internal networks to an eventual user of funds in another country. This flexibility in financing arrangements by U.S. banks and by banks of other countries has had the beneficial effect that depositors in some countries are offered higher rates on their savings while borrowers have obtained credit on better terms than they might have received if their range of choice had been confined to purely local banks. In many ways, this "internationalization of banking" has had the procompetitive effect of increasing the number of participants in various banking markets.

On the cost side, the internationalization of banking has meant that some countries have lost a measure of control over conditions in their credit markets. The comparatively uncontrolled Euro-dollar and other Euro-currency markets become attractive sources of intermediation between ultimate borrowers and lenders, in part because financial institutions operating in these markets are not required to bear the burden of required reserves and some of the other costs of banking regulation that fall upon domestic banking enterprises.

A rapid expansion in intermediation through the Euro-dollar market could mean that some borrowers and depositors in the United States would be able to obtain credit and deposit services from banking offices which are not under the control of the central bank. Thus a policy of monetary restraint in the United States could become less effective if key borrowers had ready access to major sources of credit to finance activities in the United States over which the Federal Reserve had little effective control. By the same token, a policy of monetary expansion might have less predictable effects on expanding credit in the United States and might be rendered less effective if U.S. banks utilized available resources to expand their overseas Euro-dollar activities rather than for loans which might expand business activity here in the United States.

In analyzing credit flows through the Euro-dollar market I do not mean to imply that a large share of what is essentially a domestic U.S. banking business is currently taking place in the Euro-dollar market. Our best information indicates that U.S. users of banking services have a strong preference for conducting their banking activities with banking offices here in the United States. Depositors and borrowers both desire the maintenance of established banking relationships, despite the occasional existence of interest rate or other incentives for obtaining banking services from banking offices outside the United States.

My concern over the existence of an unregulated and reserve-free market in bank services is prospective. I am concerned that in the future the existence of this market will become increasingly attractive to potential customers who today may not regard it as a feasible alternative. I believe that the present is a good time for us to begin to think about some of the policy implications of a continued growth of an unregulated market in banking, for I am convinced that the cost advantages of the Euro-dollar market will promote its continued growth into the foreseeable future.

I have mentioned the costs to banks and their customers of regulation and the fact that banks can sometimes avoid some of these costs by conducting their operations from offices foreign to the countries in which they may be obtaining resources and/or extending credits. Some of these "banking havens" do not regulate, examine, or place reserve requirements on banking activity which are in currencies external to their own. In other countries, banking regulation imposes costs on banks that are largely passed on to the banks' customers in the form of higher charges for services or lower rates of interest on deposits.

But bank regulation is not simply a burden to be avoided if possible or else to be borne with a sense of resignation. Banking regulation also conveys various generalized benefits to the banks and their customers by protecting the soundness and stability of institutions which accept deposits from the public, service the payments mechanism, and meet a large share of the credit needs of our economic system. In essence, bank regulation can build and maintain confidence, and in today's troubled world that is an attribute to be treasured.

Beginning about a year ago, a number of commercial banks learned that one value of having a strong central bank in their home country was its ability to serve as a lender of last resort in the event that the bank experienced liquidity difficulties. The events of last summer--when some soundly run banks had trouble renewing their Euro-market and other short-term liabilities, sometimes simply because the banks were small or were from countries with balance of payments difficulties--indicated the importance of central banks standing ready to assist qualified commercial banks experiencing such difficulties. Such assistance can help insure that serious problems affecting an individual bank or a small group of banks can be kept localized and prevented from causing a generalized loss of confidence in international markets.

In looking towards the future, it seems reasonable to ask whether banking organizations that enjoy the benefit of having a central bank lender of last resort should not also bear the burden of central bank regulation. In particular, I think that central banking authorities need to consider whether the time has come for some coordination of their reserve requirement regulations so that comparatively unregulated and reserve-free market in banking services does not evolve to such an extent that it threatens the ability of individual countries to pursue their domestic monetary policies.

Oversight of banking abroad

There is a fourth and final subject area concerning foreign offices of U.S. banks which needs careful review, and that is the matter of surveillance, reporting, and examination. Your subsequent speaker this morning, the Comptroller of the Currency, will be exploring this subject with you in some detail. I should like to note merely that bank regulators, and central bankers responsible for national economic policy, need timely information on what banks are doing in their international business. This information is needed both for purposes of analyzing the activities and condition of an individual bank and for the larger economic purposes of understanding capital and credit flows and their impact on the economies of different countries. I commend the respondent banks for their cooperation in the existing reporting arrangements, and I hope that in the future banks will continue to assist the Federal Reserve and our colleagues in developing information flows that answer the main public policy questions without excessive reporting burdens on the banks.

Concluding observations

What I have given you today is really an agenda. I have not attempted even tentative answers to the key questions, but rather have supplied you with a description of relevant issues and various unresolved questions in four major areas of concern to the Federal Reserve. The policy implications of the answers to some of these questions I have posed may take a considerable amount of time and effort to resolve. We solicit comments and suggestions on all these matters from you and your colleagues. I hope that as the year progresses we can all contribute to bringing international banking regulation into better alignment with present realities and prospective needs.