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Statement by

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before the

Subcommittee on Economic Stabilization

Committee on Banking, Finance and Urban Affairs

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I am pleased to appear before you this morning to present the views of the Federal Reserve Board on the proposed Fair Trade in Financial Services Act of 1991. Given our direct responsibilities with respect to the financial services industry and our desire to ensure a healthy and efficient environment for the provision of financial services, the Federal Reserve has a special interest in this legislation.

The proposed Act has two major elements that I would like to discuss this morning. First, the Secretary of the Treasury would be required to submit to Congress every two years a report identifying those countries that do not offer national treatment to U.S. banks, securities brokers and dealers, or investment advisers. A country offers national treatment to foreign firms if it offers "the same competitive opportunities (including effective market access)" as are available to their domestic firms. In the case of a country where a significant failure to accord national treatment is found, the Secretary of the Treasury must in general enter into negotiations with the country to end the discrimination. The Secretary may, at his discretion, publish in the Federal Register a determination that a country does not give national treatment; if he does so, regulatory agencies would have authority to use such a determination as a basis for denying applications by financial institutions from that country.

Second, if the Secretary of the Treasury has published in the Federal Register a determination with respect to a country, institutions from that country that are already operating in the United States may not commence "any new line of business" or conduct business from a "new location" without obtaining prior approval from the appropriate

regulators. This provision would apply to new U.S. activities or U.S. offices for which no approval process is currently required for either domestic or foreign banks. For example, a foreign-owned U.S. bank may decide to begin to offer consumer mortgage lending or investment advisory services. Currently, no application for regulatory approval is required. However, under the proposed Act such activities would be viewed as "new lines of business" requiring regulatory approval.

While we share the objectives of this proposed legislation, in that we too would like to encourage other countries to liberalize their financial markets, we think the legislation itself is unwarranted and would have unfortunate consequences. It would reject national treatment and grandfather rights -- two practices that have been fundamental to U.S. policy toward the international operations of financial organizations. These practices should be preserved. Let me elaborate on these points.

The principle of national treatment was established as U.S. policy with respect to foreign banks by the International Banking Act of 1978. Despite some individual legislative initiatives in recent years, it is acknowledged by virtually all major industrial countries as the principle upon which regulation of the international operations of banks ought to be based. Over many years the U.S. government has assumed a leadership role in building a consensus around this concept. At home, our policy of national treatment seeks to ensure that foreign and domestic banks have a fair and equal opportunity to participate in our markets. The motivation is not merely a commitment to equity and non-discrimination, though such a commitment in itself is worthy. More fundamentally, the motivation also is to provide consumers of financial

services with access to a deep, varied, competitive, and efficient banking market in which they can satisfy their financial needs on the best possible terms.

Our policy of national treatment has served this country well. The U.S. banking market, and U.S. financial markets more generally, are the most efficient, most innovative, and most sophisticated in the world. It is not a coincidence that our markets are also among the most open to foreign competition. Foreign banks, by their presence and with the resources they bring from their parents, make a significant contribution to our market and to our economic growth; they enhance the availability and reduce the cost of financial services to U.S. firms and individuals, as well as to U.S. public sector entities.

The proposed Act would replace the U.S. policy of national treatment with a policy of reciprocal national treatment. The United States would be saying that we are prepared to forego the benefits of foreign banks' participation in our market if U.S. banks were not allowed to compete fully and equitably abroad.

Based on experience to date, the Federal Reserve feels strongly that there are better ways to encourage other countries to open their markets. Relying on market forces to induce liberalization may actually be the most potent force. It is well understood that any country that wants to have a financial market with sufficient international stature to compete with New York and London must liberalize and open its market. Many countries, including notably -- but not only -- Japan and Germany, are moving inexorably in that direction.

Nevertheless, we have not relied only on such a passive strategy, however successful such a strategy ultimately may be. In 1979,

following the International Banking Act, the Treasury Department, with the help of other agencies, prepared its first National Treatment study, which has been updated several times, most recently last year, and which will be prepared regularly in the future, pursuant to the Omnibus Trade and Competitiveness Act of 1988. Based on the findings of those reports, the Treasury has engaged in bilateral talks with a number of countries, including the Japanese, partly as a consequence of which we have seen a substantial degree of liberalization in foreign financial markets.

Beyond those efforts, the Federal Reserve and others urged countries of the European Community strongly and with some success to soften the reciprocity provisions in their proposed Second Banking Directive. We have participated in a range of committees at the Bank for International Settlements in Basle and at the Organization for Economic Cooperation and Development in Paris, where work has been aimed in part at establishing the legal, supervisory, and regulatory conditions that are a precondition for ensuring a "level playing field." In addition, the Federal Reserve has joined others in the U.S. government in working vigorously to reach a meaningful agreement on trade in financial services within the current Uruguay round of multilateral trade negotiations.

I turn now to grandfathering, a practice widely accepted internationally as a means of protecting investment in existing foreign banking operations at a time of statutory change. U.S. operations of foreign banks were grandfathered in the International Banking Act. With respect to foreign operations of U.S. banks, the Federal Reserve, along with others in the U.S. government and the U.S. financial industry, objected strenuously when the European Community was considering the elimination of grandfather rights for foreign banks, including U.S.

banks, operating in Europe; in the end the EC preserved those rights, as I suspect they realized all along they would ultimately have to do. Consequently, European subsidiaries of U.S. banks may continue to conduct business and expand their operations on a national treatment basis.

If, contrary to this widely accepted practice, Congress were to adopt the proposed Act, the United States could no longer hold to a principled position in advocating liberalization in international circles. By telling existing foreign-owned banks in the United States that the rules and procedures that have applied equally to them and to all other banks operating in the United states now apply only to U.S.-owned banks, we would be denying national treatment to foreign banks. We would run the risk of introducing instability and discouraging foreign investment in our markets. Moreover, we would be inviting almost certain retaliation.

In conclusion, I would like to emphasize that we have witnessed substantial liberalization and structural reform in financial markets abroad over the past decade. Like Members of Congress, we too would like to see further progress. However, we must recognize also that U.S. markets are not as open as other countries would like, or for that matter as free as many in the United States, including the Federal Reserve, would like.

National treatment is an important concept, but in its implementation it is also an elusive one. Because it is enormously difficult to apply national treatment in a world in which the structures of banking markets in various countries differ significantly, it is tempting to seek what may appear to be direct, clear-cut solutions. However, lawmakers in each country, including the United States, must

balance considerations of competitive equity with other legitimate concerns. We cannot insist that other countries adopt our structures any more than we can let others dictate to us.

It could prove to be a costly mistake if we jeopardize the gains we have made and are continuing to make in improving our own markets, in reforming markets abroad, and in gaining access for U.S. financial firms to those markets, for the sake of trying, probably in vain, to force others to adhere to our own timetable.