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Statement by

John P. LaWare

Member, Board of Governors of the Federal Reserve System

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I appreciate the opportunity to present the views of the Federal Reserve Board on the proposed legislation on Fair Trade in Financial Services (H.R. 3248). 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 legislation has two major elements. First, the Secretary of the Treasury would be required to submit to Congress every two years a report identifying those countries which do not offer national treatment to U.S. banks or securities firms. In the case of a country where failure to accord national treatment is found to have a significant adverse effect on U.S. firms, 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 discretionary authority to use such a determination as a basis for denying applications by financial institutions from that country to make acquisitions or start new activities.

Second, if the Secretary of the Treasury has published in the Federal Register such a determination with respect to a country, institutions from that country which 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 federal regulators. This provision would appear to apply to new U.S. activities or U.S. offices for which no approval currently is

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 legislation such activities would appear to constitute "new lines of business" requiring regulatory approval.

Thus, the legislation would change two fundamental principles in our policy toward participation by foreign financial firms in U.S. markets -- national treatment and maintenance of rights lawfully acquired, that is, grandfather rights. Both of these principles are worth preserving.

I want to emphasize that the Federal Reserve shares the objectives of the proposed legislation. These objectives are important and their achievement desirable. U.S. financial firms deserve to have the same opportunities to conduct operations in foreign financial markets as domestic firms have in those markets. They do not now have those opportunities in all markets. Such fair treatment would benefit not just U.S. firms, but also the host foreign countries themselves and the world financial system in general.

However, while sharing these important objectives, the Federal Reserve opposes this kind of legislation, as we have before. In our view, it is not clear that the proposed approach would achieve the objectives, and it could have unfortunate, unintended consequences.

The principle of national treatment was established as U.S. policy with respect to foreign banks by the International Banking Act of 1978. Over many years the U.S. government has assumed a leadership role in building an international consensus around this concept. National

treatment is acknowledged by virtually all major industrial countries as the principle upon which regulation of the international operations of banks ought to be, but is not always, based. The U.S. policy of national treatment -- which has long set an example to others -- 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.

As the Federal Reserve has noted previously in connection with this proposed legislation, 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 legislation would replace the U.S. policy of national treatment with a policy of reciprocal national treatment. Through this legislation, 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. Some might think that having a reciprocity provision on the

books is merely a bargaining tool, not to be used. But once on the books, the temptation to impose sanctions becomes real, creating the potential for retaliation and for closing rather than opening markets.

The Federal Reserve believes strongly that there are better ways to encourage other countries to open their markets. Market forces and the desire to enhance the functioning of domestic financial markets are often the most potent forces to induce financial market liberalization. Moreover, 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, and that any country repressing or restraining its financial sector will witness an exodus of financial firms to other markets that are less restrained.

Nevertheless, U.S. authorities have not relied solely on market forces. In 1979, following passage of the International Banking Act, the Treasury Department, with the help of the Federal Reserve and other agencies, prepared its first National Treatment study; this has been updated several times, most recently in 1990, and we have begun the process of another update. Pursuant to the Omnibus Trade and Competitiveness Act of 1988, updated studies will be prepared regularly in the future. Based on the findings of those reports, the Treasury has engaged formally -- and others informally -- in bilateral talks with a number of countries.

Beyond those efforts, the Federal Reserve and others urged countries of the European Community strongly and with some success to modify and 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 to reach a meaningful agreement on trade in financial services within the NAFTA and the current Uruguay Round of multilateral trade negotiations. We believe this approach, which has the same objective as the proposed legislation, is more constructive.

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. Operations of foreign banks in the United States 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 agreed to preserve those rights.

If, contrary to this widely accepted practice, Congress were to adopt the proposed legislation, 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. This could be counter-productive. We would run the risk of introducing instability and discouraging foreign investment in our markets.

Moreover, market access for U.S. firms might be reduced *de facto* as countries tighten their own regulations in anticipation of the need to negotiate with the United States.

We should remember 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 more progress. But it is easy to understate the extent to which progress has been made in opening up foreign markets as a consequence of both the inexorable pressure of market forces and the diplomatic efforts of U.S. officials. Many countries are already open to U.S. firms to an extent that was not true just several years ago. For example, deregulation of interest rates in Japan is now or soon will be largely complete, and a wide range of market instruments have been developed. These reforms, which had been a principal objective of U.S. negotiators, provide U.S. financial firms with a level playing field with respect to funding in Japanese markets.

CONCLUSION

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 should remember that financial markets are regulated markets. They are regulated for a reason: Authorities in each country have the responsibility of ensuring the safety and soundness, and the integrity, of their markets. We should hesitate to dictate to others the pace of change or the specific nature of change any more than they should be allowed to dictate to us regarding such matters. We must recognize that U.S. markets are not as open as other countries would like and that many of the kinds of complaints lodged by us regarding the structure of other countries' markets are also lodged against us.

The desirability of liberalization as an objective in the financial sector, as in other sectors, is virtually universally accepted. U.S. financial firms have demonstrated their competitive ability to provide financial services to firms and residents of all countries, in a world in which national financial markets are increasingly integrated and international flows of capital are increasingly hard to constrain. To be sure, other countries have provisions for reciprocity in their statutes, but we do not need it. The United States alone has the opportunity to continue to exercise leadership in this area. I sincerely hope we take that opportunity.