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THE REGULATION OF BANKING - U.S. VIEW

Remarks of

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The growth of multinational banking in the past decade has had consequences for both domestic monetary management and banking regulation. How material these consequences have been on domestic monetary policy has been a matter of dispute and frequently doctrinaire assertion. What is clear is that contemporary monetary management needs to take into account foreign influences on the levels of domestic liquidity and interest rates, as well as growth rates of the monetary aggregates.

In the U.S. we have up to now, in one way or another, managed to avoid serious distortions in domestic policy objectives arising from external forces. Other countries, more exposed to the external sector, have not always been as fortunate as we have been and calls for coordination in monetary policies among groups of countries are becoming more and more frequent. Despite the fact that there is coming into being an international monetary climate, monetary sovereignty is still a prized national prerogative and being sought by more nations year by year. It is not my task today to speculate on the half-life of monetary sovereignty as an instrument of national policy for managing the domestic economies of our nations in the future but it would have been an interesting assignment.

I am to deal with the consequences of multinational banking on the effectiveness of banking regulation. This is a topic that has not received wide attention because of its parochial character and because banking regulation is not widely regarded as having much to do with anything except banks. This is an inadequate, if not a faulty, view of the nature of banking regulation in any country which uses monetary policy to affect the performance of its economy for there are numerous interlocks between regulatory and monetary actions.

Monetary restraint, or stimulus, places banks under the necessity or incentive to adjust their scale of lending and investing. The measure of monetary restraint or stimulus to be applied must be gauged in terms of the banking system's response capability. A knowledge of that capability depends on a first-hand and intimate understanding of the banking community's condition and psychology. That understanding is an important product of bank examination and surveillance. Regulatory guidelines can also have significant effects on the monetary climate even though their purpose is to modify some banking practices in the interest of a sounder system or one that is more responsive to public interests.

The Federal Reserve's concern that there be a strong equity underpinning for banking organizations is a good case in point. In the two years 1973 and 1974 total assets of many U.S. banks grew between 40 and 50 per cent. As equity capital grew at nothing like that rate, the deterioration in capital ratios in these institutions accelerated and reached a point where we felt a break in their over-all rate of growth was required and that substantial additions to capital should be sought. This perception of the situation was subsequently shared by the capital markets. The past year has brought on significant additions to equity, little growth in bank assets and other corrective actions that have greatly strengthened our banking system.

Throughout this episode, monetary considerations played a role and it is, indeed, impossible to segregate them from regulatory considerations. For part of the period, efforts to restrain growth and improve capital coincided with a restrictive monetary policy. More recently, continued encouragement of consolidating actions in the banking system has run somewhat counter to the thrust of a monetary policy seeking to foster economic recovery. Whatever the short-run consequences for monetary policy of changes in regulatory guidelines, I think it clear that monetary policy in the United States would be an ineffective instrument in the long run if there were not a strong, viable banking system through which pulses of restraint or stimulus could be conveyed throughout the economy.

There are numerous other illustrations of the interconnections between regulatory and monetary policies but I would mention only one which has been an important phenomena in the U.S. in the past decade. I refer to the ceilings on interest rates that banks and other depository institutions can pay for access to interest-sensitive funds. Such ceilings were originally devised to moderate competitive conditions among financial institutions. However, at various times during the 1960's, these ceilings were used as a monetary tool to constrain commercial banks' lending authority. The tool proved a powerful one but lacking in flexibility for frequent application as its use created serious competitive dislocations. We hope Congress will allow this subsidy to depository institutions extracted from savers to be phased out in the next few years.

The impact of multinational banking operations functioning of national banking systems has raised new regulatory problems involving international coordination and understanding. Traditional regulatory and surveillance systems with a largely national orientation no longer have sufficient reach nor afford effective control. For example, foreign operations have brought both profits and losses back to the home country for sharing and assimilation. Home country regulators have often had little basis for predicting what to expect next. At the same time, host country regulators worry about unseen elements and unforeseeable developments arising from foreign infiltration of their money and banking system.

Multinational banking no longer consists of international banking networks based on a long-standing colonial or trade dependency with the parent bank's country. Multinational banking is now directed toward networks serving major industrial nations with offices in the financial and industrial centers all over the world; in those centers indigenous sources of funds and local loan customers are being developed as well. These markets are now open to foreign institutions by way of de novo entry, foothold acquisitions of small local institutions and, in a few instances, the merging or purchase of a major banking organization.

Offices in less developed countries and in tax and in regulatory havens are usually of secondary importance to multinational banks. Many less developed countries still seem inclined to view multinational banks as a threat to their indigenous banking systems or as having the capability to thwart their domestic objectives. That view ignores or does not give sufficient weight to the services and credit capabilities which the multinationals have demonstrated. In a capital- and credit-short world, exclusion from the financial sector of all foreign institutions in fact and name--that is, no foreign interest in any bank or financially related enterprise--seems to me to be self-defeating. Even exclusions--that is to say, no purely foreign banks, but indigenous partnerships with foreign banks or foreign financially related enterprises such as financing, leasing, or factoring concerns--while offering operating and technological know-how, may risk losing the advantages of a superior competitive climate.

So far as the impact on domestic economies and banking systems are concerned, central bankers and regulators have by now had the opportunity to view the record of multinational banking under world-wide boom and recession conditions and thus to reflect on experience covering a full cycle of economic activity. That some costly mistakes have been made in international operations is clear but hindsight reveals that similar or equally costly errors have occurred in domestic operations. Many of the same errors of judgment have appeared in both domestic and foreign operations; real estate financing is a vivid example. Other errors have been unique to one type of operation; in the international area, an example is foreign exchange operations.

Because of these various ways in which domestic and international operations interact, the regulation of multinational banking networks must, in my view, involve coordination and cooperation among the banking and monetary authorities around the world. This is necessary not just to avoid the layering of compliance burdens and regulatory costs but to maximize the advantages of multinational banking and minimize the dangers to which it may be exposed.

The cornerstone for a workable system of international banking regulation must rest on some broadly recognized principle for the treatment of foreign banks in host countries. The Federal Reserve has accepted this in its proposed bill before the U.S. Congress concerning the rights and obligations of foreign banks seeking to do business in the United States. The principle contained in this bill is "national treatment"--or, non-discrimination. It means that foreign banks in the United States (the host country) will abide by the same rules as indigenous banks, having the same privileges and being subject to the same requirements. An approach along this line preserves for each national government the right to make the rules applicable to banks operating in its territory. There are numerous well established precedents for "national treatment" and the principle is widely accepted for other business enterprises today. Still there are some who reject "national treatment" and who prefer a principle of "reciprocity" a protean concept which seems to me to have as many interpretations as adherents. After considerable exposure to arguments along this line, I think it adds up to the contention that banks should be able to operate in foreign countries as they do at home. This is akin to asserting my right to follow the traffic conventions prevailing in the U.S. when driving in London. It could be contended that American driving rules are superior in some way to those in London but no reasonable person would try to sustain the proposition that these two traffic conventions can be successfully intermingled.

Beyond agreement on that principle, there needs also to be a meeting of minds on the locus of financial responsibility for the operation of a foreign bank. This is a very difficult issue for regulatory policy, both at a conceptual and a practical level. The issue embraces the responsibility of central banks in host and home countries, the distinction between legal and moral responsibilities, and the right of parents to succor distressed operations abroad with the possibility of weakening the parents' soundness or profitability. So far as parental responsibility is concerned, the answer is clear with respect to branches, on both legal and moral ground. Ambiguity arises, however, in the case of subsidiaries and joint ventures.

Severability is a concept urged by some for subsidiaries and joint ventures. The idea is that since members of the family are legally independent and operationally severable, the credit standing of each family member is also a severable characteristic. A wholly owned subsidiary could under this theory fail and be liquidated with losses to creditors for borrowed funds without serious consequences to the credit standing of the parent or other family members. The thrust of this argument is that the viability and soundness of the home office and branches are determined by the soundness and viability of the parent and are unimpaired by credit problems of subsidiaries or joint ventures. The concept of severability is said to be reinforced by physical separation of sites from which operations are conducted and by distinctively different corporate names.

The opposing concept is that so far as credit standing is concerned, there is no such thing as severability in a family of financial institutions whose members solicit deposits and borrow in the world's money and banking markets. The family name is built on confidence in the credit integrity of all of its members; one of them cannot default on its obligations without jeopardizing the integrity of the others.

Banking history and contemporary banking practice both at home and abroad are replete with illustrations of the lengths to which banking institutions will go to protect their credit standing. It is not a question of the legal ability to avoid meeting outstanding financial obligations; it is not even a moral or ethical issue in the final analysis. It is a question rather of survival as a financial institution in a world where confidence more than anything else determines the access of such intermediaries to the liquid funds of savers and investors.

As between these two concepts of financial responsibility, I believe there are several reasons for preferring the concept of non-severability. The main reason is that it is in accord with established practice. There may be cases in which obligations have been shucked off but few if any have escaped the attention of the financial community which sets this standard of behavior. Of course, obligations have been defaulted by discredited or deposed managements and boards of directors; these are actions *in extremis*--not those of an institution that expects to continue in business.

The other major reason for preferring the latter concept of family responsibility is that acknowledgement of this responsibility has a sobering effect on acquisition policy and on parent company surveillance of the operations of its subsidiaries.

This concept of non-severability is clearest in the case of subsidiaries but it also extends in my view to consortia or other joint ventures. Failure of a partner in such a venture to provide support commensurate to its interest or to the public's association of the bank with the joint venture could well have equally adverse consequences on the participating bank. In this case, too, acknowledgement of this type of responsibility would interject a cautioning note on joint venture investments of making sure there were responsible partners in the venture and of subsequent close attention to the affairs of that venture.

There are a number of other areas where agreement, cooperation and coordination are necessary among banking authorities if banking regulation is to perform its proper function in a multinational banking world. First of all, there should be agreement that all major banking institutions are supervised in the markets in which they operate and a general satisfaction that such supervision is adequate. Coordination is required to assure that supervision does not needlessly overlap among banking authorities or that some areas escape entirely through inadvertence. Cooperation in the form of exchanges of information about banking practices, regulatory problems, and even individual institutions is also a necessary ingredient.

I cannot provide an adequate blueprint of how this all should or can be worked out. At the moment, there are legal impediments in many instances to improved cooperation. There are, besides, national sensitivities and sovereign interests to be protected. I am encouraged by the work of the committee established under the aegis of the Bank for International Settlements to promote such cooperation and to examine possibilities for an international early warning system in the banking sector. Although in existence for a very short time and so far confined to a dozen or so countries, that committee and its work seems a promising first step. Its very existence evidences the commonality of interests among nations in assuring a sound, effective and efficient multinational banking system. With that common interest recognized, central banks and banking authorities can get to work at solving the problem of putting together an effective and efficient regulatory system which avoids unnecessary compliance costs and encourages the establishment of competitive alternatives for banking customers throughout the world.

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