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Statement by

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before the

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Regulation and Insurance

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I am pleased to appear on behalf of the Board of Governors to participate in the hearings on your Committee's study of Financial Institutions in the Nation's Economy (FINE). My assignment today is to discuss two aspects of the U.S. banking system--the role of foreign banks in the United States and the activities of United States banks abroad. Including these topics in the FINE study recognizes that any current comprehensive review of this nation's banking system must take into account the fact that banking has increasingly become a multinational business. This has been reflected both in the growing internationalization of the business of the largest American banks and in the increasing numbers and expanding operations of foreign banks in the United States.

We in the Federal Reserve have been cognizant for some time of the internationalization of banking and have actively sought to keep abreast of developments in this rapidly changing area and of their repercussions for the conduct of monetary policy, external financial policy, and the structure and soundness of the banking system. To carry forward work that had been begun earlier, the Board formally established in February 1973 a System Steering Committee on International Banking Regulation composed of some members of the Board and some Presidents of the Federal Reserve Banks. That Committee, of which I have been the Chairman, was given a twofold assignment--first, to explore the regulatory policy issues associated with the influx and rapidly expanding activities of foreign banks in the United States; and second, to review the regulatory policies

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of the Federal Reserve affecting the operations of American banks abroad in light of the changing international banking scene--precisely the topics scheduled for today's discussion.

These two topics are very broad ones, however, and to explore them fully with all of their ramifications would go well beyond the time allotted to me this morning. It has seemed to us that we could be most helpful at this stage of your Committee's work to share with you the general results and conclusions that we have reached in the work undertaken within the Federal Reserve on international banking questions. This statement has been so structured. Thus it is not confined to the specific points in Titles VI and VII of the Discussion Principles that were issued by your Committee as a means of stimulating discussion and thinking. Nevertheless those points will be touched upon in the course of this testimony.

Foreign Banks in the United States

The first half of my statement is devoted to the role of foreign banks in the U.S. banking system and the regulatory policy questions that are raised by their activities in this country. As members of this Committee know, consideration of this subject within the Federal Reserve System has led the Board to conclude that legislation is desirable to provide for federal regulation of foreign bank operations in this country. The Board has developed its own set of legislative proposals, which were introduced in the House of Representatives at the Board's request as H.R. 5617 under the title of the "Foreign Bank Act of 1975".

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There are three basic reasons that have led the Board to conclude that it is appropriate at this time to move towards a system of federal regulation of foreign bank operations in the United States. First, and most tangible, is the rapid rate of growth that foreign bank operations in this country have undergone over recent years and their increasing importance to the functioning of domestic money and credit markets as well as to international flows of funds. Second, the present patchwork system of State and Federal regulation has resulted in illogical differences in the regulatory treatment of domestic and foreign banks. While difficult to quantify, certain competitive advantages and disadvantages for foreign banks vis-a-vis domestic banks have occurred as a result of these differences. And finally, international banking operations are best conducted in a reasonably certain regulatory environment that fosters long-range planning and development. Federal legislation standardizing the national status of foreign banks not only would make for a stable regulatory environment in the United States but also would facilitate cooperation between international banking authorities and promote the eventual development of basic standards of banking soundness and stability applied on a worldwide basis.

Growth of Foreign Bank Operations in the United States

The growth of the activities of foreign banks in the United States from November 1972, when the Federal Reserve began its monthly reporting system for their operations, through September 1975, has been extremely rapid. During this period the number of U.S. banking institutions owned by foreign banks increased from 104 to 181, and their total U.S. assets more than

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doubled from $24 billion in November 1972 to $56 billion in September 1975. Excluding clearing transactions and transactions with parent banks and affiliaties, "standard" banking assets--defined as loans, money market assets, securities, and miscellaneous assets--of foreign banking institutions in the United States increased from $18 billion in November 1972 to $41 billion in September 1975.

The data in Tables 1a, 1b, 2a and 2b in the Appendix show the principal assets and liabilities of the U.S. offices of foreign banks in November 1972 and September 1975. These data indicate that the most noteworthy aspect of the expansion of U.S. activities of foreign banks in this period has been the size and rapid growth of their commercial and industrial (C & I) loans, which more than doubled in value from $11 billion in November 1972 to $23 billion in September 1975. In November 1972, the value of foreign banking organizations' C & I loans was equal to one-eighth the value of the C & I loans held by large banks which report weekly to the Federal Reserve; by September 1975, this fraction had risen to about one-fifth. In that month foreign banking institutions' C & I loans to foreign borrowers represented less than one-quarter of their total C & I loans. This ratio is larger than the comparable ratio for domestic banks and reflects the international character of the foreign banking institutions' business. Nevertheless, more than three-quarters of the total value of C & I loans of the U.S. offices of foreign banks represent loans to domestic borrowers. Clearly the C & I loans of the foreign banking organizations constitute a significant share of an important U.S. banking activity.

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Aside from their important lending to nonbank borrowers, the foreign banking institutions in the United States have been active in U.S. money markets. Their money-market assets, largely placements with other banks, were over $12 billion in September 1975, and their money-market liabilities, largely short-term borrowings from U.S. banks, were only slightly smaller. Money market activities serve as a source of liquidity for these institutions and help them manage the dollar positions of their parent organizations. These extensive money-market activities also closely connect the U.S. activities of foreign banks with U.S. money and credit markets.

Demand deposits and credit balances of foreign banking institutions in the United States remain small, reflecting the wholesale nature of their business. These liabilities have been growing, however, as of November 1972 they amounted to a little under $2 billion; by September 1975, they had more than doubled to just over $4 billion. Time and savings deposits at these institutions are larger and have been growing even more rapidly--from $4 billion to $11 billion over the same period; as of September 1975, they were equal to about 5 per cent of time and savings deposits at weekly reporting banks.

In addition to their lending and deposit activities, foreign banking institutions have also been active in international transactions, both with their parent banks and affiliates and with unrelated foreign institutions. Gross claims on foreigners rose from $6 billion in November 1972 to $16 billion in September 1975, and gross liabilities to foreigners rose from $13 billion to $25 billion over the same period, resulting in an

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increase in net liabilities to foreigners from $7 to $9 billion. Included in these international transactions as of September 1975 were net advances of $8 billion from related institutions outside the United States. The extensive international transactions of the U.S. offices of foreign banks can and often do have an impact on the overall international payments position of the United States.

The growth of foreign banking operations in the United States has taken place through agencies, branches, and subsidiary banks, the particular organizational form depending on State law and on the preference of the parent bank. As of September 1975, foreign banks maintained eighty agencies in the United States which accounted for nearly one-half of the standard banking assets of foreign banking institutions in the United States and reflected primarily the activities of Japanese and Canadian banks. Sixty-four branches of foreign banks accounted for a little over one-quarter of standard banking assets, while thirty-three subsidiary commercial banks accounted for a little under one-quarter of these assets.

New York and California are the most desirable locations for U.S. offices of foreign banks because of their importance as trade and financial centers and because of generally liberal State laws permitting entry by foreign banking institutions. Illinois enacted legislation in late 1973 permitting foreign banks to establish branches in the Chicago area, but the standard banking assets of these branches had risen to only about $1 billion as of September 1975.

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The standard banking assets of foreign banks in New York have grown from $14 billion in November 1972 to $29 billion in September 1975, while during this same period New York's share declined from 78 per cent to 73 per cent of the total for the entire United States. (See Tables 3a, 3b, 4a and 4b in the Appendix.) Traditionally, foreign banking activity in New York has been dominated by the activities of the Japanese and Canadian agencies. Canadian banks have been restricted to the agency form of operation because of reciprocity provisions in New York State law. Japanese banks have preferred the agency form of operation in New York because it permits them not only to borrow funds in U.S. money markets but also to lend without regulatory limits on the amounts loaned to individual borrowers.

In recent years, however, the most significant advances in the New York market have been through branches of foreign banks. Their total standard banking assets increased from $3 billion in November 1972 to nearly $9 billion in September 1975, when they accounted for slightly less than one-third of the standard banking assets of all offices of foreign banks in New York. The rapid growth of these branches, many with head offices in the United Kingdom and Continental Western Europe, has greatly changed the geographic pattern of ownership of foreign banks in New York and has increased the diversity of institutions conducting business in the New York market.

Although second to New York in terms of total foreign banking activity, the rate of growth of foreign bank activities in California has been somewhat more rapid, with total standard assets of foreign banks growing from less than $4 billion in November 1972 to over $9 billion in

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September 1975. As of September 1975, California accounted for 23 per cent of total foreign bank activity in the United States. (See Tables 5a, 5b, 6a and 6b in the Appendix.)

The largest foreign bank operations in California are the agencies, mainly Japanese agencies which engage heavily in net borrowings from other banks. These borrowings are used to finance their loan portfolios and to supply about $3 billion net to related institutions elsewhere in the United States.

The operations of California State subsidiaries of foreign banks continue to be smaller than the activities of the agencies. As of September 1975, these State chartered banks held a total of about $4 billion of standard banking assets, approximately one-quarter of which represented the acquisition of the State-wide branch network of First Western by Lloyd's Bank International. Another one-half of these assets represents the activities of the U.S. subsidiaries of Japanese banks which are engaged in retail banking activities. The share of the Japanese subsidiaries in the total will increase somewhat when later data include the merging of Southern California First National Bank of San Diego with total assets of about $900 million into California First Bank which is owned by the Bank of Tokyo. Including the results of this merger, total deposits at Japanese subsidiary banks will equal somewhat less than 4 per cent of the deposits of weekly reporting banks in California.

The foregoing discussion has given only a brief outline of the size, growth, and composition of the U.S. activities of foreign banks. The

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availability of detailed monthly data permits more comprehensive analysis of these activities, and some work in this area is currently under way by the Board's staff. It must be clearly noted, however, that the absolute size and rapid growth of the U.S. activities of foreign banks, and their impact on domestic money markets, domestic lending, local retail banking, and the international payments position of the United States require that these activities be supervised and regulated in a manner consistent with the regulation and supervision of domestic banks.

Current Regulation of Foreign Banks

Turning to the current regulatory environment structuring foreign bank operations in the United States, and how this has led to certain differences in the regulatory treatment of domestic and foreign banks, I think the central point to be made is that foreign banks are now almost exclusively subject to State regulation with little or no federal control.

If a foreign bank conducts its commercial banking activities in the United States exclusively through branch and agency forms of organization, it is currently not subject to any Federal regulation, supervision, or examination. Since as noted earlier, foreign banks conduct the majority of their operations through these forms of organization, the present system unaccountably exempts from federal oversight those operations that have the greatest potential for affecting the nation's economy and its major financial markets.

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The principal regulatory advantages for a foreign bank in operating through branch and agency forms of organization are the following:

(1) branches and agencies are not legally subject to any of the reserve requirements or other regulations affecting monetary policy placed on the operations of national and State member banks;

(2) branches and agencies are not subject to any federal restrictions on multi-State banking and thus can be established in any State that permits entry, even if a foreign bank has a State or federally-chartered subsidiary bank in another State (44 foreign banks have commercial banking operations in more than one State, Table 17 in Appendix);

(3) a foreign bank maintaining only branches and agencies is not subject to the prohibitions of the Glass-Steagall Act, and thus can maintain those banking operations and at the same time have an interest in a securities firm in the U.S. (21 foreign banks with commercial banking operations in the U.S. have interests in U.S. broker-dealers, Table 18 in Appendix);

(4) a foreign bank maintaining only branches and agencies is not subject to the Bank Holding Company Act of 1956, as amended, and thus can engage directly in the United States in any type of nonbanking activities and can invest in any United States commercial firm, so long as it has the power to do so under the laws of its home country; and

(5) branches and agencies are not subject to any federal bank examination, regulation, or supervision of the type carried out by the Comptroller of the Currency, the Board, or the FDIC.

The current regulatory framework has, however, also imposed certain artificial or outmoded restraints on foreign bank entry into the United States. For example, foreign banks cannot organize Edge Corporation subsidiaries that enable large U.S. banks to conduct international banking

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and financing operations in several cities that serve as centers of international trade financing. This prohibition may no longer serve the national interest since it may artificially reduce competition in some banking markets. The provision in the National Bank Act that requires all directors of national banks to be citizens has been a factor influencing many foreign banks to organize State subsidiaries. The lack of any provision in federal law for the establishment of federal branches is in sharp contrast to the situation in most foreign countries, where foreign banks establish branches approved by the national government. (As of September, 1975, there were 751 branches of domestic banks abroad.) United States regulatory policy should encourage foreign banks to opt for national rather than State subsidiaries and branches, since those options would avoid problems of State reciprocity and would afford greater federal control over the United States operations of foreign banks. Finally, the lack of availability of FDIC insurance for deposits and credit balance accounts at branches and agencies has proven a disadvantage in competing in retail banking markets, but may give a nominal cost advantage to foreign banks since U.S. banks must meet FDIC assessments on similar liabilities.

The current pattern of State regulation may also, in some cases, lead to anticompetitive and other results not in the national interest. For example, a foreign bank may not be able to enter a U.S. banking market because of State law restrictions. This situation could in some cases prevent a domestic bank from that State from entering the foreign bank's home country if the home country imposes a reciprocity requirement. The net

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effect of such a situation is a reduction in U.S. banking competition and a potential impediment to the foreign commerce of the U.S. Such situations might also involve important foreign policy considerations between the United States and the home country. Clearly, a national policy and national regulatory system are needed so questions of reciprocity, as well as other matters of national interest, can be judged on a national, not local, level.

The United States is virtually the only country that does not have central bank control over the activities of foreign banks within its borders. This situation creates a gap in the Federal Reserve's control over domestic monetary conditions that will inevitably widen and increase in importance as foreign bank activities continue to grow.

Major Points of Board's Proposal

I would now like to highlight briefly the major points of the Board's proposed legislation.

In the Board's judgment, two basic policy goals are embodied in its proposed foreign bank legislation. The first goal is the adoption by the federal government of the principle of national treatment, or nondiscrimination, toward the operations of foreign banks in this country. Second is the goal of establishing a comprehensive system of federal supervision, regulation, and examination of foreign bank operations in the United States in order to implement the principle of national treatment and to provide a framework for regulating the United States activities of

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foreign banks in view of their impact on the nation's domestic and foreign commerce.

The proposal seeks to implement the policy of national treatment by amending U.S. banking laws to provide foreign banks with the same opportunities to conduct activities in this country as are available to domestic banking institutions and by subjecting them to the same rules and regulations. Thus, the citizenship requirements for directors of national banks are relaxed in order to give foreign banks a real choice in deciding whether to establish a national or State subsidiary; foreign banks are given the opportunity to establish federal as well as State branches; the Edge Act is amended to permit foreign banks, with Board approval, to acquire Edge Corporation subsidiaries; and it is recommended that the FDIC Act be amended in order to permit branches and agencies to obtain insurance on their deposits and credit balance accounts.

The Board's proposal closes federal regulatory gaps by amending the definition of "bank" in the Bank Holding Company Act to include branches and agencies of foreign banks, and by making other amendments to that Act designed to ensure that branches and agencies of foreign banks are treated the same as any U.S. banking organization with similar commercial banking powers. As a result, all branches and agencies would have to become insured banks; additional branches and agencies could only be established with Board approval and subject to Board analysis of financial, managerial, competitive, and convenience and needs considerations; branches and agencies

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could not be established outside of a foreign bank's State of principal banking operations unless a State bank in that State could also establish such offices; the parent foreign bank would be subject to all of the nonbanking prohibitions of the Bank Holding Company Act; and, lastly, the parent foreign bank and its nonbanking subsidiaries would be subject to the Board's cease-and-desist authority for unsafe and unsound practices.

Any branch, agency, or subsidiary bank of a foreign bank with worldwide bank assets in excess of $500 million would also be required by the Board's proposed legislation to become a member of the Federal Reserve System and would thus become subject to the same kind of federal monetary and federal bank examination, regulatory and supervisory controls that apply to other member banks. In addition, as member banks, such branches, agencies and subsidiaries would become subject to the prohibitions of the Glass-Steagall Act and, as insured banks, would become subject to the provisions of the Bank Merger Act, Financial Institutions Supervisory Act of 1966, as amended, and other provisions of the FDIC Act.

The Board's proposed legislation creates a comprehensive system of federal supervision, regulation, and examination of foreign bank operations not only through the various amendments to United States banking laws but also through the establishment of a federal licensing procedure on future entry. This procedure would give the Federal government the opportunity to consider national interest and foreign policy factors in foreign bank entry, as well as the banking factors that will be considered by the bank regulatory agencies. This greater federal role will serve to

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facilitate greater cooperation among bank regulatory authorities, and will strengthen the ability of the national government to obtain national treatment for U.S. banking institutions abroad.

Title VI of the FINE Principles

There are some significant differences between the Discussion Principles in Title VI and the Board's proposal on which I would like to comment. First, the introduction to the principles makes clear that there would be no permanent grandfathering of the existing nonconforming multi-State banking, nonbanking, and securities operations of foreign banks in the United States. Rather, foreign banks would be given a certain time period to phase out their nonconforming operations. In the Board's proposal, there would be permanent grandfathering for all nonconforming banking and nonbanking operations (including securities operations) established on or before the original date of introduction of the Board's proposal in Congress--December 3, 1974. Nonconforming multi-State banking operations established after that date but before enactment would have to be phased out in two years; nonbanking operations commenced in that interval would have to be phased out over ten years.

The Board strongly believes that permanent grandfathering of long-standing foreign bank operations in this country is needed in order to minimize any possible retaliation against U.S. banks abroad. This opinion is based primarily on Board members' discussions with foreign central and commercial banks and U.S. banks with significant operations abroad. I know several members of this Committee recently went abroad

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to study international banking issues and some must have come back with this same impression. While I will discuss the size of U.S. bank operations overseas in connection with Title VII, I think it is obvious that our banking system and its U.S. banking customers would be a net loser in any possible retaliatory efforts.

Aside from such considerations, however, the Board also strongly believes that a failure to permanently grandfather existing operations would be unduly harsh and unfair in light of the grandfather privileges previously extended bank holding companies. Several bank holding companies with multi-State banking subsidiaries were given permanent grandfather rights in 1956 and again in 1966 when the test for determining a bank holding company's State of principal banking operations was clarified. In 1970, nonbanking activities of one-bank holding companies were permanently grandfathered so long as they were commenced on or before June 30, 1968 and were engaged in continuously since that date. Given these precedents, foreign banks should be afforded similarly liberal grandfather privileges. It must be remembered on this issue that foreign banks have established their operations in complete conformance with existing laws; branch and agency forms of organization are not devices for avoiding certain federal banking laws but rather are well-accepted forms of banking operations around the world.

The Board shares Congress' concern that the policies of the Glass-Steagall Act and the Bank Holding Company Act be enforced; however, rather than abolish existing foreign-owned bank affiliations that would be prohibited by those Acts, it seems that a better and fairer course of action

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would be to give the Board the power to terminate such affiliations if, in a particular case, the Board found, after notice and opportunity for hearing, that such action was warranted. Congress, in fact, adopted this type of procedure in connection with its permanent grandfathering of certain of the nonbanking interests of one-bank holding companies in 1970. The Board has suggested a similar review power over any permanently grandfathered nonbanking interests of foreign banks in its proposed foreign bank legislation.

Secondly, the FINE principles would not extend FDIC insurance to branches and agencies of foreign banks and, apparently, would not permit such entities to become members of the Federal Reserve System. Instead, under principle 5 branches would not be able to accept domestic deposits because of the unavailability of FDIC insurance; they would, however, be subject to the same reserve requirements as are domestic banks, including reserve requirements on Eurodollar deposits. The Board believes that a prohibition on acceptance of domestic deposits at U.S. branches of foreign banks would run counter to the principle of national treatment and would constitute a major operating disadvantage for several foreign banks in this country, since some branches, in funding their U.S. operations, rely heavily on the issuance and sale of large-denomination certificates of deposit in domestic money markets. While, as previously indicated, the Board believes that FDIC insurance should be extended to domestic deposits at branches, the absence of such insurance should not be used as a justification for stopping the issuance of large-denomination CDs by branches,

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since deposit insurance has little relevance to such deposits. Such a prohibition would also place foreign bank branches at a severe competitive disadvantage vis-a-vis their domestic banking counterparts in the offering of full-scale commercial banking services, and would thus have anticompetitive effects on the commercial banking industry. It is also possible that such a prohibition could lead other countries to retaliate and erect similar prohibitions on the foreign operations of U.S. banks; such retaliation could, in turn, have a severe impact on the funding of such foreign operations.

While the Board agrees that branches and agencies should be subject to the full panoply of regulations imposed for purposes of monetary policy, the Board also believes that these entities should be given the same rights as any other member bank. This does not mean that the Board would necessarily be a lender of last resort for such entities as, in the Board's judgment, the parent foreign bank's home country bears this responsibility; rather, it means that branches and agencies should have the same access to short-term credit and clearing privileges as any other member banks.

Other Regulatory Issues Involving Foreign Banks

In transmitting its proposed legislation to the Congress, the Board noted that its proposal would not cover foreign bank operations conducted through so-called New York Investment Companies, and would not specifically amend the Bank Holding Company Act in order to subject the

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several foreign bank shareholders of the European-American Bank and Trust Company, New York, New York, to the provisions of that Act.

Investment Companies organized under Article XII of the New York Banking Law have many of the same banking and financing powers as agencies of foreign banks. Seven domestically-owned Investment Companies appear to be primarily engaged in finance company operations; four foreign-owned Investment Companies are either subsidiares or affiliates of foreign banks and appear to conduct the same type of commercial banking operations carried on by agencies. In excluding foreign-owned Investment Companies from the coverage of its proposed legislation, the Board was primarily influenced by the fact that only three such companies would have been covered at the time it submitted its proposal and that the New York authorities had customarily discouraged chartering of these entities in lieu of branch or agency operations. The Board was also concerned that any attempt to cover only the few foreign-owned companies would be regarded as a discriminatory action by foreign authorities.

The Board notes that since submitting its legislation, the New York banking authorities have chartered an additional investment company subsidiary of a foreign bank and have received an application to organize another investment company from a private foreign bank. The Board understands, however, that the New York authorities are currently reviewing their policy on chartering investment companies for foreign banks.

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The Board believes that there is a potential for evasion of its proposed legislation if foreign banks can readily obtain investment company charters in lieu of agency or branch licenses. The Congress may thus wish to consider subjecting all future investment companies that would be chartered to engage principally in a commercial banking business to the same scope of federal regulation that has been suggested for agencies and branches in order to close this potential loophole.

With respect to domestic banks owned by several foreign banks, the Board notes that the New York banking authorities recently chartered a new bank that is to be owned by a group of 11 Arab banks, five foreign consortium banks controlled by Arab banks, and four domestic bank holding companies, the latter each having only a statutorily permitted 5 per cent interest. While the Board will soon be considering the issue of whether the organizers of the proposed bank will have to file an application under the Bank Holding Company Act, the current definitions of "control" and "company" in the Act do not appear to cover certain multiple ownership situations where independent shareholders might act in concert to control a bank, but do not constitute themselves into a corporation, partnership, association or similar organization. Since it could become increasingly attractive for several foreign banks to organize so-called consortium banks in the United States if branches and agencies of foreign banks are subjected to federal regulation, the Congress may want to consider amending the Bank Holding Company Act to give the Board jurisdiction over situations where

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independent shareholders that do not form themselves into a company, as defined in the Act, nevertheless act in concert to control a bank. Since any such change would affect domestic as well as foreign companies, this issue would seem best considered in the context of bank holding company rather than foreign bank legislation: consistent with the principle of national treatment, the Board believes that similar standards should be applied to both domestic and foreign organizations.

International Operations of U.S. Banks

Turning now to the second part of my assignment for this morning--the operations of U.S. banks abroad--there is not in the Board's judgment so clear or urgent a need for legislation as there is to provide for the regulation of the operations of foreign banks in the United States. Those U.S. banks with operations overseas are subject to general federal regulation and supervision in all their activities; in addition, they are subject to specific regulations and supervision concerned with their international operations that at the direction of the Congress are administered by the Board.

A number of problems and issues have emerged in administering these particular provisions of law in recent years as the international operations of U.S. banks have so rapidly expanded in scope and scale. It appears that most of these can be handled or resolved within existing statutory authority. Nevertheless, some of them involve issues of public policy on which Congress may wish to give guidance.

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I shall begin by citing a few facts about the scale and extent of U.S. banks' operations abroad. I shall then go on to an account of how the Board has administered those provisions of law on this subject for which it has been given the responsibility. Finally, I shall turn to a discussion of some of the issues, including those mentioned in the Discussion Principles.

In view of the widespread public comment in recent years on the expansion of the international operations of U.S. banks, it is hardly necessary for me to describe that expansion in any detail. A few of the key facts about those operations, however, will help provide perspective on the comments that follow:

.....As of September, 1975, 126 U.S. banks operated 751 foreign branches in more than 80 foreign countries around the globe with total assets of about $135 billion (net of claims on other branches of the same parent bank). In addition, they have a large number of foreign subsidiaries with another $25 billion in assets. Altogether, these overseas facilities are about 3 times as large in terms of assets as those of foreign banks in the United States.

.....These overseas operations are not only large in an absolute sense, they are large in relation to the affairs of the individual banks concerned; for a number of major banks, more than one-third of their assets and of their income are in overseas facilities.

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.....U.S. banks are engaged in a wide range of financial activities throughout the world through their branches, subsidiaries, and affiliates: commercial banking, trust activities, financial leasing, wholesale and retail finance companies, underwriting, investment management and advisory services--to mention a few.

.....These operations are carried on in many different locales under different political and economic conditions and aided by modern communications and transportation, involve large movements of funds across national frontiers, swift shifts of assets from one location to another, and rapid decisions to extend credits and to hedge risks.

In sum, the task of supervising and regulating banks has been substantially altered and enlarged by the large size of the banks' international operations, their potential impact on individual banks, the variegated activities that are conducted overseas, and the speed with which events may occur.

Responsibilities of the Federal Reserve

As I have already mentioned, the Congress has given to the Board specific responsibilities for supervising and regulating the international operations of member banks and bank holding companies.

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These responsibilities are spelled out in Sections 25 and 25(a) of the Federal Reserve Act and in certain provisions of the Bank Holding Company Act of 1956, as amended.

In brief, those responsibilities are:

Under Section 25 of the Federal Reserve Act

1. to authorize the establishment of foreign branches by member banks.
2. to authorize additional banking powers for foreign branches of member banks, subject to certain limitations.
3. to authorize direct investments by member banks in the stock of foreign banks, and so-called Agreement Corporations.

Under Section 25(a) of the Federal Reserve Act

1. to charter Edge Corporations, as authorized by that Section, to engage in international or foreign banking and other international or foreign financial operations.
2. to establish rules and regulations governing such Corporations.
3. to authorize investments by such Corporations in the stock of other companies not doing any business in the United States except as incidental to their international or foreign business.
4. to examine such Corporations and require the filing of reports on their operations and activities.

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Under the Bank Holding Company Act

1. to authorize investments by domestic bank holding companies in the stock of foreign corporations not doing any business in the United States except as is incidental to their international or foreign business.

The public interest with which the Board has been concerned in regulating and supervising the overseas activities of U.S. banks under these statutory provisions has been that of helping to assure the soundness of those banks in this country and their continued ability to provide banking services to their communities. Specifically, in approving member bank activities overseas, the Board has examined the condition of the individual bank and has sought to satisfy itself that the bank was adequately capitalized and had sufficient management capabilities to support those activities. Generally, in devising rules governing the overseas activities of member banks, the Board has been concerned with the nature of those activities and the risks associated with them. Throughout, the Board has been particularly concerned with the ability of the Federal Reserve and other bank supervisors to provide adequate and continuing supervision to the banks' activities overseas.

Activities and Risks in International Operations

I noted earlier that U.S. banks are engaged in a wide range of financial activities in their overseas operations. Some of these would not be permitted to them within the United States. In administering the statutory provisions to which I have referred, the Board has consistently given banks greater latitude in their direct and indirect overseas activities

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than is permissible to them at home. For example, foreign affiliates in certain countries have been permitted to engage in investment banking activities abroad; the Board has, however, maintained the Glass-Steagall wall in the United States by prohibiting any foreign company in which a U.S. bank has a direct or indirect interest from underwriting, distributing, or selling securities in the United States.

This greater latitude in activities overseas has been extended largely in order to enhance the competitive effectiveness of U.S. banks in foreign markets. Concern about the competitive posture of the banks in these markets stems directly from the purposes of the legislation authorizing the banks' foreign activities--namely, to further the foreign commerce of the United States by fostering a strong overseas banking organization to provide financing for U.S. trading and investment interests. The rules governing banks in foreign countries reflect quite different banking requirements, banking traditions, and legal and social structures from those of the United States. In many countries, banks have far wider powers than those in the United States. In these circumstances, it has seemed in the national interest to allow U.S. banks to take advantage of certain additional powers and fully and vigorously compete in those markets, unless there were compelling policy considerations to the contrary.

A second reason for extending greater latitude to the banks in their international operations is that many of the domestic constraints on banks are basically concerned with the competitive environment in the United States and with the concentration of financial resources in the

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United States. Since in foreign countries the banking and financial structure is the responsibility of foreign authorities, the Board has not extended the standards incorporated in the Bank Holding Company Act to the international activities of U.S. banks. There has been, however, a recurring question about what limits, if any, should be placed on the activities that U.S. banks are permitted to engage in abroad. Central to that question is an evaluation of the risks to which U.S. banks are or would be exposed in their international operations. There are two parts to such an evaluation--first, a judgment on the risks generally encountered in international activities; second, a judgment of the risks that might arise in connection with a particular activity.

It is clear that banking outside the confines of one's own country involves risks that are qualitatively different from those in domestic banking. They would include foreign exchange risks arising from fluctuations or changes in the relative value of currencies; political upheavals; and economic instability. The question has been whether these differences are quantitatively significant, requiring special protective rules. To date, our answer to this question has been in the negative or, more accurately, inconclusive. On the basis of results so far, and all the returns may not by any means be in, loss experience in international banking and financial operations has either been better or no worse than in domestic operations.

That question is the general one. The more specific question is whether particular activities carry greater risks than should be borne by a banking organization, whether conducted in an international context

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or not. It has been argued that for reasons of competitive equality, U.S. banks should be allowed to do anything in a foreign market that the banks indigenous to that market can do. The Board has not fully accepted this argument in acting on applications by banks to engage in activities abroad. The Board has thus far confined the banks in their overseas activities to banking and related financial activities. Equity investments in nonfinancial companies have been permitted only as minor adjuncts to financing. In large part, the Board has limited participations in nonfinancial companies because it has believed the risks associated with operating participations are unfamiliar to bank managements and would impinge on bank soundness.

The question of permissible activities abroad and the risks associated with them is directly related to the issue of bank capital, to which the Discussion Principles refer. The issue of bank capital is a very thorny one indeed, and one which has occupied the Board a great deal in the past few years. What can be said about that problem in the context of today's discussion is that the Board, on the basis of experience so far, has not been convinced that special capital requirements are necessary for overseas operations. Because of the desirability of maintaining a sufficient level of bank capital to support traditional banking and financing operations, it may well be necessary to continue to limit participation in new lines of activity overseas. Conservation of bank capital, too, argues for increasing efforts to assure that existing and traditional activities are being conducted in a sound and prudent manner.

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Supervision of Overseas Activities

I have already indicated that the explosion of international activities of U.S. banks has greatly complicated the job of bank supervisors in this country to assure that the banks are being soundly run. Not only is it much more difficult to keep track of what is taking place within the banks, it also requires trained personnel capable of assessing operations in international banking and financial markets. The dimensions of this task have been formidable and we need to continue striving for improvement.

The Board in allowing banks to engage in activities abroad has insisted in its rules that information about those activities be accessible to U.S. bank supervisors. The Comptroller of the Currency and the Federal Reserve System both send examiners overseas to inspect the foreign branches of national banks and State member banks, respectively. An important part of any system of surveillance of the overseas activities of banks is to assure that the banks themselves have adequate internal controls and audits in place and functioning; increasing attention is being given to this aspect of surveillance.

In some countries, laws aimed at protecting the confidentiality of relationships between banks and their customers are in force which carry with them criminal penalties. The existence of these so-called bank secrecy laws has posed problems for U.S. supervision of the banks' activities. These problems have been largely resolved in ways satisfactory to

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all parties and their responsibilities through the maintenance at U.S. head offices of adequate information for examination purposes.

It is proposed in Title VII that U.S. banks should not be allowed to operate in such bank secrecy countries. That proposal does not give sufficient weight to the importance of facilities in these countries to the over-all international operations of the banks in question. Nor does it give enough weight to the evolutionary process of arriving at the proper type of supervision for bank facilities in those countries.

Multinational Cooperation on Bank Supervision

Problems associated with the growth of international banking are common to bank supervisors everywhere. As a result of this experience and events of the past year or so, there is now a far greater awareness of the mutuality of interests among the banking authorities of various countries.

It is well known that under the aegis of the Bank for International Settlements a committee has been set up to serve as a forum for exchanging information and views on problems of bank supervision in the major industrial countries. The Federal Reserve is participating in the work of that committee. Already that committee is proving useful as a means of sharing experiences of dealing with such problems as capital, liquidity, supervision of foreign exchange operations, and so forth. Hopefully, it will serve as part of an international early warning system to alert banking authorities to emerging problems in international banks. It is too early to say how

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this will all work, but one can be hopeful that this cooperation among banking authorities will lead to better supervision of the international banking system.

The Foreign Window

In principle 2 of Title VII, it is stated that in order to promote competition among banks of different sizes in international financial markets, U.S. banks should be able to establish overseas departments in their domestic offices. These offices would be allowed to engage in the same activities as foreign branches and would not be subject to the restrictions placed on the domestic activities of U.S. banks.

About a year and a half ago, our staff reviewed the possible advantages and disadvantages of establishing at U.S. offices of U.S. banks a new "foreign window", or overseas department, that would be segregated from domestic accounts, and through which U.S. banks could conduct business with foreign customers free of regulations that are applied to domestic banking transactions. Although such foreign windows could provide some cost advantages, and might promote international banking by smaller banks, it was concluded that the regulatory disadvantages outweighed any potential benefits.

A poll of banks taken at the time indicated that foreign windows would not serve as substitutes for full-service branches abroad, and for many banks would not provide significant cost or other operational advantages over "shell" branches abroad. An important consideration in banks'

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decisions about any substitution of foreign windows for foreign branches would doubtless be the tax status of the window, and on this issue the Committee may want to consider the status of any such window under municipal and State taxes as well as under federal taxes.

Our reservations concerning the window arise mainly because of the scope for misuse of the window to conduct essentially domestic business. U.S. corporations--using foreign subsidiaries as intermediaries--might shift substantial amounts of their domestic U.S. banking transactions to the foreign window to take advantage of the special advantages offered by the window (e.g., higher rates on deposits, reflecting the absence of interest rate limitations and reserve requirements). If the Federal Reserve were unable to control such shifts, there could be a serious weakening of the System's influence over domestic monetary and credit conditions. An extensive and cumbersome system of regulation would thus be needed in order to control the use of any foreign window. The administrative and other costs of establishing such a system of regulation in order to prevent any potential weakening of the System's influence over domestic monetary policy would appear to outweigh any potential benefits.

Discount of Foreign Paper--Principle 5

In order to discuss the ramifications of the proposal to restrict access to the Federal Reserve discount window to borrowings secured by "domestic paper", it would be necessary to understand exactly what is meant to be included within the term "domestic paper" and what considerations led to

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presentation of the proposal. Taking the proposal at its face value, however, it would appear to prevent the Board from discounting or advancing funds on an obligation of any non-U.S. corporation or citizen. This may not only be at cross-purposes with the Board's present authority to discount obligations arising out of export/import transactions but also could in some cases restrict the Board's ability to provide periodic and seasonal liquidity assistance to member banks and to fulfill its sometimes necessary role of lender of last resort. In the present environment, such a change would be undesirable for it would disqualify a portion of a bank's assets that could be used to support its liquidity requirements. For some time Federal Reserve policy has been directed toward measures that would strengthen the liquidity positions of U.S. banks. Moreover, the Board has for several years proposed legislation to broaden the range of collateral on which member banks could borrow at the discount window. In this regard, the Board supports the provision contained in the Financial Institutions Act approved by the Senate Banking Committee to permit Federal Reserve Banks to extend credit on any acceptable collateral at the basic discount rate.

If the Committee is concerned that the System may be vulnerable to receipt of poor foreign collateral, I would like to stress that the Federal Reserve's current procedures for discount credit to member banks provides for careful monitoring and review of the financial condition of the borrowing bank and the quality of collateral presented. These procedures would, of course, apply as well to branches, agencies and subsidiaries of foreign banks if they became members. Moreover, if the proposal is intended to influence the lending policies of potential foreign bank-owned

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members of the System, it has been our general experience that the special treatment of certain types of loans for collateral purposes at the discount window is largely ineffectual in channeling a bank's lending activities since banks often can find other means to collaterize borrowings.

The proposal also appears to be inconsistent with one of the important objectives of the economic policies of this country--that of facilitating the expansion of foreign trade. Over the longer term, it would appear to create incentives to change the loan portfolios of U.S. banks, increasing the volume of domestic paper (however defined) and reducing foreign credits. This form of credit allocation would not necessarily promote domestic spending--it could, for example, reduce export credits by U.S. banks--nor would it necessarily improve the credit quality of bank loan portfolios. In summary, the Board sees no need for this proposal and believes it clear disadvantages outweigh any intended benefits.

Conclusion

One issue I have not dealt with this morning is whether it would be in the public interest to transfer the Federal Reserve's present statutory authority over the foreign operations of U.S. banks and domestic operations of foreign bank holding companies to the single bank regulatory agency proposed in the FINE Discussion Principles. I think members of the Committee would agree that this aspect of Titles VI and VII would be best considered in future Board testimony on whether there should be a single regulatory agency and whether the responsibilities of the Federal Reserve should be limited to central bank monetary functions--the subjects of Titles IV and V of the FINE Principles.

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I hope that my comments here this morning have been helpful to the Committee and have contributed to the FINE Study process. The Federal Reserve, of course, stands ready to provide any further assistance your Committee may desire in its analysis of multinational banking issues.

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