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Statement by

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of the

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I am pleased to appear before this Subcommittee, on behalf of the Board of Governors of the Federal Reserve System, to discuss the Board's reasons for recommending the enactment of legislation providing for the federal regulation and supervision of foreign bank operations in the United States.

Banking has increasingly become a multinational business in recent years in keeping with the growth in international trade and investment. (United States exports and imports combined are estimated to have exceeded 13.6 per cent of U.S. GNP in 1975 compared to approximately 8.4 per cent of U.S. GNP in 1971.) That development has been reflected in the expanded operations of U.S. banks abroad. Another aspect of this development has been the growing number of foreign banks establishing offices in this country to conduct both international and domestic banking activities. In February 1973, the Board established a System Steering Committee on International Banking Regulation composed of some members of the Board and some Presidents of the Federal Reserve Banks: part of that Committee's assignment was to review the regulatory policy issues associated with the influx and rapidly expanding activities of foreign banks in the United States. As a result of that review, the Board has concluded that the scale and nature of foreign bank operations in this country have become significant in terms of competition within the banking industry and of the functioning of money and credit markets and that, therefore, the time has come for the establishment of a national policy on foreign

banks operating in the United States and for the creation of a system of Federal regulation, supervision and examination of those operations.

To accomplish these objectives, the Board has submitted to the Congress legislative proposals for regulating foreign bank operations in the United States under the title of the "Foreign Bank Act of 1975". These legislative proposals were introduced in the Senate at the Board's request as S. 958--the subject of today's hearings. I would like to discuss the legislation embodied in S. 958 by first focussing in more detail on the reasons that have led the Board to conclude that such legislation is necessary at this time and by next describing briefly the major points of the Board's legislation. I will conclude my statement by setting forth additional Board recommendations on other regulatory issues not covered in S. 958 that the Board believes the Congress should consider in enacting legislation on foreign bank operations in this country.

Reasons for Federal Regulation of Foreign Bank Operations

There are three basic reasons that have led to 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 treatment of foreign banks in the United States not only would make for a stable regulatory environment in this country but since U.S. banks are leaders in international banking around the world it would also facilitate cooperation between national banking authorities, contribute to an emerging pattern by which foreign banking authorities could be guided in the treatment of banking interests originating outside their countries, and promote the development of international standards of banking soundness and competition.

Growth of Foreign Bank Operations in the United States

I will confine my comments this morning to summarizing what I believe to be the most important features of the recent growth of foreign bank operations in this country. In this regard, I am submitting for the record an Appendix prepared by the Board's staff that provides detailed statistical information on the size and growth of the U.S. activities of foreign banks.

As of September 1975, there were 181 U.S. banking institutions--defined to include agencies, branches, subsidiary banks, and New York Investment Companies--owned by foreign banks compared to 104

in November 1972, and their total assets have more than doubled from $24 billion in November 1972 to $56 billion in September 1975. If clearing transactions and transactions with other offices of their parent banks are eliminated, their "standard" banking assets--defined as loans, money market assets, securities, and miscellaneous assets--increased from $18 billion in November 1972 to $41 billion in September 1975.

The data on the overall growth of these institutions, while impressive, does not adequately portray the increasing importance of their impact on specific U.S. banking activities. For example, in September 1975 the U.S. offices of foreign banking organizations held $23 billion in total commercial and industrial loans, an amount equivalent to about one-fifth of such loans held by large banks which report weekly to the Federal Reserve. As recently as November 1972 their share in this important U.S. credit market was only one-eighth.

A second important activity of the U.S. offices of foreign banks is their money market transactions. In September 1975 U.S. offices of foreign banks had money market assets of over $12 billion, over one-half of which represented loans to and deposits with U.S. banks. Included in this total are loans and deposits of $3.1 billion placed with U.S. banks by the U.S. offices of banks from Continental Europe. The U.S. interbank market serves these banking institutions as a convenient outlet for managing the dollar balances of their parent organizations.

U.S. offices of foreign banks also had substantial money market liabilities totalling $11.7 billion as of September 1975. Of this total, $6.6 billion, or over one-half, represents interbank borrowings

by U.S. offices of Japanese banks, which use the U.S. interbank market as an important source of funds to finance their U.S. operations. The U.S. offices of banks from countries other than Japan do not rely on U.S. banks as a continuing net source of funds, although they utilize borrowings from U.S. banks as a source of liquidity when needed.

The important point to note from this brief discussion of the extensive transactions of the U.S. offices of foreign banks in U.S. money markets, is that these transactions closely link the U.S. activities of foreign banks with domestic U.S. money and credit markets.

In addition to their U.S. lending and money market activities, foreign banking offices engage in substantial international transactions with offices of their parent banking institutions as well as with unrelated foreign institutions. For example, as of September 1975 their gross claims on foreigners were $16 billion and their gross liabilities to foreigners were $25 billion. Included in these figures were net advances of $8 billion from their related institutions outside the United States, which advances are, in effect, used to finance their U.S. banking activities.

Thus, it should be clear from this summary data that the size and growth of these operations, their impact on important credit and financial markets in the United States, and their influence on the international payments position of the United States are matters of national import. Furthermore, the size and character of these operations require that they be supervised and regulated in a manner consistent with the supervision and regulation of domestic banks.

Current Regulation of Foreign Banks

Let me turn now 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 detailed in the Appendix, 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 our nation's economy and its major financial markets.

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 effecting monetary policy that are placed on the operations of their primary competitors--large national and State member banks in our major financial markets;

(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 of 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. (20 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 or indirectly 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 and financing operations in several cities that serve as centers of international trade financing. This prohibition, which was originally enacted in 1919 amidst fears of foreign domination of U.S. trade financing, no longer serves the national interest as our banks have since that time developed into strong and efficient competitors in international and foreign banking. Thus, that prohibition today can only function to preclude additional 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 our 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 reciprocity between individual States and foreign governments 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 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 a foreign bank's home country if the home country imposes a reciprocity requirement. The net 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 banks' 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 the legislation proposed in S. 958. 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 foreign banks in view of their impact on the nation's money and credit markets.

The legislation embodied in S. 958 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 (Section 12); foreign banks are given the opportunity to establish federal as well as State branches (Section 18); the Edge Act is amended to permit foreign banks, with Board approval, to acquire Edge Corporation subsidiaries (Section 10); and it is recommended that the FDIC Act be amended in order to permit branches and agencies to obtain insurance on their deposit and credit balance accounts in the United States (Section 17).

The legislation proposed in S. 958 also closes federal regulatory gaps by amending the definition of "bank" in the Bank Holding Company Act to include branches and agencies of foreign banks (Section 2(4)), 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 (Sections 2-4). 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 could not be established outside of a foreign bank's State of principal banking operations unless a State bank headquartered

in its State of principal operations could also establish such offices; the parent foreign bank would in its U.S. activities 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 in their U.S. activities be subject to the Board's cease-and-desist authority for unsafe and unsound practices.

Any branch, agency, or incorporated subsidiary bank of a foreign bank with worldwide bank assets in excess of $500 million would also be required by Section 3(3) of S. 958 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.

S. 958 creates a comprehensive system of federal regulation of foreign bank operations not only through various amendments to United States banking laws but also through the establishment of a federal licensing procedure on future entry (Section 25). 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

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

In addition, I would like to emphasize that the legislation embodied in S. 958 does not undertake to supplant State regulation or remove options for State chartering or licensing. Rather, it seeks to superimpose federal controls on foreign bank operations in those areas where Congress has already subjected domestic banks to national regulation, such as the Bank Holding Company Act, or where foreign bank activities involve matters of national interest that are clearly the responsibility of the federal government, such as the effect of their operations on national money and credit markets.

Grandfathering of Existing Operations

An important policy issue that must be considered in subjecting foreign banks to the federal multi-State banking and nonbanking restrictions currently imposed on domestic banking organizations is the extent to which the Congress should afford foreign banks grandfather privileges for existing operations that do not currently conform to those domestic standards.

In Sections 3 and 4 of S. 958, the Board has recommended permanent grandfathering for all nonconforming banking and nonbanking operations (including securities operations) established by foreign banks 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 overseas. Since the overseas operations of United States banks are about three times as large in terms of assets as those of foreign banks in the United States (as of September 1975, 126 U.S. banks operated 751 foreign branches in more than 90 foreign countries with total assets of about $135 billion), 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 in light of the grandfather privileges previously extended U.S. 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.

Furthermore, it would appear that the extent of permanently grandfathered nonbanking activities would be relatively small and that the period of temporary grandfathering provided is not unreasonably long in light of divestiture experience under the Bank Holding Company Act.

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 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 section 4(2) of S. 958.

Other Regulatory Issues Involving Foreign Banks

In transmitting its proposed legislation to the Congress, the Board indicated 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 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 subsidiaries 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 policies on chartering investment companies for foreign banks.

The Board believes that there is a potential for avoidance of the objectives of its proposed legislation if foreign banks can readily obtain investment company charters in lieu of agency or branch licenses. The Board thus recommends that all future investment companies that would be chartered to engage in a commercial banking business be subjected 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, in addition to European-American, the New York banking authorities recently chartered a new bank--UBAF Arab-American Bank--that will 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. The Board recently considered the question of whether

a bank holding company was being formed in the organization of UBAF and determined that, on the basis of certain specific undertakings made by each of the shareholders of the bank with the Board, that a "company" had not been formed and that an application was not required under the Act. The cases of European-American and UBAF, among others, however, demonstrate that 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 this consortium form of arrangement might become an attractive vehicle for entry if branches and agencies of foreign banks are subjected to federal regulation under the Bank Holding Company Act, the Board recommends that Congress amend the Bank Holding Company Act to give the Board jurisdiction over situations where independent shareholders that do not form themselves into a company, as currently defined in the Act, nevertheless act in concert to control a bank. Since the scope and impact of any such amendment will depend, to a great degree, on the precise legal language chosen, the Board, at your request, will be glad to suggest several alternative amendments to the Bank Holding Company Act and to describe the ways in which such amendments would affect the shareholders involved. It should be noted that any such amendment would apply to domestic as well as foreign companies and thus the Congress may also want to consider such an amendment in the context of Bank Holding Company legislation.

Conclusion

This nation's domestic banking system is, of course, currently undergoing a thorough reexamination by the Congress and we at the Federal Reserve welcome this study and are glad to provide whatever assistance we may be called upon to give. It is our belief, however, that the enactment of legislation regulating foreign bank operations in the United States should not await or be made contingent upon the resolution of more fundamental domestic banking issues, such as whether U.S. banks should be allowed to engage in multi-State operations or securities activities. In our judgment, if foreign bank regulation is tied to such fundamental domestic changes, an undesirable end result will be further postponement of the enactment of any legislation regulating foreign bank operations in the United States. The longer such legislation is delayed, the more difficult will be our task in this regard, since foreign bank operations will continue to grow, thus making grandfathering proposals less acceptable and increasing the likelihood of retaliatory pressures against our banks abroad. The Board thus strongly recommends enactment of S. 958 during 1976.