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Statement by

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of the

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I appreciate the opportunity to appear before this Subcommittee to discuss the important and timely topic of international lending by U.S. banks. In my statement this morning I will present a brief survey of: (1) the growth in scope of U.S. banks' international lending, with emphasis on recent developments, (2) some problems and concerns that arise from the international operations of U.S. banks, and (3) actions that the Federal Reserve System has taken in the supervisory area as growth in international operations has proceeded. It seems appropriate to keep this review brief since this Subcommittee, together with the House Committee on Banking, published an extensive study of "U.S. Banks Abroad," only nine months ago as part of the FINE study.

Growth of U.S. Banks' International Activities

The expansion of U.S. banks' international activities in the past decade has reflected a number of developments, in addition to the central role of the dollar in international finance. In part, the expansion was the consequence of the growth of international trade, which has more than quadrupled over this period, and the greatly expanded activities of multinational corporations that have increased the needs of these corporations for international financial services.

Superimposed on these broad trends were two further developments that have greatly added to international credit demands from U.S. and other banks. The first of these developments was the substantially increased credit demands from a large number of countries, many of which had embarked on expansionary programs during the commodity price surge and worldwide inflation of the early 1970's, and subsequently found themselves with unsustainable rates of growth of imports. Borrowers in this position -- not only the developing countries, but also other primary producers and some highly industrialized countries -- have obtained substantial amounts of loans from American banks and also from banks of other major industrial countries.

The second major development was the sharp increase in oil prices, and the special financing problems that resulted from the emergence of a current account surplus for the OPEC countries which has aggregated close to $150 billion in the past three years. The rapid accumulation of debt appeared relatively manageable so long as it seemed probable that the OPEC surplus would diminish fairly rapidly. Developments that became apparent in the course of 1976 indicate that the OPEC surpluses will be larger and persist longer than had been expected several years ago. This changed outlook makes more difficult the situation of the borrowing countries, calls for a more deliberate process of balance-of-payments adjustment on their part, and may also make it necessary to develop alternative financial arrangements.

Growth in international lending by U.S. banks in the late 1960's and early 1970's was concentrated at foreign branches, since foreign credits extended by U.S. offices were subject to the Voluntary Foreign Credit Restraint Program. Subsequently, foreign lending from U.S. offices expanded rapidly, as that program was relaxed and terminated. By the end of 1976, total claims on foreigners of domestic offices and foreign branches of U.S. banks combined amounted to $207 billion, most of which were held by foreign branches.

In addition, majority-owned foreign subsidiaries of U.S. banks had total assets of $30 billion at end-1975, the latest date for which comprehensive data are available. The activities of these subsidiaries, which include both banks and other financial institutions, are in most cases similar to those conducted through overseas branches. A preference for subsidiaries, where it exists, reflects mainly reasons relating to corporate structure, or to legal and regulatory requirements in particular foreign countries.

Let me now turn to the geographic distribution of foreign claims at head offices and foreign branches. At the end of 1976, U.S. banks held $45 billion of claims on non-oil LDCs. Loans to Mexico and Brazil each accounted for about one-fourth of the total, and the remaining loans were mainly to a few major Latin American countries, and to Korea, the Philippines, and Taiwan. Thus lending by U.S. banks to countries classified as LDCs has been concentrated in the upper income LDCs whose economies have been growing rapidly in recent years. Many of these countries have been traditional customers of U.S. banks because of long-standing economic relations with the United States. U.S. bank lending to some of the more highly publicized LDC problem countries have actually been relatively small.

The largest share of the foreign assets of U.S. banks represents claims on G-10 countries and Switzerland, and claims on offshore banking centers such as the Bahamas, Singapore, Panama and Hong Kong. Altogether, these claims total about $125 billion. A large proportion of these claims, especially in the case of the United Kingdom and the offshore banking centers, are interbank placements with offices of major international banks, including foreign branches of non-affiliated U.S. banks. These placements typically have short maturities and frequently serve as secondary liquidity reserves in Euro-currency banking. These interbank placements result in some enlargement of reported U.S. bank claims on individual countries since the placements between different U.S. banks are not netted out.

Apart from interbank transactions, the claims on G-10 countries include a wide variety of credits -- longer term credits to multinational companies, short-term trade finance, equipment leases as well as some loans to major public sector borrowers.

It should be emphasized that these aggregate figures on loans to individual countries cannot be used to measure the amount of exposure of our banks in these countries. Part represent interbank placement where the exposure is generally regarded as small; part represent local currency lending funded locally; and other portions may be externally guaranteed or possess different characteristics offering protection to the lending banks.

Problems and Concerns

Rapid growth of international lending by U.S. banks has given rise to some problems. These problems are a subject of legitimate concern to bank supervisors and to the banks themselves. Before turning to some of these problems and concerns, perspective requires recognition of the benefits that have been derived from the expansion of international lending by commercial banks.

First of all, this lending has filled a traditional and important role in the financing of our foreign trade. It has also contributed to the efficient functioning of world credit and capital markets and to the financing of vital projects such as North Sea oil development.

Another important benefit from international lending has been the contribution to the earnings of U.S. banks. In recent years, reported international earnings have accounted for as much as 60 to 70 per cent of total earnings for a few of the largest banks, and for close to half of total earnings for a number of other large banks. Earnings from international operations have enabled the banks to add to their capital resources and have helped provide a cushion to absorb the effects of domestic loan losses.

Nevertheless, the expansion of the banks' international activities has necessarily been accompanied by greater risk exposure. The principal elements of this exposure are the traditional credit risks in international loan portfolios, the separate risks arising out of lending in different sovereign jurisdictions (the "country risk" problem), and the risks associated with the banks' foreign exchange operations under floating exchange rates.

Many of the credit risks in international lending are the same as in domestic lending, even though the banking practices and the legal and regulatory environments may differ. On the other hand, international lending is subject to special kinds of risk, usually subsumed under the heading of "country risk." This type of risk may be divided into two categories:

(1) Balance-of-payments difficulties resulting from external or internal economic causes that can lead to devaluation, foreign exchange controls, or some form of debt rescheduling or even default;

(2) Risks arising from social or political upheavals.

Concern about the country risk element in international loans has, of course, been greatly enlarged by the effect of the oil crisis on the payments positions of many countries and the large payments deficits and growing volume of external indebtedness that have ensued.

Despite these special risks in international lending, U.S. banks' loan loss experience to date has been better internationally than domestically. Over the five years from 1971 to 1975, the loss ratio on international loans of the seven largest U.S. banks was about one-third of the loss ratio on the total loan portfolio. Even in 1975 and 1976, when loan losses rose sharply on all types of loans, the loan loss ratio on international loans remained substantially below that for domestic loans. So far problem international loans seem to have been concentrated in real estate, as has been true of problem domestic loans. Nonetheless, it would be unwise to project automatically the past's low international loan losses into the future.

Besides these risks in international credits, the potential exposure of banks in their foreign exchange operations has been increased by the shift in the international monetary system to floating exchange rates and by the actual fluctuations that have occurred in foreign currency values. The contribution of improper foreign exchange dealings to the failure of Franklin National Bank is well known, as are the losses incurred by some banks overseas. While U.S. banks appear to have adopted management procedures adequate to limit their exposure in their foreign exchange dealings, their success in controlling that exposure must be a matter of continuing concern to regulatory authorities.

In addition to these concerns about the exposure of the banks, the view has sometimes been expressed that foreign lending by U.S. banks is occurring at the expense of lending to creditworthy domestic borrowers. On this subject, several points should be kept in mind. The great bulk of the international lending by American banks is financed by foreign-source funds. This statement applies not only to the loans made by the overseas branches of American banks, but also to loans made from offices in this country. There is, of course, some cyclical variation in the extent to which foreign lending from U.S. offices is matched by foreign sources of funds to the banking system. In periods of relatively reduced domestic demand for bank loans, as occurred in 1975 and 1976, banks may rely more heavily on U.S.-source funds to finance foreign loans, while in periods of high credit demands in our economy U.S. banking offices may become net users of foreign-source funds, as occurred in 1974.

But, more broadly, it must be stressed that at times such as the present, when the United States has a deficit on its international transactions in goods and services (current account), we are a net capital importer.

If American banks lend additional amounts abroad, and if the foreign borrowers do not buy more of our goods and services, but instead purchase goods and services from other countries, a company, bank or official institution abroad will acquire additional financial assets in the United States, such as U.S. Treasury bills or securities.

Actions Taken by the Federal Reserve

This review of some of the current problems in international lending is necessarily abbreviated. While care needs to be taken not to exaggerate these problems, concern about them is legitimate and, as

I indicated earlier, is shared in the banking industry as well. One indication of such concern is the steps that have been, and are being, taken within the banks to review and tighten their procedures and controls in the international area.

Bank supervisors have also responded to changes in the international activities of U.S. banks. I should like therefore to turn to the measures that have been taken and are being taken within the Federal Reserve System in the exercise of its supervisory responsibilities in this area.

First, however, I should emphasize that zero-risk banking is not an objective of bank supervision. Banks must make judgments and take reasonable risks. One way bank supervisors can strengthen the banking system is by ensuring that adequate information is available to the banks. An example is the current effort by the Federal Reserve System, in cooperation with the BIS and other central banks of the G-10 countries, to obtain data on the total amounts, maturity distribution, and guarantee status of bank credits to borrowers in individual countries other than those developed countries participating in this effort. The expanded coverage and the maturity information in this report will represent a marked improvement over data currently available to banks and bank supervisors. Moreover, for the first time, aggregate information will be available that includes the geographic distribution of credits that are covered by guarantees external to the borrowing country.

In addition, other reports received by the System are being reviewed and in some cases revamped to make them more useful from a supervisory point of view to the monitoring of the banks' international operations. In the same vein, the frequency of our overseas examinations has been stepped up and the procedures by which examiners scrutinize bank management systems and controls over their international operations are under active review.

Secondly, the banks have been encouraged to keep their international, as well as their domestic, expansion within prudent limits through the Board's "go-slow" policy. The Board has been unwilling to approve proposals for new expansionary ventures or investments when in the Board's judgment management's priority attention should be directed to improve the bank's own condition, and particularly to strengthen its capital structure.

The Board has also cautioned the banks about their exposure in international joint ventures. In a policy statement issued early last year, the Board indicated that, in considering applications to make investments in foreign joint ventures, it would take into account the possibility that the applicant might for business reasons accept a degree of financial responsibility for the foreign joint venture well beyond that indicated by its investment.

In the area of foreign exchange the Federal Reserve conducted a survey in late 1974 of bank practices regarding foreign exchange exposure and controls over their foreign exchange operations. That survey, the results of which were sent to the Congress in 1975, indicated that the banks surveyed set conservative limits on their foreign exchange positions and that the measures followed by them in controlling that exposure through reporting practices, internal controls, and auditing procedures were generally adequate. However, we are continuing to work with the banks and the Comptroller of the Currency to develop minimum standards for the internal control of their foreign exchange operations.

Among other efforts to improve our supervision of international lending, the Federal Reserve is currently conducting, through interviews, an informal survey of commercial bank practices in defining, monitoring, and controlling country risk. This survey, which covers about 25 large banks, reveals that U.S. banks engaged in international financial activities typically have systems for measuring and controlling country risk, although the content of these internal systems difers from bank to bank. The banks surveyed are aware of the complexity of measuring country exposure and are actively seeking to improve their internal systems.

Finally, I should like to mention the initiatives that have been taken to improve international cooperation in the supervision of international activities. The Federal Reserve is an active member of the BIS Committee on Bank Regulation and Supervisory Practices. That Committee was established in early 1975 as a means of promoting exchanges of information and of views about bank supervisory practices and bank supervisory problems. In addition to the educational value of such exchanges, the contacts established and maintained through this Committee have materially strengthened the ability of bank supervisors in the major countries to deal with individual problems as they emerge.

Over the longer run, one of the benefits of these international cooperative efforts will be improved supervision of our banks' operations overseas with the assistance of foreign banking authorities and, from their point of view, improved supervision of their banks' activities in the United States with the assistance of American bank supervisors.

One complication in development of close cooperation in banking supervision between national authorities is the fact that supervisory authority over the entry and activities of foreign banks in the United States is primarily the responsibility of the State banking authorities. The United States is unique in this respect. To improve this situation, and also because of the growing importance of foreign banks in the functioning of U.S. credit and money markets, the Board has been urging enactment of Federal legislation for the regulation of foreign banks in the United States. It is sincerely to be hoped that these proposals will be reviewed this year and that they will soon be incorporated into U.S. law.

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ATTACHMENT TO STATEMENT OF GOVERNOR HENRY C. WALLICH

Claims on Foreign Countries of Head Offices and Foreign Branches of U.S. Banks[1/]
(in billions of dollars)
December 1976

G-10 and Switzerland	
Belgium-Luxembourg	6.1
France	10.0
Germany	8.8
Italy	5.8
Netherlands	2.8
Sweden	1.3
Switzerland	3.0
United Kingdom	41.4
Canada	5.1
Japan	15.8
Subtotal	100.1
Other Developed Countries	
Austria	1.2
Denmark	1.0
Finland	1.1
Greece	1.8
Norway	1.5
Portugal	.4
Spain	2.8
Turkey	1.2
Other Western Europe	.7
South Africa	2.2
Australia	1.2
Subtotal	15.1
OPEC Countries[2/]	
Ecuador	.7
Venezuela	4.1
Indonesia	2.2
Middle East countries	4.2
African countries	1.5
Subtotal	12.7
Non-Oil Developing Countries	
Argentina	1.9
Brazil	11.8
Chile	.8
Colombia	1.3
Mexico	11.5
Peru	1.8
Other Latin America	2.8
India	.2
Israel	1.0
Korea	3.1
Malaysia[3/]	.5
Philippines	2.2
Taiwan	2.4
Thailand	.7
Other Asia	1.0
Egypt	.4
Zaire	.2
Zambia[3/]	.1
Other Africa[4/]	1.4
Subtotal	45.2
Eastern Europe	
U.S.S.R.	1.5
Yugoslavia	.8
Other Eastern Europe	2.8
Subtotal	5.2
Offshore Banking Centers	
Bahamas	9.3
Barbados	5/
Bermuda and British West Indies	4.3
Netherlands Antilles	.6
Panama	2.7
Lebanon	.1
Hong Kong	2.3
Singapore	4.6
New Hebrides[3/]	5/
Subtotal	23.9
Miscellaneous and Unallocated	5.1
GRAND TOTAL	207.3

Footnotes on Following Page

Footnotes to table on preceding page:

1/ Data are adjusted to exclude claims of U.S. agencies and branches of foreign banks on listed countries, and to exclude accounts between offices of the same parent bank. No adjustment can be made to exclude claims of one U.S. bank or its overseas branches on an overseas branch of another U.S. bank.

2/ Includes Bahrain and Oman (not formally members of OPEC).

3/ Foreign branch claims only; separate data for claims of U.S. offices are not available.

4/ Excludes Liberia, which is included in "Unallocated."

5/ Less than $50 million.