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Statement by

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before the

Committee on Banking, Housing, and Urban Affairs

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I am pleased to testify before your committee on three current issues in international banking.

First, I should like to give you my views on the proposal by the New York Clearing House that banks in the United States be permitted to establish special international banking facilities (IBFs) that could accept deposits from foreign customers free of reserve requirements and interest rate limitations, and could make loans only to foreigners. As you know the Board has twice sought public comment on specific features of the proposal, and this afternoon, the Board will review the comments received most recently. The proposal has a number of important implications, and I cannot promise you that this will be the last occasion for Board discussion of this proposal.

The comments received by the Board have been useful in identifying two principal issues posed by IBFs: the implications of IBFs for U.S. monetary policy and credit availability and their implications for competition among banks.

Because IBFs, as proposed, would offer attractive obligations with highly flexible maturities, free of reserve requirements and not subject to risks associated with asset holdings in foreign countries, they are likely to be attractive to some foreign investors that now hold funds in the United States or in the Eurodollar market.

Shifts of foreign funds from deposits in U.S. banks to IBFs would affect the monetary aggregates whereas shifts of foreign funds from the Euromarket would not. Most foreign demand deposits in the United States are held by banks and official institutions, and under a proposed redefinition of the aggregates, these deposits would be excluded. Demand deposits held by foreign nonbanks represent only a little more than 1 percent of M_1. Time deposits held by nonbank foreigners are about

1 percent of M_2. It has been argued that shifts of foreign deposits would be sufficiently small in size so that -- with adequate monitoring -- they would not lead to major problems in assessing the monetary aggregates.

There is a danger, however, that IBFs could pose difficulties for domestic monetary policy by attracting funds that U.S. companies might otherwise keep in U.S. banks. The readiness of domestic companies to place funds in IBFs through their foreign affiliates would likely depend on the availability of alternative domestic facilities. If the Board were to take action to reduce the availability or attractiveness of alternative domestic investments (such as RPs), U.S. companies might seek to use (or to establish) new foreign affiliates to take advantage of the attractive features of IBFs. It would be extremely difficult and costly for the Federal Reserve to control such shifts through supervisory action or to monitor such shifts in order to make adjustments to the monetary aggregates.

In its request for comment on the IBF proposal, the Board suggested two possible safeguards against circumvention of the ground rules for IBFs by domestic companies: limiting maturity of deposits to 7-day or longer, and prohibiting IBFs from accepting deposits from foreign affiliates of U.S. companies. The response of the banking community was that these restrictions would impair the usefulness of IBFs for conducting customary international business.

An alternative method of dealing with the problem might be to establish limits on the rate of growth of IBFs - thereby limiting the extent of possible shifting.

In my judgment, this issue remains unresolved.

IBFs could affect availability of bank credit in those markets where foreign deposits are used to fund local lending. So long as IBFs were able to lend to their parent banks free of reserve requirements the parent bank could fund local credits using deposits placed in the IBFs. But, if for monetary policy reasons, the Federal Reserve were to re-establish a reserve requirement on borrowings by U.S. offices from foreign branches - and, as has been proposed, apply this requirement to borrowings from IBFs - the IBFs might cease financing their U.S. parent banks and extend loans abroad.

In that case, there could be increased foreign lending by IBFs and - in the first instance - reduced domestic lending bv U.S. offices of those IBFs. If those domestic offices could not find alternative sources of funds on comparable terms (as, for example, by borrowing in the Federal funds market) availability of bank credit in certain markets could be adversely affected.

I might note that increased foreign lending under those circumstances could also adversely affect the exchange rate for the dollar.

The second issue regarding IBFs - competition among banks - has been the focus of comments by the banking community. Banks located outside New York have been concerned that they should have an effective degree of competitive equality with New York City banks. Some banks have indicated that they would favor IBFs only if they could have a physical presence in New York that would enable them to compete for deposits on a comparable footing with New York banks, and could have access to a mechanism for settlement of international transactions on terms that they would deem equitable.

The Federal Reserve is currently engaged in reviewing the role that it might have in facilitating international settlements; once that review is completed it may be possible to determine whether a settlements mechanism can be developed that would meet the need of IBFs as well as of the international banking community generally.

The issues that I have been discussing pose some as yet unanswered questions regarding IBFs. There are, however, some areas where questions can be resolved. One is supervision for safety and soundness - which is distinct from the regulatory aspects to which I have referred.

Supervision of IBFs would logically fall under the jurisdiction of the agency that supervised the parent bank - the Comptroller for national banks and the Federal Reserve for state member banks. Because IBFs would be located in the United States they could be supervised from the standpoint of safety and soundness to the same extent as the U.S. offices of the same bank: there would be no loss in supervisory capability.

Nor would IBFs be inconsistent with current efforts to establish some measure of control over Eurobanking. If broad international agreement can be reached on measures to be applied -- such as reserve requirements -- those measures or their equivalent would also be applied to IBFs. On the other hand, if agreement cannot be reached, the establishment of IBFs would tend to draw to the United States some of the banking activity now taking place offshore -- and we would have a somewhat greater opportunity to influence that business if it were conducted here.

The second topic which you have asked me to discuss relates to the regulation of Edge Corporations.

The International Banking Act of 1978 (IBA) amended the Edge Act and required the Federal Reserve Board to revise its regulations governing Edge Corporations by June 14, 1979. The IBA directed the Board to remove unnecessary regulatory restraints in order to make Edge Corporations more effective providers of international banking services, enable them to compete effectively with similar foreign-owned institutions in the United States, and foster ownership of Edge Corporations by smaller and regional institutions. However, the IBA did not amend the specific statutory language of Section 25(a) of the Federal Reserve Act that limits the powers Edge Corporations may exercise in the United States. In amending its regulations, the Board sought to increase the effectiveness of Edge Corporations through the removal of unnecessary restraints on their activities, while at the same time retaining the international character of Edge Corporations and not making them full-scale domestic commercial banks. In some cases, execution of this task involved difficult judgments.

Edge Corporations conduct a wide range of international banking activities both inside the United States and abroad. In general, these activities can be summarized as: (1) investing in foreign companies (primarily banking and financial institutions); (2) receiving and lending money abroad; and (3) providing international banking services in the United States (on the lending side this consists largely of financing international trade). Although the Board liberalized many aspects of its regulations pertaining to Edge Corporations, the amendments that have drawn the most attention are those dealing with the U.S. activities of Edge Corporations.

One change permits Edge Corporations to establish branches in the United States. Previously, domestic branching had been prohibited. However, banks had been allowed to own a number of Edge Corporation subsidiaries and many of the largest banks owned Edge Corporation subsidiaries in several States. In the view of the Board, domestic branching of Edge Corporations merely provides an alternate organizational form through which banks can conduct a multi-State Edge Act business that has already been permitted through ownership of multiple Edge Corporation subsidiaries. The Board regards this change as consistent with the Congressional mandate to remove unnecessary regulatory restrictions. The Board does not believe that this change violates the spirit of the McFadden Act ban on interstate branching by banks. Edge Corporations have not been regarded as commercial banks and, historically, a principal purpose of these Corporations has been to provide a means by which banks could conduct an international banking business outside of their home State. Moreover, this change may especially benefit regional and smaller banks that have been constrained the most by the capital requirements involved in establishing multiple Edge Corporation subsidiaries. (Banks can only invest 10 percent of their capital in Edge Corporations and each Corporation must be capitalized at a minimum of $2 million.) Prior approval of the Board is needed for all domestic branches of Edge Corporations and the public will have an opportunity for comment.

A second change permits Edge Corporations to finance the production of goods for export. Previously, Edge Corporations were restricted to financing the transportation, storage and actual exporting of goods sold abroad (as well as similar import transactions). This expansion of powers was especially designed to meet Congressional concern about the financing of exports. To insure that Edge Corporations retain their international character and to guard against possible abuse, the Board required that such working capital financing be extended only where there were firm export orders or where the goods being produced were readily identifiable as being for export.

Probably the most controversial proposal was one to allow Edge Corporations to conduct any type of business with certain customers, termed "Qualified Business Entities" ("QBE"). (Final action on this proposal was deferred.) These customers were to be firms engaged primarily in exporting or importing. This proposal represented a marked departure from existing Edge Act regulations that require each Edge Act transaction to be directly associated with an international transaction, usually one involving the import or export of goods. Under this proposal, the transaction-by-transaction approach would be eliminated in the case of Edge Corporations' dealings with QBE's; instead, all transactions with such firms would be presumed to be international in character. For example, if an Edge Corporation did business with an export-import firm, under the proposal, the Corporation could finance the purchase of a U.S. warehouse by that company, and the company could use its Edge Corporation deposit account to pay domestic expenses such as its payroll or its utility bills, transactions currently prohibited.

This proposal offered three principal advantages: First, it would have reduced the regulatory expense currently associated with checking Edge Corporation accounts to make certain a transaction is directly related to an international activity permitted under the regulation. Second, it appeared to offer convenience and increased efficiency to the export or import firm that might have looked to an Edge Corporation to finance most of its business but could not use the Edge account for certain normal business expenditures. Third, enabling Edge Corporations to offer full service banking to this limited group of customers would make them more effective competitors vis-a-vis foreign banks, as well as domestic banks.

The primary problem associated with this approach was how to insure that the business was truly incidental to international business, so that Edge Corporations retained their international character and did not, in fact, become domestic banks.

The principal objections to this proposal have arisen from concerns that it would too broadly expand the domestic banking powers of Edge Corporations and lead to the creation of a new group of domestic commercial banks that would have an advantage of being able to do business across State lines. Some of this concern arose because of uncertainty about the administrability of the "qualified business entities" (QBE) standards and the number and characteristics of companies that might be covered. Data on the latter are almost nonexistent.

In the end, the Board decided to postpone implementation of the QBE proposal and instructed the staff to explore the matter further. In the coming months, it is intended to review the customer accounts of Edge Corporations, consult with other banks and possibly commercial firms with the aim of developing alternatives to the present transaction-by-transaction approach to monitoring the U.S. activities of Edge Corporations. Any new proposal will, of course, be issued for public comment.

I would like to emphasize that it was never the Board's intention to alter the basic international character of Edge Corporation's business. As part of any final action, one principle will be that Edge Corporations are international banking institutions, not domestic commercial banks, and that the rules governing Edge Corporations must maintain that distinction. However, it is my view that this does not preclude Edge Corporations from taking some domestic deposits and making some domestic loans to a business that is basically international in character.

Finally I shall turn to the question of foreign acquisitions of U.S. banks.

Federal Reserve policy on foreign acquisitions of American banks accords with U.S. policy on foreign investment generally. We believe that our economy and our financial system benefit from foreign competition, and from foreign capital, so long as the investment is subject to the same rules and regulations that apply to domestic companies. This principle of national treatment is embodied in the letter and spirit of the International Banking Act, and it underlies the exercise of the Federal Reserve's responsibilities regarding foreign banking in the United States.

The last two years have seen an increase in the acquisition of U.S. banks by foreign parties. However, foreigners still own only a tiny fraction of our more than 14,000 banks and even including pending acquisitions, assets of the acquired banks would only be about 3 percent of total U.S. commercial bank assets. Most of the significant foreign acquisitions have been by banking institutions.

I should like to emphasize at the outset that there is a framework of law covering foreign acquisitions of U.S. banks and that recent acquisitions have been made in accordance with law. I refer to Section 3 of the Bank Holding

Company Act. The Federal Reserve evaluates proposed acquisitions according to standards set forth in the Act: the financial and managerial capabilities of the acquiring company, the convenience and needs of the community to be served, and the effect on competition and concentration of resources in the United States. In my view, these are appropriate standards for assessing individual applications.

It is important to recognize the potential benefits from foreign investment in individual banks. One of the principal benefits of a foreign acquisition can be an addition of capital to the bank. This would strengthen both the bank invested in and the U.S. banking system as a whole -- at a time when U.S. bank capital has been eroded by inflation and (historically) is costly. Foreign purchases of U.S. bank stock reduce the available market supply of that stock, and tend to raise the price-earnings ratio of stock of that bank and ratios of U.S. bank stocks generally. Higher price-earnings ratios may enable banks to raise capital through stock issues without substantially diluting the equity of existing stockholders. Actions that would restrict the flow of foreign capital to the American banking industry would also reduce the attractiveness of that industry to domestic investors. In recent years the nonbanking sector has grown relative to the banking sector in this country, and if we are to have a healthy, flourishing banking industry, we cannot afford to discourage investment in U.S. banks.

Foreign investment may also bring innovation and improved efficiency to U.S. banks: traditional bank pricing and lending techniques may be modified and improved by innovative foreign management -- with benefits both for the bank and for its customers. It is, of course, essential that a foreign bank seeking to acquire a U.S. bank be soundly managed.

Further, foreign investment can contribute to financial stability when the bank invested in is a "problem" bank, or is in danger of failing. In this connection I should note that the Federal Reserve has recommended that the Bank Holding Company Act be amended to permit domestic banks to acquire a failing bank in another state; such an amendment would broaden the range of alternatives that might be open to bank supervisors in cases of failing banks.

On the other hand, some questions have been raised regarding possible adverse effects of foreign ownership of U.S. banks. The first concerns the ability of the Federal Reserve to achieve its monetary policy objectives. Most large foreign-owned banks accept membership in the Federal Reserve System, and thus are subject to reserve requirements and other instruments of monetary policy. Moreover, the record indicates that foreign-owned banking institutions are likely to live by the spirit as well as the letter of U.S. monetary policy measures -- just as overseas banking offices of American banks abide by monetary policy and regulatory actions in force in their country of domicile. This is not surprising, since non-indigenous banks generally regard themselves as guests in the host country. I might note, as an example, that foreign banks cooperated with the Federal Reserve's anti-inflationary voluntary marginal reserve program that was in effect a number of years ago. Bills to improve monetary control that are currently under consideration in the Congress would, of course, help ensure that foreign-owned banks remained subject to the Board's monetary policy measures.

A second question concerns supervision of foreign-owned banks. When the investor is a foreign bank, the Federal Reserve has authority under the Bank Holding Company Act. The Board's policy statement on foreign bank holding companies makes clear that the foreign bank is expected to be a source of strength -- both financial and managerial -- to its American subsidiary. Moreover, the Board recently announced new measures to improve the evaluation of foreign banks at the time of an acquisition, and subsequently to monitor their condition and increase surveillance of their subsidiary banks.

When the foreign investor is an individual, rather than a bank or bank holding company, the standards for approval of acquisitions are those of the Change in Bank Control Act of 1978. That Act requires individuals seeking to acquire control of a bank to give the relevant Federal bank regulatory agency 60 days prior notification. The proposed acquisition may be disapproved if it would substantially lessen competition, result in a banking monopoly in any part of the United States, jeopardize the financial stability of the bank or otherwise be contrary to the interests of the bank to be acquired. Once a bank has been acquired by a foreign investor, the Board has the same supervisory powers available that it has in dealing with possible abuses by domestic owners -- notably the ability to issue cease and desist orders.

A third question concerns the impact of foreign acquisitions on the supply of banking services to meet the needs of U.S. industry and consumers. Probably the best protection in this regard is the competitiveness of U.S. banking. Banks that do not meet the needs of their community quickly lose business to those that do. As they are good businessmen, foreign bankers can be expected to recognize that fact and act accordingly. Moreover, the Bank Holding Company Act requires the Board in acting on any proposed acquisition to consider the convenience and needs of the community being served. In this connection, the Board reviews how an acquisition will affect the services of the bank being acquired and generally expects some showing of improved services. Further, foreign owned banks -- like domestic banks -- are subject to the Community Reinvestment Act, which requires the Federal bank regulatory authorities to evaluate the extent to which a bank is servicing all elements of its community, and also the Equal Credit Opportunity Act, which prohibits discrimination in lending.

Finally, I should like to emphasize that while we should work diligently to ensure that our banks receive national treatment in their activities abroad, it would not be appropriate for us to hold up approval of otherwise desirable foreign investments in U.S. banks because some countries may not permit non-indigenous banks (including U.S. banks) to acquire majority investments in their very large banks. Large American banks have been able to develop extensive foreign operations, and I would expect that some U.S. banks will continue to grow internationally both through branches and subsidiaries.

U.S. banks have in the past acquired sizable ownership interests in large foreign banks. For example, in 1974-75, Citibank acquired control of a German merchant bank and a related German consumer bank. These two at the time had combined assets of $2 billion. Also, in 1975, Citibank increased its ownership of Grindlays Bank to 49 percent and installed a Citibank employee as chief operating officer. Grindlays is a major British overseas bank whose assets at the time approximated $4.5 billion. It is not possible to state precisely how large a foreign acquisition might be permitted by foreign authorities because the only instances that come to the Board's attention are those where a U.S. bank has successfully negotiated an acquisition that has required U.S. approval. At the present time, we have no information that U.S. banks are seeking to purchase very large foreign banks.

I support fully current efforts under way to ensure national treatment for U.S. banks abroad. However, it would be wrong in my view to limit arbitrarily the growth of sound international banking activity, particularly on the basis of policies that foreign authorities might follow in hypothetical circumstances.

Nor would I favor establishing arbitrary limits on the total percentage of a particular banking market in this country that could be held by foreign-owned banks as a group. Such a limit would needlessly interfere with national treatment, and, if publicized, might tend to accelerate foreign efforts to acquire U.S. banks to get in "under the wire." The Bank Holding Company Act contains protection against domination of a market by one or more large banks -- foreign as well as domestic. Under the Act the Board may not approve acquisitions that would substantially lessen competition or lead to an undue concentration of resources. In most cases involving a foreign bank acquisition, the foreign bank would not be a substantial competitor in the market in question, but it could be considered a significant potential competitor.

Thank you, Mr. Chairman. I appreciate the opportunity to comment on these important issues.

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