For release on delivery
10:00 A.M. EDT
September 26, 1989

Testimony by

Manuel H. Johnson

Vice Chairman

Board of Governors of the Federal Reserve System

before the

Subcommittee on Financial Institutions Supervision,

Regulation and Insurance

of the

Committee on Banking, Finance and Urban Affairs

United States House of Representatives

September 26, 1989

I appreciate the opportunity to appear before this Subcommittee to discuss the implications for U.S. financial institutions of plans by the European Community to complete its internal market at the end of 1992. These plans involve removing remaining internal barriers to the free circulation of goods, services, capital, and people. The actions are intended to exert downward pressures on costs and prices, and as greater competition fosters increased economic efficiency, to raise the level of output within the Community. Residents of other countries, including the United States, have an interest in how these events unfold because of their important trade and financial relations with the Community. A stronger European economy should benefit the United States and other nations that trade with Europe.

The moves to a barrier-free internal market by the European Community will, of course, be felt most profoundly by citizens and businesses of the Community. While the full impact of these actions will not be felt for a number of years, corporations in the Community have been actively engaged in planning the restructuring of their activities in anticipation of the new operating environment.

The current situation is one where all tariff barriers within the Community have been dismantled for more than two decades. The elimination of intra-Community tariffs has contributed greatly to European economic prosperity, just as the absence of interstate barriers to trade has enhanced U.S. economic welfare. It is impressive that the European countries already have been able to achieve many of these same efficiencies associated with free trade, and will build further on these steps, within the context of sovereignty of the individual nation states.

The 1992 program focusses on removing remaining barriers to intra-Community trade which result from a variety of nontariff barriers, such as differences in national rules or laws regarding product standards. Such differences may effectively prohibit products made in one Community country from being exported to another. In order to deal with the remaining barriers to trade within the EC the Community has opted to apply the concept of "mutual recognition," whereby member states agree to respect the validity of each others' laws, regulations, and administrative practices that have not been harmonized at the Community level. In essence the member states have pledged not to use differences in national rules to restrict cross-border flows of goods and services.

The philosophy of mutual recognition adopted by the Community has been extended to the banking and financial sector through proposals for the creation of a "European financial area," which refers to both the free movement of capital and the establishment of a framework for a Community-wide market in financial services. Under this system, financial institutions chartered by any individual member nation will be deemed by other member states to be adequately supervised on a consolidated basis by their home country in accordance with requirements set forth in EC directives, and therefore will be permitted to branch freely throughout the Community without the need to seek approval or license from host-country regulatory bodies. The host country will, however, retain the right to establish regulations for such branches that are needed for the implementation of monetary policy, assuming such regulations are applied consistently to all banks operating in that country.

A feature of the new banking framework is that banks permitted by their home country to engage in a list of activities delineated in the Second Banking Directive would be permitted to engage in such activities anywhere in the Community, even if such activities were prohibited to locally chartered banks. For example, a bank permitted to underwrite and deal in corporate securities in its home country would be permitted to do so in any member state within the Community, even if local banks in a host member state were prohibited from such securities activities themselves. This explicit right of expanded activities for nonlocal banks, based on activities permitted in their home country, has no precedent in international banking. It will need to be monitored closely because it may have important implications for the types of European-based financial institutions that will emerge as major competitors with U.S. banks.

The implications for U.S. financial institutions of these important and innovative steps to integrate the financial sector of the European economy would appear to depend on the answers to at least three questions. First, what will be the impact on costs, margins, and profitability of financial institutions operating in the Community? Second, what types of financial institutions will evolve after the emergence of the European financial area as major competitors with U.S. banks in both European and worldwide financial markets, and how will these institutions differ from large U.S. banks? Third, what will happen regarding the right of entry and expansion for foreign-based financial institutions in the new operating environment in Europe?

Before discussing these three issues some background on the current situation and the scope of activities of U.S. banks in the countries of the Community might be helpful. As discussed in detail in the National Treatment Studies submitted to Congress in 1979, 1984, and 1986, U.S. banks have generally been relatively free to enter and compete in the major European markets and have taken advantage of these opportunities. As shown in the attached table, as of December 1988, U.S. banks operated 149 branches in the countries of the Community with total assets of $130 billion. On that same date, 17 U.S. banking organizations had majority-owned subsidiaries in Europe with total assets of $80 billion. These subsidiaries conduct banking activities and nonbanking activities of a financial nature. The nonbanking activities include underwriting debt securities and, under very narrow limits, equity securities, to the extent permitted by U.S. laws and regulations and where authorized by local law for affiliates of banking organizations. The major determinants of the decisions by U.S. banks to enter and participate in these markets appear to have been three-fold: first, to provide banking services to U.S.-based companies with major European operations; second, to profit from opportunities where margins on local banking business are attractive, sometimes in an area where they had specialized expertise; and third, to participate in the Eurocurrency and Eurobond markets that are primarily located in London.

The decision by the European Community to create a European financial area will certainly mean that the financial services sector within Europe will become more competitive, as low-cost producers of banking and other financial services are freer to enter and compete with higher-cost local firms that have operated in protected local markets. One study cited in a report by the Commission of the European Communities (the Cecchini report) used estimates of the costs of providing financial services in the four lowest-cost countries as a rough benchmark for how far intermediation costs might fall following integration, and concluded that intermediation costs might decline on the order of slightly more than 10 percent in the Community after integration. Analysts may disagree with the methodology used in that study, and its quantitative results may be biased by cases where the estimates of lowest costs contain observations with an element of a cross-subsidy. However, it seems reasonable to conclude that margins and profits in local European banking will be reduced because of greater direct competition or because of potential competition from outside banks who will be free to enter if margins and profits in local markets are particularly attractive.

Some European banks are reacting to these expected developments by mergers, acquisitions, and strategic operating alliances through banking groups, all of which should result in some operating efficiencies. These developments will mean reduced profit margins on certain types of business for European offices of U.S. banks as well as for local banks. While some U.S. banks may compete aggressively in the broader European market, a number of U.S. banks have already announced their decisions to restructure their activities in that market and, on balance, the expected reduction in profit margins on banking in Europe should result in some further consolidation and retrenchment by U.S. banks in their European operations.

The retrenchment by some U.S. banks in response to lower profit margins may take place over a relatively short period of time. Over the longer run, the reduced margins on banking that are expected to occur in Europe may actually induce some European banking organizations to restructure their activities and it is indeed possible that some will devote greater resources to expanding their banking activities here in the United States as well as in other markets outside of Europe if these markets are perceived to offer better returns. Declining profit margins on financial intermediation that result from greater competition in Europe, while painful to banks and their shareholders, are of direct benefit to the broader market of consumers of banking services and constitute a large part of the expected efficiency gains from the further integration of the European market.

The second issue confronting U.S. financial institutions is the types of indigenous competitors that will emerge within the European Community. Banks in a number of European countries are permitted wider powers than U.S.-based banks, including the ability to underwrite both debt and equity securities on an unlimited basis directly within the bank without having to establish separate holding-company affiliates whose activities are restricted and separated from the banks by firewalls. The plans by the Community to allow banks established in member states to provide certain services throughout the Community that are permitted in their home country, even if prohibited to domestically chartered banks in a specific host country, should create pressures for some of the more restrictive member states of the Community to liberalize their banking laws and regulations in these areas. This process is well understood by the member states and is referred to as regulatory convergence.

The ultimate result of this process of regulatory convergence is difficult to predict at this stage. To some degree it seems likely that U.S. banks will be confronted with competition from a number of large well-capitalized banks based in Europe that will be able to offer a broader range of financial services to their customers. This structure will differ markedly from our own structure in the United States. We have either prohibited institutions that accept deposits from the public from engaging in certain types of activities, or permitted some of them only through holding-company affiliates with firewalls between the banking and nonbanking activities. The reason for the firewalls applied between U.S. banks and their domestic securities affiliates is to ensure that the federal safety net is not extended to these affiliates and that bank holding company affiliates do not have an unfair competitive advantage vis-a-vis their unaffiliated competitors.

Outside the United States there is a different statutory basis for U.S. bank activities. Abroad, U.S. banks are permitted to engage in banking and nonbanking activities, including, as I have already stated, debt underwriting and very limited equity underwriting, through subsidiaries of Edge corporations that are in turn subsidiaries of the bank or through subsidiaries of the parent holding company. Subsidiaries of the bank may engage in nonbanking activities only to the extent the Board finds the activities to be closely related to banking or other financial activities. This standard imposed by the Edge Act was intended to allow U.S. banks to compete effectively abroad; however, the Board has not allowed U.S. banking organizations to engage in activities abroad that could present undue financial risk or otherwise potentially harm the safety and soundness of the banking institution.

The resolution of this evolving divergence between the United States and Europe regarding permissible activities for banking organizations that operate behind an explicit or implicit taxpayer supported safety net is uncertain. Over the foreseeable future major U.S. banks will be competing on a worldwide basis with large European banks that will be able to conduct a broad-based securities business and will have greater flexibility than U.S. banks to own shares of nonfinancial companies. Until the consequences of this disparity are better understood, we should not lose sight of the fact that our own supervisory policy of separating the deposit side of banking, with its safety net protection, from other kinds of financial businesses with different risks, has served this country well. On the other hand, we must be alert to any long-term competitive difficulties that it may pose for U.S.-based institutions as we consider and debate our own policies for broadening the range of permissible activities for U.S. banks. The Federal Reserve and other banking agencies will monitor the competitive situation carefully, here and abroad, and where necessary will draw upon our contacts with banking authorities in other countries for information.

The third issue for U.S. financial institutions, and the one that has drawn the most attention recently, is the conditions under which banks based in countries outside the Community, including U.S.-chartered banks, will be permitted to enter and expand into that broad market. As background to discussing this complex issue it should be noted that the United States has a policy of national treatment for banking which was established in the International Banking Act of 1978 (IBA). National treatment means providing foreign institutions the same competitive opportunities that are permitted to domestic banking companies.

The United States adopted that policy after careful consideration of various alternatives. We adopted that policy in the belief that it was equitable, that it would serve as a good example to other countries whose banking systems were not as open to foreign banks as our markets, and because we perceived the benefits to our own financial system of a dynamic participation by foreign-based banks.

This last reason, the unilateral benefits we as a nation of consumers of banking services derive from open markets, underlies our policy of not requiring reciprocal foreign treatment for U.S. banks. However, the Treasury, the Federal Reserve, and other federal banking agencies have been sensitive to the need to ensure that U.S. banks receive equitable treatment in foreign markets. Congress has required that the Treasury, with the cooperation of other agencies, including the Federal Reserve, conduct and publish National Treatment Studies that highlight existing cases where foreign countries restrain entry and expansion by nonlocal banks including U.S. banks. A new National Treatment Study is underway and will be completed in 1990. That study will contain a chapter analyzing the banking and securities markets in the European Community. In addition to the National Treatment Studies, formal and informal contacts between U.S. banking officials and their counterparts in other countries have also been used as a vehicle to highlight problems of entry to local markets.

The results of the approach taken by the United States have generally been successful, both for the operation of our domestic banking and financial markets and for improving access for U.S. banks to foreign markets. U.S. offices of foreign-based banks have brought innovations to our domestic market, including pressures to price loans off market interest rates. Interbank deposit markets and foreign exchange markets in the United States have been deepened by foreign bank participation, and in some areas retail banking has become more competitive because of foreign bank participation.

In recent years a number of industrial countries have followed our example and have liberalized their laws and regulations concerning foreign bank access to their domestic markets. These liberalizations have occurred largely through a recognition of the need to improve their own domestic banking and financial markets, partly in recognition of the success of the U.S. experience. In some cases these liberalizations have followed constructive dialogues with U.S. and other foreign banking agencies.

The European Community has also had a lengthy debate about its treatment of foreign-based banks in the broad financial area that will be created by the measures scheduled to be implemented at the end of 1992. Our best reading of their intention is that the Community plans to adopt a policy of what is usually referred to as "reciprocal" national treatment on a Community-wide basis. Under that policy, countries offering national treatment to all Community-based banks will be offered national treatment for their banks throughout the Community. While less desirable than a policy of pure national treatment without any preconditions, the policy of reciprocal national treatment should not, if implemented fairly, present significant problems for U.S.-based banks because of our longstanding commitment to national treatment for foreign banks in the United States.

As we learned in our experience with the IBA, however, the concept of national treatment does not always provide simple answers to a number of complex policy issues when banking systems and structures differ widely across countries. One example arose when Congress was confronted with adopting the statutory standard for the nonbanking activities of foreign banks with U.S. operations in the IBA. After a lengthy and complex debate, the Congress permitted nonbanking affiliates of foreign banking organizations to operate in the United States, even though U.S. banks are not permitted to have the same kind of domestic affiliations, to avoid an unintended application of U.S. law on an extraterritorial basis to banks chartered in countries that permit direct ownership by banks of nonfinancial companies.

A second example arose more recently in the requirement in the Primary Dealers Act of 1988 for the Federal Reserve to determine whether foreign countries offered U.S. securities firms the same competitive opportunities in government securities markets as are offered to domestic firms. The staff analysis on which the Board based its decision that U.S. firms are offered the same competitive opportunities in the government securities markets in Japan and the United Kingdom noted explicitly that "the concept of 'same competitive opportunities' does not require that every country adopt a structure for its government securities market that is identical to ours, any more than we should be required to adopt a banking structure identical to theirs."

One important lesson in both of these cases is that differences in national banking and financial structures can make determinations of national treatment and equal competitive opportunity very complicated. The second, and perhaps even more important lesson, is that different structures in foreign markets should not be used as an excuse for denying foreign banks equal competitive opportunity in a domestic market. In particular, restrictions on types of activities or geographic locations of banking offices adopted by the United States for reasons of public policy, and which apply to U.S. banks as well as to foreign-based banks operating in the United States, constitute national treatment and equal competitive access, and therefore are not reasons to restrict national treatment for U.S. banks abroad.

As a practical matter, major U.S. banking organizations are already well represented in the European Community through branches and subsidiaries, and access of many of them to the entire Community will be grandfathered through their subsidiaries. However, the structure of the ownership of banking in the United States is rapidly changing, and we are seeing the emergence of a number of active regionally based banking institutions in the list of our largest banks. Many of these institutions do not currently operate subsidiaries in the Community and their future access to that market is an important matter of public concern.

The question of access by foreign banks to the European financial area is coming at a critical time because services, including financial services, are included in the upcoming Uruguay Round of trade negotiations. These negotiations will involve a broad group of developing countries as well as the major industrial nations. We hope to utilize this important opportunity to achieve a liberalization of trade in financial services through a national treatment approach. That goal might be more readily achieved if a major precedent restricting the free flow of service trade were avoided. Because of our longstanding interest and expertise in this area, the Federal Reserve has been involved in developing the U.S. negotiating agenda for the forthcoming meetings on trade in financial services.

A final area that deserves mention is the implications of the plans by the Community for the post-1992 era for banking supervision. Over the last decade and a half bank supervisory issues have become increasingly international in scope. This is certainly appropriate as international banking and financial markets have become more integrated and as large banks conduct an increasing share of their activities in offices outside their home country and in foreign currencies. Where possible, regulatory systems need to avoid competitive inequities, and bank supervisors need to be able to share information on a confidential basis. The Basle Committee of Bank Supervisors has performed these functions admirably. The recent agreement on risk-based capital standards achieved by that Committee, and scheduled to be fully implemented by participating countries by the end of 1992, is a major accomplishment in reducing one area of competitive inequity.

The movement toward a European financial area may well mean that additional pressure will be exerted within the Community for further harmonization of bank supervisory and regulatory practices. Decisionmaking in financial services generally may increasingly flow from individual national authorities within the Community to a Community-based body, just as it has in the case of commercial policy. This process appears to be underway already as bank supervisors from Community countries have been meeting regularly for a number of years. For U.S. bank supervisors, as well as bank supervisors from Japan, Canada, and other non-EC countries, this change may well mean that various issues discussed in the Basle Committee will have already been discussed by an EC body and that there will a greater unity of positions taken by representatives of EC countries in meetings of the Basle Supervisors Committee.

In summary, the prospects for improved European integration offer potential benefits for non-European nations that trade with the Community as well as for the member states. Whether these potential benefits are realized depends on whether the measures are implemented in a manner that is trade-creating or whether they are instead offset by restrictive measures directed toward firms in countries outside the Community. At present we do not anticipate any problems of access for U.S. banks into the Community, but the Federal Reserve and other agencies will monitor the situation closely. The reduction in profit margins in banking that is expected to occur in Europe will play a very important role in determining the nature of future activities of both foreign and local banks in that market. While I cannot predict exactly which activities will be found to be profitable by U.S. financial firms, I am confident that our financial service firms are capable of being competitive in that new environment. The Federal Reserve, together with the Treasury and the other federal banking agencies, will do our part to help to ensure that unfair impediments to U.S. firms will not occur or persist.

Table 1

Activities of U.S. Banks in EC Countries: December 1988

	Branches			Subsidiaries	
Country	Number of U.S. banks with branches	Number of branches	Total assets ($ billions)	Number of U.S. banks with subsidiaries	Total assets ($ billions)
Belgium	3	7	7.9	4	2.8
Denmark	2	2	.2	1	--[1]
France	10	11	8.2	12	4.3
Germany	11	17	4.0	7	16.9
Greece	5	21	2.1	0	0
Ireland	3	4	.7	0	0
Italy	10	16	3.2	7	4.6
Luxembourg	1	1	--[1]	7	6.5
Netherlands	2	2	1.1	4	.8
Portugal	1	1	.2	1	.3
Spain	9	15	5.3	7	4.7
United Kingdom	31	52	99.3	16	38.5
Total	33[2]	149	132.2	17[2]	79.4

1. Less than $.1 billion.

2. Numbers are not additive because some banks maintain offices in more than one country.

Source: Year-end Call Reports.