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DEVELOPMENTS IN INTERNATIONAL BANKING

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

to the

Association of Foreign Banks in Switzerland

Bern, Switzerland

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My topic here today is "Developments in International Banking" and it seems an appropriate one for the occasion. The world of banking has two sides. One is the substance of the business, the gathering together of money and the allocation of these resources through loans and investments. The other represents the framework, the endless ramifications of laws and regulations that determine what banks can and, more often, cannot do. For the central banker, there is a similar division between his responsibility for monetary and economic stability and his regulatory and supervisory chores that are a necessary counterpart. In my opinion, both private and central bankers today are compelled to spend too large a part of their time and energy struggling with the framework. This leaves not enough time and energy to deal with what should be the substance. My talk today will be no exception. I shall have to be concerned very predominantly with the framework and with the legislative and regulatory changes that are occurring in it.

National Treatment

Last year, after extended discussions, the U.S. Congress passed the International Banking Act (IBA). The law reflected the undeniable fact that foreign banks were expanding rapidly in the United States, that these activities were to some extent free from the regulations that confine American banks, and that as a result foreign banks enjoyed a competitive advantage. Accordingly, the basic theme of the IBA has been "national treatment." Foreign banks in their numerous manifestations, as branches, subsidiaries, agencies, are to be treated like American banks in order to provide equality of opportunity. The alternative to "national treatment," which is "reciprocity," was discarded as inconsistent with our competitive philosophy as well as impractical. Given the wide disparities of legal treatment to which American banks are exposed in the foreign countries in which they operate, reciprocity would lead to a crazy quilt of divergent rules. Banks from a country with liberal banking legislation would receive correspondingly liberal treatment in the United States. Banks from a country with more confining legislation would be treated correspondingly severely. Both treatments very likely would differ also from the treatment given to U.S. banks in the United States and create competitive inequities.

National treatment, to be sure, is not always easy to define in a country with such diverse banking laws and rules as the United States, which includes national banks, State member banks, State non-member banks, insured banks, and in the various State jurisdictions. I believe that the IBA has solved these problems fairly. It has placed

large foreign banks in the same framework, with respect to reserve requirements and other monetary policy tools, as well as insurance and supervision, in which large American banks situate themselves. The "grandfathering" of existing multi-state offices of foreign banks preserves a competitive advantage over American banks and takes care of what would have been legitimate complaints, if foreign banks had been required to close existing offices. The outlook of the Act is toward the future, seeking to provide a framework of competitive equality.

Bankers and their supervisors must recognize nevertheless that perfect equality is unlikely to be achieved by law. In the United States, there is no law or regulation, for instance, determining the minimum amount of capital with regard to total assets, or risk assets, or deposits that banks should have. There are certain concepts of capital adequacy employed in bank examinations and in bank holding company acquisitions. Typically these are based on the capital ratios of some peer group of the bank in question. Where appropriate, we look at these capital ratios on a consolidated basis. This is especially important in the case of banks owned by a bank holding company where the holding company has leveraged the consolidated capital further by issuing holding company debt.

Because of different international practices with respect to requirements for consolidation, as well as differences in bank accounting in general, it is difficult to compare the capital ratios of large banks internationally. It is clear, nevertheless, that banks of some countries have substantially lower capital/asset ratios on average than American

banks. This leads to a very significant competitive advantage in the pricing of loans as can readily be demonstrated.

For every loan that a bank adds to its portfolio, the bank must earn an income sufficient to sustain the added capital needed to support that loan. In other words, the bank must have earnings from the loan to pay dividends and provide for retained earnings sufficient to keep the capital/asset ratio unchanged. If assets rise by 10 per cent, so must capital and so must income after tax. How much of a spread is required in order to pay for the added capital depends on the cost of capital, the earnings return before taxes, and on the interest earned on the loan. Today, the interest earned on loans is high, of the order of 10 per cent or more. But the cost of capital for American banks is also high, owing to the low price/earnings ratios at which their stocks are selling. After tax, a price/earnings ratio of 5 means a cost of capital of 20 per cent. Before taxes on incremental income, the cost of capital could be twice that. As interest rates rise in relation to the cost of capital, that part of the cost of capital not covered by the interest on the loan diminishes. Accordingly, the spread that the bank has to charge over the cost of borrowed money in order to defray the cost of capital also diminishes. That may be one explanation why banks have been willing to accept lower spreads as interest rates have been rising. But at a cost of borrowed money of 10 per cent and a pre-tax cost of capital of 40 per cent, a bank with a capital ratio of 5 per cent still needs a spread of 1.5 per cent on the loan merely to cover its cost of capital, without any

allowance for incremental risk or overhead. If interest rates were to return to more normal levels without a change in the cost of capital, the spread, to be adequate, would have to widen proportionately. For banks with capital ratios lower than 5 per cent, which is the case of many foreign banks, the cost of maintaining their capital would be less and they would have a corresponding competitive advantage.

The problem of maintaining adequate capital ratios in American banks transcends, of course, the problem of foreign competition and the advantage that foreign banks with lower capital ratios have with respect to American banks. Capital ratios of large American banks, on average, improved during the years 1975-76 thanks to relatively slow growth of bank assets. However, during the following two years, they tended to worsen again, as the economy, the inflation, and bank lending all accelerated. Over the years, total U.S. bank assets have tended to grow at a rate slightly higher than nominal GNP, which accelerates with inflation.

In order to prevent a continuing shrinkage of capital ratios during high inflation, banks would have to aim at maintaining a constant rate of return on assets rather than on capital. A constant rate of return on assets will eventually lead to a capital/assets ratio that is sustainable from retentions without new stock issues, although that ratio might be inadequate. But the practice of banks seems to have been to allow the return on assets to shrink while the return on capital was increasing only moderately if at all. There is no stable capital/assets ratio at the end of this tunnel into which the banks have maneuvered themselves.

What I have said about capital ratios should suffice to make clear that the ideal of national treatment is not easily attained. Its superiority to the "reciprocity" principle nevertheless remains unchallenged. Reciprocity enters in only one regard: reciprocity in national treatment. Just as the United States has made an honest effort to provide national treatment for foreign banks, so the United States would like to see American banks receiving national treatment in other countries. And this means equality of treatment not only in law, but in practice. Where the laws are so designed or so administered that foreign banks cannot make progress while local banks do, national treatment de facto has not been achieved, whatever the wording of the law. I expect that these issues will be examined in a study of national treatment for U.S. banks abroad mandated by the IBA in which the Federal Reserve is participating. The report is to be completed by September 1979.

Large Bank Acquisitions by Foreign Banks

In the last few months, the Federal Reserve Board has approved the acquisition of three large American banks by foreign banks. These acquisitions have raised questions among the Congress, the public, and the regulators themselves. How open to foreign ownership should U.S. banking be?

Ours is an economy open to foreign investment. We welcome foreign competition and foreign capital. The principle of national treatment is embodied in the letter and spirit of the IBA. It has been further reaffirmed in a policy statement issued by the Federal Reserve Board on February 23, 1979,

concerning foreign bank holding companies. This statement also makes clear that safety and soundness of the banking system is the principal criterion for entry and operation of foreign banks, and that foreign bank holding companies acquiring American banks are expected to be a source of strength to their American subsidiary. This emphasis on the foreign bank as a source of strength to the American bank is not inconsistent with the desire of foreign banks acquiring American banks to create what is sometimes termed a "dollar base." Participation in the already large U.S. money market will help to broaden and improve that market. But it is clear nevertheless that the resources of the acquired American banks can be drawn upon by its foreign bank holding company only within the limits set by Section 23-A of the Federal Reserve Act, changes of which the Federal Reserve has recommended to Congress, and other applicable legal provisions. The Federal Reserve has instituted monitoring procedures to keep abreast of flows of funds between the parent and the American subsidiary, and between the American subsidiary and customers of the parent. In addition, the Federal Reserve requires adequate information concerning the situation of the foreign bank holding company.

There are certain specific advantages for the U.S. banking system and U.S. economy associated with the entry of foreign banks into the American market. Competition is enhanced to the benefit of bank customers. Traditional bank pricing and lending techniques may be shaken up by innovative foreign examples. Foreign acquisitions reduce the market supply of bank stocks, and some improvement in the very low valuation given to bank stocks in the market can be hoped for. An inflow of capital also strengthens our balance of payments.

But the United States has created, somewhat inadvertently, legal limits for the absorption of American banks by other American banks that do not necessarily apply to foreign banks which are new entrants to the U.S. market. These legal limits, therefore, provide favored treatment for the latter as far as acquisitions of American banks are concerned. An American bank seeking to acquire another bank can only do so within its home State, if at all, because the McFadden Act and the Bank Holding Company Act restrict interstate branching and interstate acquisitions of banks. At the same time this American bank is limited in the acquisitions it can make in its home State by State law and restrictions of the Clayton Act which prohibit acquisitions "where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly." For a large American bank seeking a merger partner or acquirer, therefore, other large American banks either in or out of State are practically ruled out. A foreign bank may be the only possibility. From the point of view of a foreign bank, meanwhile, acquisition of a subsidiary rather than creation of a branch through merger or de novo may appear relatively more desirable than before. This is the consequence of the restrictions placed on the activities of multi-State branches of foreign banks which now can accept deposits only on the same conditions that apply to Edge corporations. Edges, as you know, are subsidiaries of U.S. banks limited to foreign trade.

Some moves are afoot to improve the competitive situation of U.S. banks in these regards. One is a proposal by the Federal Reserve Board to broaden the powers of Edge corporations under the IBA. Another is a governmental study of the McFadden Act which restricts interstate branching. A

third is a legislative proposal to permit across-State-line acquisitions of failing banks by out-of-State bank holding companies. The basic thrust of most of these proposals is toward improving the domestic side of the U.S. banking system. But some benefits are possible also in terms of the ability of U.S. banks to compete with foreign banks in the United States market.

Those who are concerned about the inroads made upon U.S. banking by foreign acquisitions must bear in mind one fundamental cause of recent takeovers -- the low value placed by the market upon U.S. banks. This low value reflects a multitude of factors: the attrition of bank capital, and hence of bank earnings, by inflation, the regulatory costs visited upon U.S. banks in the erroneous belief that true, i.e., inflation-adjusted, bank profits are high and, from the viewpoint of the foreign investor, the low international value of the dollar. The removal of most of these adversities to banking is in our own hands. In some cases, foreign acquisitions can be helpful to that end. Virtually no contribution, so far as I am able to see, would be made by placing restraints on the entry of foreign banks into the United States. Once more, however, I would like to revert to my earlier caveat: the only reciprocity that the United States seeks is in achieving national treatment for American banks abroad.

Capital Ratios, Liquidity, and Consolidation

I have already commented on the problem posed by differential capital ratios in achieving competitive equality among banks. Capital ratios also, however, can be viewed as a means of limiting the expansion of bank credit and of the money supply. Liquidity ratios can be employed for the same purpose. An essential condition of doing either in an

effective and meaningful way is the worldwide consolidation of every bank's balance sheet with those of its branches, subsidiaries, and joint ventures. The United States has practiced consolidation, for purposes of bank supervision, for at least ten years. The effect of consolidating typically, although not necessarily, is to show less liquidity and lower capital ratios together with higher concentration of loans to particular borrowers. This is the result of the consolidation process which nets out intra-company liquidity, lengthens balance sheets as the netting out of subsidiaries' assets and liabilities disappears, and typically adds little if anything to the equity of the parent company. Naturally, there are gray areas in the process of consolidation. Precise instructions issued by the supervisors help to keep ambiguities within limits, however. On the whole, the process has proved quite feasible.

Bank secrecy provisions in some countries have interfered marginally with consolidation. It should be noted that consolidation and its purposes are not intrinsically at odds with the purposes of meaningful and legitimate bank secrecy. Consolidation is concerned with the overall position of the bank and, where it deals with individual customers, with the bank's overall loans to a particular customer. This information is needed for evaluation of risk. Consolidation is not directly concerned with the deposits of individual customers. Typically, it is deposits of, rather than loans to, customers with which bank secrecy is concerned. Therefore, it should be quite possible to reconcile consolidation with a reasonable degree of confidentiality concerning the deposits of particular customers.

The United States has not tried to use consolidated balance sheets for the purpose of restraining bank credit, either by way of capital ratios, liquidity ratios, or overall credit ceilings. Detailed studies that have been made indicate that it would be extremely difficult to arrive at capital ratios for U.S. banks that would be fair in an overall sense, appropriate to the current and often very different positions of individual banks, and effective in achieving the purpose of macro restraint. The nature and quality of bank assets differ enormously. A given capital ratio, therefore, would not imply equal protection for depositors and creditors in different banks.

Notwithstanding these considerations, capital adequacy is, of course, a major concern to U.S. bank supervisors. It represents one of the five categories under which banks are rated, the others being quality of assets, quality of management, earnings, and liquidity. But while differential ratings have proved possible and indeed desirable, rigid standards have not.

This does not imply that capital standards could not have usefulness in particular circumstances. Some countries are indeed applying them as part of their prudential regulatory approach. What needs to be examined is whether an adequate degree of consolidation is observed. Capital adequacy standards for banks with large unconsolidated subsidiaries are not meaningful, nor would be standards for banks with holding companies unless these are consolidated. Properly designed capital standards could also be employed for monetary control purposes, perhaps on an incremental basis in order to minimize inequities, if other tools of monetary policy do not suffice.

Similar considerations apply to liquidity as a possible constraint on bank lending. The time has long gone by when bank liquidity could be evaluated in terms of the volume of short-term liquid assets -- so-called secondary and perhaps tertiary liquidity. Today, bank liquidity consists largely of access to borrowed funds, and in the maintenance of a degree of solvency and a standing in the market that assures this kind of access. The concepts of liquidity and solvency are converging.

A distinction can be drawn, however, between liquidity in a bank's home currency and liquidity to meet obligations in foreign currency. Liquidity in the bank's home currency derives strength from its intimate relationship with the domestic money market. It derives strength also from the presence of a lender of last resort who can issue the bank's home currency. In the case of American banks, finally, liquidity derives strength from the presence of an insurer who protects deposits up to a limited amount and who can, in appropriate circumstances, deal with a failing bank through the device of purchase and assumption as employed by the Federal Deposit Insurance Corporation (FDIC) in accordance with its statutes and policies. To the extent that a bank operates in foreign currencies, liquidity must be viewed differently. The matching of maturities of foreign currency assets and liabilities must be more closely observed. Domestic liquidity does not always translate unequivocally into liquidity in foreign currencies. For this reason, it would probably be difficult to arrive at standards of liquidity that would be internationally comparable.

Reserve Requirements on Euro-liabilities

In view of the difficulty of achieving some degree of control of international bank lending through capital standards, liquidity standards, and consolidation, the concept of reserve requirements on the Euro-market deserves intensive study. The Euro-markets particularly today constitute an important source of credit and monetary claims. They add to the world's liquidity in a manner that is not readily taken into account by the national monetary policies of the countries whose currencies are involved. Given the competitive advantages of the Euro-markets, and the growing awareness of borrowers and depositors of the opportunities offered by these markets, rapid growth of money and credit creation in these markets must be expected. Over time, expansion in these markets might come to equal or exceed domestic creation of money and credit.

It is important, therefore, to make sure that domestic monetary and credit policies are not undermined and circumvented by the expansion of the Euro-markets. These markets are not "out of control" in the sense that is sometimes alleged. The volume of money and credit that they create depends on the level of interest rates which, in turn, is closely related to interest rates in home markets. But, typically, interest rates for the depositor in Euro-markets are higher and rates charged to the borrower are lower than the corresponding rates in home markets. This reflects cost advantages such as freedom from reserve requirements, absence of deposit insurance premia, and economies of scale. It would take more severe restriction in domestic markets, therefore, to bring about a given amount of restraint in Euro-markets.

Moreover, it must be expected that as more restraint is exerted in domestic markets, some of the domestic demand will shift to the Euro-market and be met there, although at rising interest rates.

In time, therefore, the Euro-markets are likely to pose a mounting threat to domestic monetary policy. To be effective with respect to the total creation of money and credit in a given currency, both at home and in the Euro-market, growth of money and credit must be slowed increasingly in the domestic market, to the detriment of borrowers dependent on this market. Moreover, as the share of the Euro-market in aggregate money and credit creation expands, the inflationary potential mounts unless domestic monetary policy is geared increasingly toward controlling expansion in the Euro-market via stringency imposed at home. This situation is likely to convey a mounting inflationary bias to monetary policies as the Euro-markets gain on domestic markets.

Reserve requirements or other restraints imposed on Euro-deposits would help to stem this development. So would, of course, removal of reserve requirements or other restraints from domestic deposits. Either action would reduce the competitive edge of the Euro-banking markets and place them more nearly in conditions of equality with domestic banking markets. If the expansion of the Euro-markets proceeds at a rate no greater than domestic monetary expansion, much of the inflationary bias will disappear. Removal of reserve requirements in the United States could undermine this advantage, however, by removing one of the bases of the monetary policy mechanism.

As matters stand now, control over the volume of money and credit in any currency with a Euro-component threatens gradually to slip out of the hands of the central banks. This development has begun slowly but is accelerating and can be expected to accelerate further. That is why the concept of reserve requirements on Euro-markets deserves intense study. An idea such as this takes time to mature and it is, therefore, essential that we begin our preparations now and prepare this instrument for the day when we shall wish that it were available.

I have spoken here about some of the developments that are under way in international banking. Change is the essence of banking in more than one sense. The only thing that is futile is trying to resist change. Working together, we can all help to make sure that change is for the better.

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