The Federal Reserve and International Banking

Remarks of Mr. Robert P. Mayo, President
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before the
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I am pleased to be with your Committee this afternoon. As many of you know, I have great enthusiasm for the future of international banking in Chicago. You obviously share that enthusiasm or you wouldn't be here today.

When I returned to Chicago in 1970 after my service in Washington, I was convinced that Chicago and the Midwest could and should play an increasingly important role in international finance. I have argued publicly many times for the positive encouragement of the growth of international banking in our Seventh Federal Reserve District--Illinois, Indiana, Iowa, Michigan, and Wisconsin. What has taken place in the last few years has exceeded my expectations in many ways. Now my appetite has been further whetted so I have even greater expectations for the Midwest in international banking and finance.

It is that attitude that clearly influences my thinking on the role of the Federal Reserve System in international banking. My views have a decidedly regional cast to them. I'm not being provincial in taking this position. Rather as I see it, developments here in the Midwest are an important element in understanding what is happening to both the international activities of U. S. banks and the operations of foreign banks in the United States.

As we all know--but others, particularly those in the East, dispute or ignore--Midwestern domestic banks have made significant inroads in foreign financial centers--they are a real not a nominal presence. And foreign banks have made significant inroads in U. S. centers outside New York. What we are seeing is the process of U. S. banks and foreign banks expanding and reorienting their presence both abroad and here--essentially a process of expanding by location and activities beyond the money market and related functions normally associated with prominent financial centers such as New York and London.

Branches of U. S. banks now operate in all of the major international centers of commerce. But U. S. bank presence in these cities was only contemplated after the initial European penetration had taken place via London. Just as the London money market and its ancillary attractions provided the incentive for U. S. bank entrance into Europe, so did the presence of the New York money market provide the initial rationale for foreign bank entrance into the U. S. And once that initial position was attained, the banks moved out to centers of commerce outside of New York.

Foreign banks have now been active in the U. S. for more than a decade. Since 1965 there has been more than a six-fold increase in their total U. S. assets, which now amount to over $38 billion. They have acquired expertise in U. S. banking techniques, and have been able to introduce a number of innovations of their own that have influenced these techniques. Foreign banks have become familiar with U. S. banking supervisory practices. They have also acquired "names" which are now recognized in U. S. money market transactions. But even more important from my standpoint is the fact that foreign banks have clearly recognized

that they have a potential clientele beyond that which is interested in the dollar clearing and associated technical functions related to the New York money market.

The branches now being established in Chicago are part of the process of reorientation of the foreign bank activity in the U. S. For 17 of the 18 applicants for foreign branch licenses in Chicago, Chicago is not the initial point of entrance into U. S. commercial banking. These might be described as second generation entrants. Furthermore, in the case of 12 of these 17, banking offices have now been established, or have been applied for, in all three major financial center--New York, Illinois, and California. In addition, the parent banks of the three foreign-affiliated banks located in Chicago have also entered the other major financial centers.

This process of reorientation is the major factor in whetting my enthusiasm for midwestern international banking. For too long have too many viewed international banking in the U. S. as a New York dollar clearing activity. Strictly on the basis of international money market operations, the Midwest does not reasonably expect to supplant New York. But taking the broader view--the financing of trade, facilitating direct investment, etc.--the Midwest with its massive productive capacity and markets is a natural. Our Seventh Federal Reserve District leads the nation in total agricultural and industrial production as well as in exports. This is a fact that none of you has obviously overlooked.

Now this brings me to tthe questions raised by foreign bank activity in the U. S. and the related issues of U. S. bank activities abroad. As you are well aware, some would like to put these questions off. But I do not feel that we should or can. Foreign bank presence in the U. S. now represents a substantial segment of the U. S. banking

community. In the first place, in terms of U. S. interbank markets, offices of foreign banks in the U. S. as of last fall had $6.8 billion outstanding due to non-affiliated banks in the U. S., and $4.4 billion in loans to U. S. banks. Affiliates of foreign banks in the U. S. are no longer insignificant adjuncts to the national money market. They have become large transactors in the interbank markets. At the same time they have, of course, sharpened their ability to effectively arbitrage U. S. and European money markets. Furthermore, foreign banks are no longer insignificant participants in other banking activities in the U. S. Their outstanding total of $15.4 billion in commercial and industrial credits last fall represented 8 percent of all such loans in the U. S. And I should also note assets of foreign bank affiliates located outside of New York doubled in 1973 to a level somewhat in excess of $10 billion. It is expected that with the expansion of the number of foreign banks in California, and the opening of Illinois to branches of foreign banks, the importance of foreign banks outside of New York will continue to increase. Associated with this U. S. expansion, beyond the mere maturing of activities of foreign banks in the U. S., has been the increased interest of foreign multinational corporations in direct investment in the U. S.

Foreign banks have benefited from the absence of federal regulation of their U. S. operations. In particular, they have benefited from the absence of the obligations of Federal Reserve membership, as contrasted to all of their U. S. major multinational competitors. The anomalies of the present regulatory structure are such as to allow foreign banks to evade federal regulatory presence under the guise of our state rights-oriented dual banking system. This is obviously not an

analogous situation to that which exists for U. S. banks in the European Community, since each of the member states has an independent monetary authority, to whose supervision U. S. banks must submit themselves. The harmonization of European Community banking law should not be regarded as being analogous to the introduction of federal regulation in the U. S. In the case of the European Community, it represents an effort to integrate various national banking structures which are regulated by separate monetary authorities. In the U. S., it represents an effort to introduce a degree of responsibility to the national monetary authority itself.

I know that each of you is familiar with the arguments concerning the regulation of foreign banking in the U. S. Nevertheless, I would like to review the issues briefly, giving my views as to what may be the most logical position.

Recent discussants of the regulatory philosophy with respect to foreign banks in the U. S. have taken three different positions. First, there is the laissez faire--or in this instance "do-nothing"--approach. This approach relies on a mixture of traditional arguments for dual banking and warnings concerning the possible retaliation against U. S. banks overseas which would result from any increase of federal regulation of foreign bank operations in the U. S. Advocates of this approach argue that, if any change is needed, it should be the liberalization of U. S. banking laws so that U. S. banks can expand their powers and be subject to fewer regulatory burdens. More often than not, advocates of this position imply that something is faulty with the present structure of U. S. banking regulations since the tail, namely the present manner of regulating foreign banks in the U. S., is not allowed to wag

the dog, that is, the regulation of the U. S. domestic banking sector. This approach may sound pretty good. But the threat of foreign banks with interstate branches is not, in my opinion, a major weapon in convincing legislatures to liberalize their banking laws. Nor is it an effective or appropriate force in modifying U. S. views on the necessary separation of commercial and investment banking activities.

The main argument against this position is that reliance on purely state regulation may be politically unstable. We all remember the highly restrictive legislation vis-a-vis foreign banks which gathered substantial support in the California state legislature last year. Only federal coordination can provide for stability of the regulatory environment. Stability in a regulatory environment is clearly preferable to uncertainty.

The "do-nothing" approach also ignores the desirability of subjecting foreign banks to Federal Reserve controls for monetary purposes. In the absence of central bank reserve requirements on foreign bank operations in the U. S., the precision of Federal Reserve monetary control is reduced. Some centralized control also is needed because of the importance of the U. S. affiliates of foreign banks in international capital movements. State regulatory authorities do not tend to place great importance on matters such as international capital movements but rather tend to place the bulk of their emphasis on insuring the safety of depositors--and appropriately so.

At the other end of the regulatory spectrum is the position that foreign banks in the U. S. should be severely restrained by federal authority. Protectionist legislation based on this position has been introduced in the Congress, as you well know. These bills are directed toward limiting foreign bank participation in U. S. banking and financial markets. In

particular, foreign banks would be allowed only one full-service bank and not be allowed the alternatives available to U. S. banks in the form of related nonbank financial subsidiaries. This position ignores or at least downgrades what I view to be the considerable public advantage to having viable and effective competition on equal grounds between foreign and domestic banks.

In between is the approach developed in the Federal Reserve System Committee on International Banking Regulations. Basically, the System Committee approach has been to suggest the framework of federal regulation which would allow foreign banks to be full participants in the U. S. banking markets, but at the same time meet the responsibilities inherent in their important position in U. S. banking. The System Committee appears to feel most comfortable with achieving this goal via extension of the Bank Holding Company Act of 1970 to all affiliates of foreign banks. Considerable concern has been expressed by the foreign banking community regarding two aspects, in particular, of the possible Federal Reserve approach. First, foreign banks point to the fact that in their home countries there is no separation of commercial and investment banking, and that this represents their normal mode of operations. Furthermore, they argue that U. S. banks do not, in their overseas operations, observe the U. S. domestic structures against the combination of investment and commercial banking. The foreign banking community argues that significant investment has been made in securities operations in the U. S., and it would be highly unfair if the choice between securities and commercial banking operations were now required for U. S. operations.

Obviously, prohibition of securities activity would eliminate a potential competitive advantage for foreign banks in the present post-interest equalization tax situation since they would not be able to

provide the flexibility of financing via fixed interest obligations--a service which U. S. banks cannot perform. Foreign banks, however, tend to forget that the brokerage but not the investment banking functions performed by their securities affiliates could be performed as part of the trust functions of their banks.

Foreign banks are also justifiably concerned with the maintenance of their multi-state activities, and they fear that the limitations on multi-state banking business of the Bank Holding Company Act would compel them to limit the extend of their U. S. presence. Governor Mitchell has indicated in his statement of the Bankers' Association for Foreign Trade that the ultimate decision as to whether facilities already in place should be continued or not obviously rests with the Congress, but that he would not see any substantial difficulties with the approval--or "grandfathering"--of the existing multi-state branches of foreign banks. Foreign banks may feel some discomfort with any limitation on their multi-state activities, since they may argue that their customers in the U. S. do not have the same geographical orientation as customers of U. S. domestic banks. However, foreign banks may not have explored the alternatives available to them under the Bank Holding Company Act, and if they did, they would find other ways to serve their potential customers.

The type of approach which now appears to be shaping up in the System, would, in my view, be equitable for both the domestic banks and the foreign banks operating in the Midwest. Foreign banks can and should play a positive role in the provision of banking and financial services in the U. S. In viewing the regulation of foreign banks in the U. S., we should not be focusing negatively on what is required to

prevent retaliation against U. S. banks overseas. All we want to do is create an environment in which regulatory authorities abroad understand Federal Reserve efforts to achieve the same type of relationship with foreign banks in the U. S. as U. S. banks enjoy overseas. We favor mutual non-discrimination. Foreign banks should have the same privileges in our country as U. S. domestic banks. Such a regulatory philosophy would, I sincerely believe, allow foreign banks to serve both their own private interests and U. S. public interests as they continue to grow in a healthy manner.