INTERNATIONAL BANKING

AND THE FED

An address delivered by Robert P. Mayo,
President of the Federal Reserve Bank of Chicago
at the Annual Meeting of the Mid-America Council
on International Banking, June 30, 1978

It is, indeed, a great pleasure for me to be here with you tonight. In my professional career in the Midwest that spans some fifteen years, I have been intimately involved--first as a banker, and for the past seven years as a public servant--in promoting the growth of international banking activities in the area. Therefore, I feel a great affinity with people who, like yourselves, have been an integral part of that movement.

Tonight, I would like to share with you some of my thought on [redacted] in international banking in the United States in general, and in the Midwest in particular.

Let me, if I may, look at the overall picture first, and start out with some figures to place the U.S. international banking trends in a perspective. At the end of 1977 commercial banks of the ten major industrial countries had $657.3 billion in foreign loans and other claims outstanding, an increase of over $100 billion in a single year. The U.S. commercial banks have been in the forefront of this expansion. Their total claims on foreigners (including the claims booked through their foreign branches), rose from $61 billion in 1970 to about $347 billion at the end of 1977--a five-fold increase in seven years.

We at the Federal Reserve have, of course, watched this development with great interest. Our response to it has been a product of two sets of considerations: On one hand, we have recognized that the tremendous increase in the international activities of U.S. banks was a constructive response of these institutions to the rising need for credit globally. In part, this rising demand for credit was an extension of a long-term trend reflecting rising aspiration of peoples everywhere for improvements in their standard of living. Investment--and credit--have always been an integral part of that process. But far more important in this surge in demand has been the "energy crisis" that surfaced in 1973-74. The five-fold increase in the price of oil created tremendous disequilibria in the world balance of payments. The huge balance of payments surpluses accruing to the OPEC countries had their counterpart in large deficits by the oil-consuming nations. These deficits had to be financed if the world were to survive the "energy shock." The commercial banks around the world rose to the challenge of the "petrodollar recycling." In that sense, they have been performing a vital function of sustaining world's economic activities by helping to finance--directly or indirectly--the oil-related deficits sustained by virtually every nonoil producing nation in the world. As an institution charged by Congress with the responsibility of contributing to the economic health of the country, we at the Fed responded positively: From this perspective, the expansion of U.S. banks' activities abroad has been viewed by us at the Fed as highly beneficial.

But there has been another side to this coin: The tremendous expansion in the foreign lending has considerably altered the traditional loan/capital ratios of many participating banks, and opened the banks to new risks. As an institution charged with the responsibility of maintaining sound, viable banking industry in the United States, the Fed, obviously, reacted with concern.

Of particular concern has been the dramatic increase in the debts of the developing countries. It has been estimated that the debt of some 70 non-OPEC developing countries amounted to some $160 billion at the end of last year. Of that total, almost a half—or some $78 billion—was owed to private lenders, primarily commercial banks in the industrial countries of the world—an increase of some 150 percent since the end of 1973, following the oil crisis. Doubts emerged about the ability of many of these countries to service the debt. There were fears of defaults, of "domino effects" that could severely undermine the active structure of world banking.

The Federal Reserve, in cooperation with the central banks of other major countries, and with other U.S. bank regulatory agencies, took steps to guard as much as possible against excesses in the international activities of the U.S. banks that could lead to such developments. In 1976, the Board of Governors of the Federal Reserve System created a Committee on Foreign Lending consisting of members of the Board of Governors and of several presidents of individual Federal Reserve banks, to study and appraise the situation, and to recommend appropriate measures if need be. ~~I have had the privilege to be a member of that committee.~~

The work of the committee has just been completed, and the Federal Reserve, together with the Comptroller of the Currency, and the FDIC, is now in the process of implementing some of the measures that appeared desirable.

One of the first steps has been the effort to obtain, and to make available to the commercial banks engaged in international activities, a better and more comprehensive data on international banking world-wide. We wanted to provide the management of these banks with best available information so that they themselves are able to make rational decisions in respect to lending. The Fed has always strongly felt that the exercise of prudence in banking lies primarily with the management of individual banks. Thus the System's current efforts to assure the soundness of international banking activities derive, in the first instance, from that premise.

Going beyond this, the System is now in process of implementing a new supervisory, bank examination approach that would incorporate some precautions against credit over exposure on part of individual banks in their foreign lending to individual countries. I will not go into details of this approach. It will be communicated to your banks in due course.

What I would like to emphasize, however, are some broad philosophical principles on which the approach is based. It is not a mechanical approach that would tell banks where to lend and where not to lend. It has been fully recognized that the "country risk"encompasses a whole spectrum of factors, economic social, political, and legal that cannot be analyzed and evaluated mechanically.

While some "objective criteria" such the country's current account imbalance, and the rate of its external debt accumulation will be used to "screen out" countries for in-depth analysis, the final determination of the "risk exposure" will be broadly based, and will include such factors as the degree of concentration, maturity structure--but above all other subjective criteria.

Looking from a broad perspective at the overall posture of the Federal Reserve toward the international activities of U.S. banks, one may come to a conclusion that the posture has been one of being posed at the sharp edge between the efforts to promote the growth of international banking on one hand, and on the other hand trying to moderate it. But perhaps a very close look may suggest that the dichotomy does not really exist; after all, a continued expansion of international banking can take place only if the excesses that may threaten to undermine it in the long-run are guarded against. And that, I believe, is what the Fed has been trying to achieve in forming its attitude and policies toward the international expansion of U.S. banks in general.

In trying to sketch out for you some of the issues relating to international banking, I have spoken, so far, as a member of the nation-wide Federal Reserve System. Let me now "switch the hats," don a hat of the president of a regional Federal Reserve bank, and focus briefly on some of the issues relating to international banking activities in the Seventh Federal Reserve district, and the Midwest in general.

When I came to the Midwest in 1962 I soon became aware of the glaring gap between, on one hand, the extensive international orientation of the business and agriculture in the Mid-West, and on the other hand, the still rather modest and timid involvement of a great majority of the mid-western banks in international banking. For example, in 1960, when the five Midwest states that comprise the Seventh Federal Reserve district were exporting over $3.0 billion in manufactured goods (some 21 percent of the national total) and almost $800 million (or some 17 percent of the total) in agricultural products—a total of almost $4.0 billion of exports originating here--the export financing bankers' acceptances--the major financial instrument traditionally used to finance exports--outstanding at all the district banks amounted, at the beginning of that year to--would you believe it--$8.3 million! Indeed, the total claims on foreigners by all these banks amounted to $100 million at that time! By 1970, the situation improved somewhat--but not dramatically. Export-financing acceptances were still only about $42 million even through the volume of exports originating here expanded to $8 1/2 billion. But the total claims on foreigners, including those booked from by these established foreign branches of several district banks amounted to over $5 billion--a fifty-fold increase in just 10 years.

What was particularly significant about this expansion that took place during the sixties was the fact that it took place under the severe limitations imposed on the international activities of the district banks by the Voluntary Foreign Credit Restraint program imposed in 1965 for purposes of shoring up the country's balance of payments. Under that program--which many of you in this audience still painfully remember, I am sure--the nation's banks were confined in their foreign lending activities to the amounts that were only a percentage of an early sixties base period. The program was particularly painful for the district banks because it caught them in an expansionary phase of their international activities, and thus with a relatively small base. Indeed, the total claims on foreigners booked at the head offices of the district banks remained virtually frozen at around $900 million level between 1964 and 1970; the expansion in foreign lending that I previously mentioned took place almost exclusively at the foreign branches of these banks. Incidentally, this development highlights what may be viewed as a "positive" side of the program. The VFCR program, painful as it was for the Midwest banks in restricting their head-office foreign activities, provided an impetus for an expansion of the district banks' activities abroad. Many of the district's banks set up or expanded their foreign branches and subsidiaries so as to be able to meet the needs of their customers for international banking services without the encumbrance of the program that made it difficult for them to meet these needs from their head offices. While in the early sixties, there were no foreign branches of the district banks, by the end of 1977, the district banks were maintaining more than 70 banking facilities abroad.

Finally, in 1973, a new dimension of international banking activities in the Midwest emerged. Foreign banks came to Chicago. Recognizing finally the long-standing importance of the Midwest as a heart-land of America's industrial, agricultural--and export--activities, and recognizing the emerging importance of the Midwest as an international financial center, the foreign banks took advantage of the 1973 State Banking Law, and 31 of them opened their offices here in Chicago.

The changes in the complexion of banking in the Seventh Federal Reserve district implicit in the figures that I just cited, brought with them new dimensions to our functions at the Federal Reserve Bank of Chicago. Many of our traditional activities that we perform as a regional banking regulatory authority had to adjust to these profound changes: Our people in the Reserve Analysis Division of our Bank had to learn to cope with the intricacies of assessing the legal reserve requirements of Eurodollar transactions of our member banks; our Bank Examination people had to learn to evaluate banks' international assets that were unfamiliar to them; our Statistical Section had to learn to decifer statistical reports on our banks' activities in places that they never heard of; and I could go on, citing examples of the adjustments we had to make in our responding to the developments in international banking in the district.

But in a way, these responses, important as they have been in our overall operation, have been only a small part of the profound changes that have taken place at the Federal Reserve Bank of Chicago. We have not only responded. We had to become initiators.

Our initiative has evolved essentially on two planes: One was "internal" to the Federal Reserve System as a whole, the other was "external" as it has related to our member banks.

On the internal plane, our efforts can perhaps best be characterized as efforts to decentralize System's regulatory policy making processes as they relate to international banking. For many years, when U.S. international banking was concentrated almost exclusively on the Eastern Seaboard, regulations ~~concerning~~ affecting international activities of U.S. banks were initiated and promulgated, quite logically, by the Federal Reserve Districts in that region. As the U.S. international banking began to move to the Midwest, we at the Federal Reserve Bank of Chicago felt that we must share in the internal processes by which regulations affecting international activities of U.S. banks are developed and promulgated--so that the peculiarities of operations of banks in our district in their own international activities may eventually be given recognition in structuring the regulation. For example, we worked hard for the modification of the Voluntary Foreign Credit Restraint program that caught our banks at the initial stages of their international expansion, and thus with a very small base to work from in their international lending. We fought for, and invariably obtained representation on various special System's committees, both on the staff level and at the principal level, dealing with various aspects of

U.S. international banking. For example, we at the Federal Reserve Bank of Chicago were represented on the System's Task Force on Foreign Operations of U.S. Banks in 1972 (that examined at great depth all aspects of international banking; I, and some members of my staff were members of the System's Committee on Foreign Banks Regulation that examined the operations of foreign banks in the United States, and drafted the legislative proposal now before Congress; I and members of my staff have been members of the System's Steering Committee on Foreign Lending that, among other things, is now in the process of drafting examination standards for the international operations of U.S. banks. These are just few examples of our efforts within the Federal Reserve System where we have tried to project the international orientation of our banks into the overall policy **making** processes.

On what I have referred to earlier as the "external" plane our activity relating to the international orientation of our district has also been quite extensive. Just to mention a few of these, back in the early 1970, we launched the publication of a weekly "International Letter" to provide comprehensive, concise summary of significant international economic developments to the general public so as to increase their awareness of important issues in the international financial area. We have devoted a considerable amount of resources in exploring the possibility of changes in the international payments-clearing procedures with the ultimate objective being the breaking up of the virtual "monopoly" of New York City in these transactions due to the peculiarities of the Clearing House settlements procedures. We have been, and we are working hard in the area of bankers' acceptances. This area has been viewed by us as being of particular importance because it touches most intimately on that bothersome "gap" I mentioned earlier, a gap between the international orientation of business, commerce and agriculture in our district on one hand, and the supporting financial activities of our banks. We published several articles on bankers acceptances designed to familiarize the general public with that instrument; we have been supportive of efforts to provide for better and more easy marketing of bankers' acceptances of the district banks--including the exploration of the possibilities of establishing a market in bankers' acceptances in Chicago--so as to make the usage of that instrument more attractive to the Midwest banks; we are currently involved in restructuring our internal procedures in handling questions and interpretation of regulations dealing with bankers acceptances. We are working toward a goal of creating a System-wide information clearing system whereby interpretation of regulations on bankers' acceptances rendered, say, by the New York Fed to one of its banks will be made available to all banks, including those in our district. We expect that this will eliminate the situations we encountered in the past where banks in some regions of the country were issuing eligible bankers acceptances in financing transactions that banks in other regions of the country believed would be ineligible, and thus excluded themselves from such financing.

Well, I suppose I could go on--but you, I am sure, are by now anxious to resume this evenings activities. So let me close my remakrs by summarizing--and emphasizing --the underlying philosophy of all those things I talked about tonight: I want you to know that in your efforts to expand international banking activities in the Midwest, you have friends at the Federal Reserve Bank of Chicago.