MULTINATIONAL BANKS: THE IMPACT OF EXPANSION

Remarks by

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INTRODUCTION

The multinational banks and their customers, the multinational corporations, seem to have replaced the lengendary gnomes of Zurich as the "bad guys" of international finance. At one extreme, the multinationals are accused of causing the foreign exchange crises of the last year and a half, and even of having been primarily responsible for last February's devaluation of the dollar. On their side, the multinationals claim they do not engage in speculative foreign exchange transactions, but merely transfer funds from one currency to another in line with sound business practice. As is so often the case, the truth probably lies somewhere between these polarized views.

The multinational banks are eyed with suspicion for several reasons. One factor, certainly, is the dramatic growth in international banking itself that has taken place in the last decade. As world trade and investment have grown, international banking has expanded to keep pace. Banks, both American and foreign, have greatly increased in number, in size, and in the type of business they conduct. And with this growth in international banking, the task of the authorities simply in keeping track of the fast changing scene has become formidable.

Today, multinational banks operate in a changed and changing international monetary system. The explosion in world liquidity, the increasing volatility of short-term capital movements, the development of a Eurocurrency market linking together the domestic money markets of developed countries are all factors which have combined to present a very different environment for the multinational banks today from that in which they operated 10 to 12 years ago.

In order to understand some of the problems we face as regulators of banking activities, I'd like to give you a few of the facts that characterize the evolution of multinational banks in recent years.

Growth in U.S. Banking Abroad

At the end of 1960, 8 U.S. banks had 131 overseas branches with assets of $3.5 billion. By 1965, the number of U.S. parent banks had increased to 13 and their 211 branches had assets of over $9 billion. But the dramatic growth in international banking has occurred in the past 7 years. At the end of the last year, 108 U.S. banks had 627 overseas branches with total assets of over $90 billion -- 10 times their 1965 holdings.

U.S. banks not only have expanded their foreign operations in numbers and size, but their foreign business has also become a relatively greater share of their total activities. In 1960, for example, foreign assets of U.S. banks, including domestic offices and foreign branches, were less than 3 percent of their total assets. By 1972 this component was nearly 10 percent of the total.

The picture of rapid growth and spread in overall foreign business can be somewhat misleading unless one is aware of the continued concentration of international banking at a few of the very largest multinationals. For example, in 1972 the four largest multinationals, ranked by size of deposits at foreign offices, accounted for about 60 percent of such deposits at 20 large banks. And for these four banks,* deposits at foreign offices represented some 37 percent of the total domestic and foreign deposits.

The introduction of the Voluntary Foreign Credit Restraint (VFCR) Program in 1965 explains in large part the unprecedented expansion of U.S. branches abroad beginning in that year. Between 1960 and 1964 (prior to the inception of the VFCR Program), most of the expansion in loans to foreigners took place from head offices, with an average annual growth rate of 22.8 percent. From 1964 to 1972, after the imposition of the VFCR, the average annual growth rate in foreign assets of parent banks was only 4.5 percent. Conversely, lending activity at foreign branches increased at about double the rate from 1964 through 1972, following VFCR, that it had during the preceding 5 years (37.7 percent vs. 18.5 percent).

The split of total foreign credit outstanding between parent banks and foreign branches also highlights the shift that took place after 1964. In 1960, foreign assets of branches constituted only 36 percent of the total. In 1965, the books of the branches still showed only slightly over one-third of the total foreign credit extended. But by the end of last year, the foreign branches accounted for over 80 percent of the total foreign credit extended by U.S. banks.

A parallel trend in the expansion of U.S. international banking has been the growth in domestic subsidiaries established as Edge and Agreement Corporations under the Federal Reserve Act to engage in foreign

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* First National City Bank, Bank of America, Morgan Guaranty and Chase: Data as of June 30, 1972.

banking and investment. In 1960, there were only 15 such subsidiaries with combined assets of less than $1 billion. By 1964, the number of such subsidiaries had more than doubled (to 38), but their total assets were still less than $1 billion. By 1972, however, there were 89 Edge Act subsidiaries with assets of over $4.5 billion. Many banks have established an out-of-state Edge Act subsidiary in order to compete for international business. In all, 39 U.S. banks have established out-of-state corporations of which by far the majority, 21, were located in New York.

Growth of Foreign Banking in the U.S.

Information on the growth of foreign banking in the United States is more difficult to obtain than similar information on U.S. banking operations abroad. This results primarily from the fact that the agencies, branches and subsidiaries of foreign banks in the United States are established under state laws and regulated by individual state banking authorities.

The available data indicate that agencies, branches and subsidiaries of foreign banks in the U.S. had less than $7 billion in total assets at the end of 1965. As of January of this year, foreign banks had 59 agency offices and 27 branches in the United States. There were also several foreign subsidiary banks, primarily Japanese-owned banks in California. These various affiliates had total assets of $26 billion. In addition, foreign banks also have 125 representative offices in the U.S., which do not engage directly in banking operations.

Despite the rapid growth in foreign banking activities in the U.S., the total assets and lending operations of these banks are still only a small share of the U.S. total. Moreover, most of these banks are still very much oriented toward financing trade between the United States and their home country, and conduct their principal operations in the money and foreign exchange markets.

Regulating the Activities of U.S. Banks Abroad

This remarkable expansion of international banking activities has raised many questions for the authorities who regulate banking activity. The Board of Governors of the Federal Reserve System has established a special committee to study various aspects of multinational banking, both here and abroad, and has asked the committee to recommend changes in existing regulations where it feels they are appropriate. As a member of this committee, I am in the process of formulating my own views on possible policy recommendations and am not in a position to put forward any conclusions at this time. However, I would like to share with you some of the types of questions that confront us.

There are several basic principles that guide us in examining current regulations and any proposed changes in them. First, we must do nothing that would adversely affect the financial integrity of the U.S. banking system and the public's confidence in it. Second, we have an obligation as central bankers for the world's largest trading nation to change regulations only in ways that strengthen international financial relationships. At the same time, U.S. multinational banks must be permitted to operate in a regulatory environment that permits them to serve U.S. commerical interests abroad.

A different type of consideration has to do with maintaining the separation between banking and commerce that is such a strong tradition in

U.S. domestic banking. As you know, this tradition is not nearly so strong in many other industrial countries, where banks are permitted to engage in a wide variety of nonfinancial activities. And yet, while ensuring this separation at home, we must design regulations that permit U.S. banks to compete effectively abroad. Obviously, we are engaged in a balancing act, trying to reconcile principles that on their face may be incompatible. Yet tradeoffs are possible, and it is our task to weigh the sometimes conflicting considerations in an attempt to arrive at an acceptable compromise.

Below the level of general principles, there are some very specific issues that must be resolved. Is there any need, for example, to limit the size of operations abroad by any individual bank? Two types of questions bear on this issue. First, how great is the potential risk to the parent bank's solvency from unlimited expansion of its international operations? Second, are there grounds for believing that growth in a bank's operations abroad gives it such an edge as to substantially reduce competition in the U.S.? We are still in the process of collecting data on this subject, but to date I see no grounds for limiting a given bank's expansion -- either on the basis of risk, or competitive advantage.

Another question that confronts us is that of organizational form. Should any limitation be placed on the type of subsidiary -- branch, wholly or partly owned affiliate, or joint venture with foreign banks -- in which a U.S. bank can participate? Certainly, there's a general disposition to leave the form of organization to business judgment whenever possible, and at this point I'm not aware of considerations that should cause the authorities to favor one form over another.

This does not imply, however, that no distinctions should be drawn based on structure. There do seem to be sound reasons for limiting quantitatively or qualitatively, some activities of U.S. foreign affiliates. For instance, it seems reasonable that branches as such be constrained to engage solely in financial activities similar to those conducted by domestic branches. The rationale for this restriction has to do with the unlimited liability of the parent bank to its branches, in contrast with the restricted liability, in legal terms at least, to other forms of affiliates. Nonfinancial activities could be conducted through bank holding company affiliates (or joint ventures), just as they are in the United States.

A related, and perhaps more difficult, question has to do with where to draw the line for regulatory purposes between substantial control of an affiliate and minority investments in enterprises that do not carry management influence or responsibility. Unfortunately, no easy answer exists in this area, even though conceptually the distinction is obvious and important.

A problem that arises frequently in ruling on U.S. banking activity abroad is that of permitting a greater range of activities to a bank's foreign affiliates than is permitted domestically. The banks, of course, have long contended that they need more leeway overseas in order to remain competitive with the local banking industry. On the other hand, there may be an element of additional risk, especially for smaller banks, when they undertake activities in fields where they have little or no management experience at home. On the whole, it seems to me there's a strong case for greater flexibility in the activities of banks' affiliates abroad than we are prepared to accept in the U.S. At the same time, I feel it is desirable to retain the present regulation that severely limits any activities by foreign affiliates of U.S. banks in this country.

Regulating Activities of Foreign Banks in the U.S.

Regulating the activities of foreign banks in the U.S. is, if anything, an even thornier problem. As I mentioned earlier, affiliates of foreign banks operate under state charters and under state supervision, so that we are dealing with a multiplicity of laws and regulations. A few foreign-owned banks have opted to establish holding companies and thus come under the Bank Holding Company Act and are subject to the same rules as domestic bank holding companies with respect to the permissible range of their activities. In general, however, foreign branches, agencies and all but one subsidiary are not members of the Federal Reserve System, and therefore do not have to comply with the Federal Reserve regulations and standards. Although they have to meet state reserve requirements, in most cases these are lower than the corresponding federal requirements, or reserves against such requirements may be invested in interest-bearing securities. Similarly, liabilities of branches, agencies and other affiliates in the U.S. to their foreign parent banks are not subject to reserve requirements, whereas funds drawn into this country by U.S. banks from their branches abroad are now subject to an 8 percent reserve requirement.

Because foreign affiliates are subject to state, not federal, regulations, they have been able to engage in activities prohibited to domestic banks. Several foreign banks have established subsidiaries that are actively operating as brokers and dealers in the U.S. stock markets. Some of these subsidiaries also engage in underwriting and selling new and secondary U.S. security offerings.

One of the most difficult problems involving the foreign affiliates arises in connection with the U.S. prohibition against interstate bank branching. Suppose, for example, a U.S. bank makes a joint venture investment in a foreign-based financial institution. The foreign banking institution subsequently sets up an affiliate in a state other than the home state of its U.S. bank partner. Has the U.S. bank now acquired a subsidiary in another state in violation of the interstate banking prohibition? Guidelines to resolve this issue have still to be established.

In any discussion of the operations of affiliates of foreign banks, one frequently hears reference to the principle of reciprocity. Application of this principle is obviously complicated by the diversity of current state laws with regard to foreign banks. In fact, one may wonder how the concept of reciprocity can be applied at all when we start with a range of different state statutes to reconcile with national laws abroad. And even if this were not a problem, one finds that while the term "reciprocity" implies equal treatment, in practice the operations, organizational structures, and historical basis of financial institutions operating in different jurisdictions may be so varied that the introduction of presumably equal powers may have very unequal impacts. Nevertheless, there is something anomolous about a legal and regulatory structure in the U.S. that accords treatment to foreign banking institutions operating here that sometimes is more favorable than that permitted to resident institutions.

All of these complex problems are being examined by the staff and members of the Federal Reserve's System Steering Committee on International Banking Regulation. The Committee has been charged with the task of developing "proposals destined for Board action on the regulation of foreign banking activity in the United States and on the regulation of U.S. banks (and their affiliates) abroad." In the press release announcing the formation of this committee, it was noted that the review would focus on the structural aspects of multinational banking and does not extend to the volume and types of international flows of funds through such institutions.

Although we have a sense of urgency about establishing equitable regulations in the entire area of multinational banking, the complicated nature of the questions involved makes it imperative that we devote sufficient time to studying the ramifications of any proposed changes. Moreover, we have promised, as is only right, adequate time for comment on any proposed changes by the institutions that would be affected.

Problems Posed by International Liquidity

Any changes in U.S. banking regulations affecting the operations of U.S. banks abroad and foreign banks within our country must be made against the background of major changes that have taken place in the international monetary system. Indeed, international economic relationships have changed markedly in the almost 30 years since the Bretton Woods Agreement was signed. Then the United States was the dominant economy in the world. Today the United States is facing economic equals in Japan and the enlarged Common Market. Yesterday the U.S. dollar was the base for the world's financial system as a reserve currency, a transactions currency, and an intervention currency for the entire world. Today, while the dollar remains an important currency in all three respects, it no longer dominates the world financial scene.

One of the most pressing problems threatening the stability of the international financial system at the moment is the size and volatility of short-term capital flows. Indeed, the need to devise methods for controlling these short-term flows is one of the more difficult tasks facing the negotiators of international monetary reform. Following a meeting last March, the Committee of Twenty issued a communique which recognized this as a problem for a reformed international monetary system. The Committee stated that "An intensive study should be made of effective means to deal with the problem of disequilibrating capital flows by a variety of measures, including controls to influence them, and by arrangements to finance and offset them." The Managing Director of the IMF underlined this point again just a couple of weeks ago in a talk he gave.

There have been numerous proposals for multinational efforts to control flows of short-term capital. In 1971, governors of the central banks of the major industrial countries agreed to stop their own placement of funds in the Eurocurrency market. And many countries have restricted the flow of funds into and out of this market by their own nationals, both individuals and corporations. It has been recommended in the foreign press that central banks of developed countries coordinate reserve requirements on foreign currency liabilities and foreign exchange positions of their domestic banks. It has also been suggested that central banks conduct something akin to open market operations in the Eurocurrency market, as has already been done in an embryonic way from time to time.

While I agree that we ought to explore various mechanisms for damping the impact of speculative flows of funds that originate in the Eurocurrency market, I disagree with those who have made this market the scapegoat for the recent ills of the international monetary system. The Eurocurrency market has merely facilitated flows of funds that would have taken place in any event, given the real incentives for capital movements that existed.

It is true that we have entirely too little factual information about short-term capital movements. The errors and omissions component of the balance of payments for the first quarter of this year was exceptionally large, indicating that we do not really know much about U.S. capital outflows in this latest period of currency crisis. As a result, the Secretary of the Treasury and the Secretary of Commerce have written to businessmen requesting them to review their reporting of monetary transactions.

The Federal Reserve System has also been analyzing information supplied to it by the banking system in an attempt to trace capital movements during the first three months of this year. So far, there appears to be little evidence that U.S. multinational banks, through either their home office or branches abroad, actively speculated against the dollar on their own accounts during this period. Nor does it seem that they played a major role in assisting their multinational customers to take positions against the dollar, although the information on this question is somewhat more sketchy.

Role of U.S. Bank in International Financial Markets

At the same time that we are joining with other nations in exploring means to control speculative flows of short-term capital, the Secretary of the Treasury has announced the intention of the U.S. government to dismantle our own controls on capital outflows. It is proposed that the Interest Equalization Tax, the controls of the Office of Foreign Direct Investments and the Federal Reserve's Voluntary Foreign Credit Restraint Program be terminated by December 31, 1974. It is my hope, and I believe it is a realistic one, that the evidence of improvement in our balance of payments will be sufficient to permit us to keep this pledge.

I am in complete agreement with those who contend that these controls, and the adverse balance of payments situation that necessitated them, have diverted much of the growth in U.S. international banking to overseas locations. There is a certain irony in the fact that government policies in this area have encouraged the expatriation of financial services at the expense of employment, profits and taxes in this country, at the same time that many people are voicing concern about the loss of jobs supposedly associated with the foreign investments of our multinational firms. I hope that we will be able to recapture a major part of the business that was forced offshore, once we are able to dismantle capital export restraints.

The proposed termination of these controls has drawn attention in financial markets abroad. Particularly in London, there is an awareness that a good part of the international banking business conducted there may then return to New York. This concern is aggravated by reports that many branches of U.S. banks in London are operating on low profit margins. In general, however, I see no reason why international banking should not continue to grow at a rapid rate abroad as well as at home. Even if the U.S. regains a larger share of the market in the years to come, I do not foresee any damaging impact on foreign international banking centers.

Revisions in U.S. banking regulations governing the operations of our banks abroad and foreign banks here, along with the termination of our present system of capital controls, should provide an improved environment in which U.S. banks can compete effectively. Given the resourcefulness U.S. banks have shown in the last few years, I have no doubt that they will be quick to take advantage of any opportunities such changes may present.