

Research Department
Federal Reserve
Bank of
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Regulating Foreign Banks

One day last September, without fanfare or much press coverage, President Carter signed into law the International Banking Act of 1978, which established for the first time a *national* policy regulating foreign banks' activities in the United States. Previously, foreign bank entry and expansion had been largely determined by individual state laws. In other words, each state determined whether to permit foreign banks to operate within the state, the types of banking activities they were permitted to conduct, and how much reserves (and in what forms) they had to hold.

Amidst this kaleidoscopic network of state banking regulations, foreign banks' operations have grown phenomenally in this country. In November 1972, when the Federal Reserve started collecting such statistics, there were 52 foreign banks operating 100 banking facilities in the United States. By May 1978, both the number of foreign banks and the number of banking facilities had more than doubled, to 123 and 268, respectively. Foreign banks' standard banking assets (excluding interbank clearing balances and due from related institutions) rose 260 percent from \$18 billion in November 1972 to \$65 billion in May 1978, whereas the assets of the 300 or so largest U.S. domestic banks increased by only 57 percent over that period, from \$353 billion to \$556 billion. Thus, the ratio of foreign banks' banking assets to those of large U.S. banks rose from 5 percent in 1972 to about 12 percent in 1978. Furthermore, over the same period, the ratio of foreign banks' commercial and industrial loans to those of large U.S. banks rose from

10 to 20 percent, and the ratio for standard banking liabilities rose from 3 to 11 percent of the total. (Standard banking liabilities exclude clearing liabilities and liabilities to related institutions.)

Across state lines

This phenomenal growth, combined with the lack of a national policy, has created several problems in the area of bank competition. These are related to the fact that U.S. domestic banks are forbidden by the McFadden Act to engage in inter-state branching. That does not mean, however, that domestic banks are completely precluded from inter-state banking. In fact, through the Fed-funds and the CD markets, domestic banks can tap short-term funds on a nation-wide basis; through their out-of-state representative (loan-production) offices, they can solicit loan business across state lines; and through their Edge Act corporations, they can engage directly in international banking. Again, through their parent bank-holding companies, they can conduct non-banking financial businesses — such as leasing, mortgage banking, consumer financing, and credit-related insurance — anywhere in the nation. However, under the McFadden Act, domestic banks cannot establish branches and tap retail deposit bases out of their home state, nor can they maintain agencies out of their home state for booking loans and servicing local customers.

Foreign banks, on the other hand, can and do conduct inter-state branching and maintain agencies across state lines, because they are not subject to

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the McFadden Act. Fully half of the 123 foreign banks operating last May in this country — 63 banks with a total of 122 banking offices — operated in two or more states, and their assets outside their home states totalled nearly \$25 billion. For example, the Barclays Group (U.K.) operates state-chartered banks in both New York and San Francisco, as well as branches in Boston, New York, Chicago, and the Virgin Islands, plus agencies in Atlanta and San Francisco. A number of French, Swiss, and Japanese banks operate similar wide-flung banking networks across the United States.

Other problems

A second competitive issue has arisen from the fact that foreign banks operate some 21 securities affiliates that underwrite and sell stocks in the United States. Again, these are activities in which domestic banks cannot engage, in this case because of prohibitions written into the Glass-Steagall Act. This reflects a difference in banking tradition. In Europe, banks are the principal factors in the securities-brokerage business; indeed, European branches of U.S. banks actively participate in that business. But in the United States, as a result of speculative abuses occurring in the 1920's, domestic banks have been excluded from the securities business. Foreign banks have been able to get around that prohibition, however. To the extent that they confine themselves to branch or agency operations and do not own subsidiary commercial banks in this country, they are not considered as U.S. banks or

bank-holding companies, and hence are not subject to restraints of the Bank Holding Company Act.

Thirdly, despite the size of these foreign banks — nearly all have worldwide assets of more than \$1 billion — they have not been subject to Federal Reserve reserve requirements. In contrast, nearly all the large U.S. domestic banks are Federal Reserve members, and as such must maintain reserves in non-interest-earning vault cash and deposits at Federal Reserve Banks. Depending on the state in which they operate, foreign banks can either escape reserve requirements entirely (as in Illinois), or hold the required reserves in correspondent balances or in interest-earning assets such as government securities. (California, for instance, permits state-chartered banking institutions to hold up to four-fifths of their required reserves on time and savings deposits in U.S. Government securities.) This lower reserve cost has given foreign banks an advantage over the large U.S. banks with which they compete.

Toward a solution

The International Banking Act of 1978 redresses some of these competitive inequities. On inter-state branching, each foreign bank must now select one state as its "home state" of operation, and it can establish a *new* branch or agency outside the home state only with that state's express permission. New branches and agencies operating outside the home state may conduct full banking services to the extent permitted under state law, but those new *branches* can accept deposits only from non-residents or from activities related to international-trade financing.

Foreign banks will retain an important advantage over domestic banks because of "grandfathering." The activities of all their existing out-of-state branches, agencies, and subsidiary banks are "grandfathered" under the new legislation — i.e., are exempt from new legal restrictions. Moreover, those institutions can establish new out-of-state branches and agencies to book domestic loans locally, a privilege denied to domestic banks. The provision represents a compromise between two sometimes conflicting principles, both of which are fundamental to the U.S. banking tradition: nationwide competitive equity and states rights in bank regulation. Under the new legislation, the states retain their right to attract foreign banks if they so desire; on the other hand, foreign banks' deposit-taking powers in new interstate operations are restricted to what domestic banks can do in their out-of-state Edge Act operations.

Meanwhile, the existing operations of security affiliates of foreign banks are also "grandfathered", but new entry into the field is prohibited. Although statistics are lacking, foreign affiliates apparently constitute only a fraction of the U.S. security business.

Finally, on reserve requirements, the new law provides that all branches and agencies of foreign banks shall be subject to Federal Reserve reserve requirements if their parent banks have world-wide assets of \$1 billion or more. These institutions, however, will not become Federal Reserve members, although they will maintain reserve balances and have access to the Federal Reserve discount window and other services on terms comparable with member banks.

Since nearly all the foreign banks operating in this country are very large banks, this new provision equalizes reserve costs for foreign and domestic banks. Still excluded, however, are the state-chartered subsidiary banks of foreign banks, which account for about one-fifth of foreign banks' total assets in the U.S. — some individual subsidiaries range up to \$2 billion in size. Their freedom from Federal Reserve reserve requirements, as well as the amendments to the National Banking Act permitting foreigners to become directors of National banks, further encourage foreign banks' already substantial interest in that form of operation in the United States.

National policy

Altogether, the International Banking Act of 1978 establishes for the first time a *national* policy on the regulation of foreign banks in the United States. The policy in some respects still falls short of equal treatment for foreign and domestic banks. However, given the strong tradition of states rights in banking, it may be the best compromise obtainable at this point.

It should be noted also that the law requires the President to re-examine the continued applicability of the McFadden Act, and to submit a report with recommendations within a year. In view of the fact that the new law continues to extend an advantage to foreign banks in the form of inter-state branching privileges, it may hasten the day when branching rules will be relaxed for domestic banks as well.

Hang-Sheng Cheng

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding	Change from	Change from year ago	
	11/1/78	10/25/78	Dollar	Percent
Loans (gross, adjusted) and investments*	120,482	+ 1,330	+ 17,061	+ 16.50
Loans (gross, adjusted) — total	97,675	+ 1,469	+ 17,167	+ 21.32
Security loans	1,993	+ 271	+ 39	+ 2.00
Commercial and industrial	28,440	+ 403	+ 3,909	+ 15.93
Real estate	33,854	+ 116	+ 7,524	+ 28.58
Consumer instalment	18,088	+ 113	+ 4,010	+ 28.48
U.S. Treasury securities	8,395	- 164	+ 134	+ 1.62
Other securities	14,412	+ 25	- 240	- 1.64
Deposits (less cash items) — total*	115,220	+ 926	+ 16,106	+ 16.25
Demand deposits (adjusted)	31,696	+ 1,013	+ 2,858	+ 9.91
U.S. Government deposits	355	- 604	+ 120	+ 51.06
Time deposits — total*	81,006	+ 220	+ 12,859	+ 18.87
States and political subdivisions	6,642	+ 78	+ 1,354	+ 25.61
Savings deposits	31,628	- 141	- 74	- 0.23
Other time deposits ‡	39,769	+ 229	+ 10,657	+ 36.61
Large negotiable CD's	19,247	+ 157	+ 8,334	+ 76.37
Weekly Averages of Daily Figures	Week ended 11/1/78	Week ended 10/25/78	Comparable year-ago period	
Member Bank Reserve Position				
Excess Reserves(+)/Deficiency (-)	+ 9	+ 70	+ 1	
Borrowings	44	36	228	
Net free(+)/Net borrowed (-)	- 35	+ 34	- 227	
Federal Funds—Seven Large Banks				
Interbank Federal fund transactions				
Net purchases (+)/Net sales (-)	- 218	+ 455	+ 1,430	
Transactions with U.S. security dealers				
Net loans (+)/Net borrowings (-)	- 608	- 371	+ 280	

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

Editorial comments may be addressed to the editor (William Burke) or to the author. . . .

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