THE PROPOSED FOREIGN BANK ACT

AND ITS PROBABLE EFFECT ON CALIFORNIA BANKING

Remarks by

John J. Balles, President

Federal Reserve Bank of San Francisco

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I am delighted to appear at this California Bankers Association seminar to discuss the foreign bank situation, a topic of increasing importance to this state's banking community. As you know, the Federal Reserve System sent to Congress last month a proposed bill to bring under effective Federal control the foreign banks operating in the United States. This legislation, the Foreign Bank Act of 1974, concerns an activity which since 1966 has grown from less than \$7 billion to more than \$40 billion in domestic assets.

The legislation is a product of the Federal Reserve System Steering Committee on International Banking Regulation, on which I have served along with two other Reserve Bank presidents and three members of the Board of Governors. We have worked since early 1973 to develop an appropriate national framework for regulating foreign banking activities in this country. We have consulted with domestic banks, with foreign banks, and also with foreign governments and their central banks. As part of this work, I visited eight countries around the Pacific Basin last spring to discuss the proposed legislation. On the basis of my close involvement with this subject, I would like today to discuss the general features of the bill and to assess its probable impact.

The main reason for the proposed legislation is the lack of a uniform national policy on foreign banks operating in the United States. The

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present situation is a patchwork of state and national jurisdiction that is not only unfortunate, but also unacceptable in terms of the long-term interests of this country. We want to be able to treat foreign banks fairly and to put them on an equal standing with equivalent U.S. banks. We also want to be in a stronger position in negotiating on behalf of our banks with foreign governments.

In the present situation, the terms of entry and the powers of foreign banks are effectively controlled by the various states and not by the Federal government. States such as California and New York give foreign banks considerable freedom, so that they have become important parts of the local banking community. In states such as Florida and Texas, the entry of foreign banks is forbidden by state law; indeed, forty states explicitly or implicitly forbid foreign entry. Ten states, including the largest financial centers, permit some kind of foreign entry, and the result is a growing network of foreign banks. But foreign banks come under Federal law only if they control subsidiary banks, in which case the Bank Holding Company Act applies, or if they join the Federal Reserve System and become subject to System membership requirements. Branches and agencies, which are the most common forms of foreign bank operations, are offices of their parent companies and thus have no separate corporate charter. Hence, they are not regarded as "banks" for purposes of the Bank Holding Company Act.

This situation of scattered authority cannot continue. The foreign banks are now too important for that; over sixty now have banking offices of some kind in the United States, and as I've already mentioned, they

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support over $40 billion in domestic assets. More are likely to enter and the size of this sector undoubtedly will grow even further. Foreign banks are generally outside the direct control of the Federal Reserve System for purposes of monetary control; in no other country have the national authorities such little control over foreign banks. Moreover, under present arrangements, foreign banks have operating advantages which could give them an important competitive edge over their domestic competitors--most noticeably the right to establish multistate banking operations. Thirty-eight of the foreign banks located in California have banking offices in at least one other state, reflecting their ability (through branches or agencies) to escape the barriers against interstate banking which apply to domestic banks.

Another frequently forgotten but major consideration is this: the U.S. government under present conditions is hampered in its negotiations with other governments over the rules imposed on our banks operating abroad. The bargaining power of our government is weakened, because it cannot carry through with its promises (or threats). Since the regulatory power here rests with the individual states, U.S. banks abroad sometimes find themselves facing restrictions which might be removed or modified if the Federal government had a direct influence on the entry of foreign banks into the domestic market.

Principles Behind Legislation

The development of ground rules for regulating foreign banks has required considerable time and thought. The System Steering Committee eventually decided that the appropriate principle would be that of

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nondiscrimination; foreign banks would have the same privileges as equivalent domestic banks in this country, but no more privileges than that. The Foreign Bank Act is designed to bring about such competitive equality.

The Committee considered three possible approaches, but found two of them to be unacceptable. One approach might be called the "home powers" standard: foreign banks would be allowed to do in the United States what they are permitted to do at home. Under this rule, French banks, which can combine commercial and investment banking businesses in France, would be exempted from the provisions of our Glass-Steagall Act and be allowed to conduct both investment-banking and commercial-banking operations here. The decision of France to allow its own banks to engage in both investment and commercial banking may be appropriate to French banking and the French economy, but it is clearly inappropriate to expect that practice to be automatically extended to French banks operating in another country.

A second approach, which could be described as "quid pro quo," is a variation of the first, except that it would give foreign banks the same rights in the United States that the foreign country extends to U.S. banks operating within its borders. In this case, the rights of foreign banks in this country would be automatically determined by their respective government's treatment of U.S. banks operating abroad.

Under both of these approaches, foreign governments in effect would determine foreign banks' powers inside the United States, regardless of our views on appropriate banking powers. This is a crucial

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weakness, and therefore we have opted for a third approach, that of nondiscrimination. Under this rule, the United States determines what the proper functions of commercial banks should be in the light of our own institutions, and it then grants appropriate powers to both foreign and domestic banks. We do not expect foreign countries to grant privileges to U.S. banks that their own banks do not enjoy at home, nor do we expect them to discriminate against U.S. banks by giving them fewer powers than their own banks enjoy at home. On the other hand, foreign countries should not expect to have their practices extended to this country. To repeat, nondiscrimination means that foreign banks would have the same privileges as U.S. banks, but no more than that.

I should add that we recognize that not all foreign banking systems are as well developed as ours. It is not realistic to expect small countries to allow the unregulated entry of U.S. banks; local institutions would be swamped. We cannot expect even the developed countries to adopt strict nondiscrimination, since such uniformity would ignore the wide differences in business customs and institutions in various countries.

The slogan "reciprocity" frequently arises in discussions of this subject. However, if it is defined carefully--and usually it isn't--it can be subsumed under one of the three approaches I have already discussed. If reciprocity means either of the first two approaches, then I can think of no surer way of provoking foreign retaliation. In a contest of reciprocal retaliation, this country would be the loser, since its banks overseas are much larger than foreign banks operating here. However, reciprocity in the sense of nondiscrimination is the

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fairest solution to the treatment of domestic and foreign banks operating within a single country.

Nondiscrimination recognizes equally the right of individual countries to operate with differing laws and practices, and the right of foreign banks to compete on the same basis with domestic banks. Nondiscrimination may not be feasible for underdeveloped countries with underdeveloped banking systems, but for advanced countries, nondiscrimination is a completely equitable formula.

Provisions of the Act

Now let me review the main features of the Foreign Bank Act as it was presented to Congress. I will comment on the significance of each clause as I go along.

(1) Branches and agencies of foreign banks would be defined as "banks" for the purpose of bringing them under the Bank Holding Company Act.

The main effect of this clause is to prohibit interstate expansion. A foreign bank entering the U.S. for the first time would be limited to one state for its domestic banking activities, and foreign banks now here would be limited to their current sites of operation. However, the clause does not cover joint ventures, where ownership is divided among several banks, none with more than 25 percent of the outstanding shares, and it does not cover banking-type organizations licensed as investment companies under New York State law. These organizations are not defined as banks because of their limited competitive importance, and also because of the complications that would arise from classifying

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domestic corporations as banks when their business is primarily in nonbanking areas. Foreign banks under this clause would be able to take advantage of the Bank Holding Company Act to expand in those non-bank fields open to domestic holding companies. Nonbank subsidiaries of course are free to expand across state lines.

I should note in passing that the barrier to interstate banking is not absolute. The Bank Holding Company Act allows interstate bank expansion by domestic as well as foreign holding companies, if the states concerned pass legislation specifically authorizing acquisitions by out-of-state bank holding companies. Such enabling legislation has been introduced in both the New York and California legislatures, but has failed to pass. Whether these bills are brought up again this year remains to be seen.

(2) Entry of new foreign banks would be controlled by Federal bank licenses issued by the Comptroller of the Currency, although registration alone would be required for foreign banks' existing operations. A license would be needed whether the foreign bank applies for a national or a state charter.

The key feature here is that, with each new application, the Comptroller must submit to the Secretary of the Treasury the views of both the Secretary of State and the Federal Reserve Board of Governors. If the Secretary of the Treasury then determines that the issuance of a license would not be in the interest of the United States, the Comptroller would be prohibited from issuing a license.

Existing branches, agencies, and bank subsidiaries would not be affected by the new licensing requirements, apart from the formality

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of registering. However, any additional branch or agency office of a foreign bank would need a license because it would be treated as a separate new "bank" under the Bank Holding Company Act. In contrast, banking subsidiaries would retain their existing rights under state law to expand by de novo branching and would not need to obtain Federal licenses.

I have argued strongly for the inclusion of this clause as a result of my talks with U.S. bankers around the Pacific. At present, there is no statutory basis for delaying the entry of banks of another country on foreign policy grounds. This clause would give the Federal government direct powers over entry, powers which could be used in helping obtain more favorable treatment for U.S. banks in their activities abroad. I do not expect this power to be used frequently, but its very existence should help the State Department in negotiating with foreign governments on external banking matters.

(3) National banks for the first time would be able to allot as many as half of their directorships to foreign nationals, and foreign banks would be allowed to operate branches under a Federal license issued by the Comptroller of the Currency. Foreign banks would be allowed to convert from state to Federal status.

Under this provision, a national charter for a banking subsidiary would be a more attractive alternative for a foreign bank than it is now, although I think the advantages of a Federal branch license might be even more attractive. Such a branch would have the same powers as a national bank, except that its lending limit would be based on the

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capital of the foreign parent, not the capital and surplus of the domestic subsidiary bank.

Some state banking supervisors have objected to these particular provisions. But it seems to me that defenders of the dual banking system should not object to legislation that for the first time brings foreign banks under that system. At present, national status is not a practical alternative to state status for foreign banks. Application of the principle of nondiscrimination means granting foreign banks the same effective rights as domestic banks to operate under state law or under national law. It would be inconsistent to argue that the choice inherent under the dual banking system should not apply to foreign banks.

(4) Federal Reserve System membership would be compulsory for all foreign banks whose worldwide assets total $500 million or more.

I have strongly supported this feature of the bill because it establishes competitive equality between foreign banks and their domestic competitors. The foreign banks affected by the membership requirement are generally large banks, whose domestic equivalents are System members. Under this provision, foreign banks would gain the privileges of membership, but they would also take on reserve requirement burdens comparable to those borne by similar U.S. banks.

(5) FDIC insurance would be made available on branch and agency deposits.

This feature would give foreign banks equal rights with respect to deposit insurance coverage. One result, at least in California, would be the ability of state-licensed agencies to accept domestic

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deposits once insurance was obtainable. Apart from this, I am not certain there would be significant competitive benefits. Most foreign banks operate in the wholesale-banking field, and those which seek domestic retail-type business usually have domestic subsidiaries which can receive FDIC coverage. Nevertheless, I see no reason why there should be discrimination against foreign banks on this matter.

(6) Federal Reserve Act provisions dealing with Edge Act Corporations would be changed to allow foreign banks to conduct international banking business outside their principal state of operations, on the same basis as domestic banks.

This clause would provide foreign banks with an interstate banking alternative already open to U.S. banks. Since most foreign banks specialize in international finance, the right to own Edge Act Corporations would be beneficial to them, and it would partially offset the restrictive impact of being brought under the multi-state banking prohibitions of the Bank Holding Company Act.

The legislation contains another important provision that applies to domestic as well as foreign-controlled Edge Act Corporations. The Board of Governors of the Federal Reserve System would be allowed to waive capital and surplus limitations imposed on the aggregate liabilities outstanding of Edge Act Corporations. The present lending restrictions do not make sense to me. They only make Edge Act Corporations go through complicated paperwork to get loan participations onto the books of parent banks. It seems sensible to cut through this facade for the sake of both domestic and foreign banks and to recognize that

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the true lending limits of these corporations are determined by the resources of the parent banks.

(7) Finally, all existing operations of foreign banks would be "grandfathered," and future expansion rights would be determined by the Bank Holding Company Act.

Since expansion rights are a critical issue, I will be more specific. In a branching state, state-chartered bank subsidiaries could have multiple branches, and could expand (as permitted under existing law) by de novo branching or merger. A shift to national charter would not affect these rights. The provisions with respect to future bank holding company acquisitions are more restrictive and complex. In its principal state of operations, a foreign bank could continue to make acquisitions of bank subsidiaries and to open new branches or agencies under state or federal law. In other states, Holding Company Act prohibitions against interstate acquisitions would apply, except where state legislation specifically gives permission for interstate acquisitions to both foreign and domestic banking organizations.

New branches or agencies of a foreign bank would be treated as an acquisition of a holding company and would be restricted accordingly, regardless of the presence of other "grandfathered" branches or agencies in the same state. In California, the legislation would not affect the rights of existing state-chartered banks to branch inside the state. Existing foreign branches and agencies also would not be affected, but future interstate expansion would be restricted to Edge Act Corporations.

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A liberal grandfather clause has seemed suitable for several reasons. It would not mean any significant competitive advantage for foreign banks, especially since their largest domestic subsidiaries are already grandfathered under the existing Bank Holding Company Act. Also, the tradition of U.S. banking law has generally been to grandfather existing operations--witness the multi-state operations of Bank of California and Western Bancorporation. Moreover, grandfathering recognizes the fact that foreign bank offices here were established legally and in good faith. Confirmation of these existing rights is consistent with this country's international treaty obligations; indeed, failure to grant grandfather rights might be considered a violation of our trade treaties with other countries. Without a liberal grandfather clause, we would face the strong possibility of retaliation abroad, especially in continental Europe.

Prospects and Probable Impact

Whether Congress will approve any legislation without substantive changes is always difficult to predict. However, it should be recognized that the Foreign Bank Act has received very careful study by the Federal Reserve System and other Federal agencies, and that the views of foreign banks and governments have also been sought. This is a well-designed piece of legislation that helps to provide a foundation for the orderly growth of the foreign banking sector. We expect that Congress will consider it carefully and will approve of the principle of nondiscrimination. My preliminary impression is that the prospects for passage are favorable.

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Now, how will this legislation affect banking in California? I think it will have a strong impact on international business, and will add further impetus to the growth of San Francisco and Los Angeles as international financial centers. Foreign branches would have increased lending and deposit-accepting powers that would permit a more rapid expansion of their operations. The foreign-trade sector of the state's economy should clearly benefit from this expansion of international financial services.

However, I am not certain that we will see a significant increase in the actual number of new foreign competitors, since most of the important foreign banks are already established here. Edge Act Corporations of out-of-state domestic banks have been playing a more important role in international finance, and their competitive position should be enhanced by the proposed modification of lending limits. New foreign-bank Edge Act Corporations, on the other hand, are less likely to be an important factor, because most large foreign banks (except those from continental Europe) already maintain international banking operations in California.

In addition, the new legislation should have an indirect benefit for the California economy. Foreign banks could count on their business not being upset by ill-judged pieces of state legislation as was threatened in 1973. Similarly, California banks with foreign operations would be less exposed to foreign retaliation, and the strengthened powers of the Federal government in negotiating over foreign banking

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matters should help reduce some of the barriers California banks now face in certain countries.

Outside the financial centers, the pattern of California banking may not be strongly affected. Where foreign banks already compete vigorously in local markets, they will continue to do so. These subsidiaries could continue to operate under state law if they so desire. But those foreign banks considering expansion outside the financial districts of San Francisco and Los Angeles would face the high costs of building up a branch network.

The expertise of most foreign banks is in international and business lending, and these skills are not easily transferred to retail banking, where markets are dominated by state-wide branch systems and by strong local banks. There is not going to be a sudden wave of foreign banks spreading over the state because of the new legislation. Expansion into retail banking markets is always a slow and costly process. This is true for northern California banks trying to move south and for southern California banks trying to move north, and it is particularly true for any foreign bank, regardless of the resources behind it.

In most other states, the impact of the Act may be small, since the type of business foreign banks are interested in is simply not there. Foreign banks, specializing as they do in wholesale banking or international finance, would tend to choose New York, Los Angeles, San Francisco, or perhaps Chicago as their prime banking base. Most states which do not already have foreign banks are in fact unlikely to get them, and those states desirous of attracting them would find in practice

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that a modified Edge Act Corporation would be an acceptable substitute for a foreign bank subsidiary with full powers. In Washington, for example, where the state law has recently been changed, only one office of a foreign bank is allowed, and that office is limited in the domestic deposits that it can accept. There would be little difference, in view of the restrictions currently imposed on foreign banks, between a state-licensed branch in Washington and an Edge Act Corporation. So although the Foreign Bank Act has clarified groundrules and equalized competitive advantages, its effects are likely to be significant only in those states where foreign banks already operate.

Internationally, there should be definite benefits for U.S. banks. The example of a nondiscriminatory policy, combined with the State Department's new power to make recommendations on foreign bank licensing, should encourage a more equitable environment for our banks and, indirectly, a boost for the general economy.

Finally, the Act may reinforce the pressures building up to allow limited interstate banking. I say "may" because the legislation works both ways. Under present rules, the interstate branching privileges of foreign banks are used as an argument for extending similar privileges to domestic banks. The proposed Act removes this privilege--and thus also removes one argument for interstate banking. The Act also maintains the right of states to prevent interstate banking, and any such restrictions would apply to domestic as well as foreign banks. On the other hand, the Act strengthens the Edge Act Corporation, so we may see domestic

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banks, more so than foreign banks, taking advantage of their increased powers to build up a network of international banking offices.

On balance, the Act maintains the trend toward increased interstate banking for international and corporate financing. But for retail banking, there is little net effect. The interstate banking bills introduced in New York and California would have allowed only two offices, and thus they provide no base for developing a retail business. The foreign banks, with a few noticeable exceptions with which you are all familiar, do not appear to be interested in retail banking.

Concluding Remarks

With its emphasis on nondiscrimination, the Foreign Bank Act should be judged primarily as a measure to improve the functioning of the international banking system and to remove certain competitive inequalities within the United States. The principal changes will be on wholesale and international banking. This does not mean the bill is of no interest to small banks, because any measure which improves the functioning of the financial system indirectly benefits them through better money-market facilities and increased specialized knowledge. In terms of purely local considerations, the benefits to the State of California are clear. The further development of financial markets in San Francisco and Los Angeles resulting from such legislation is in the interest of the whole state, especially because of the focal role of foreign trade in the state's economy. Overseas, the Act should help improve the regulatory environment within which U.S. banks operate. The Foreign Bank Act thus represents another strand in an increasingly interdependent world economy.

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