



FEDERAL RESERVE BANK OF SAN FRANCISCO  
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# **DEVELOPMENTS IN WORLD BANKING**

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## Developments in World Banking

I am delighted to be with you here in Boulder, participating in the ABA's very successful School for International Banking. It seems paradoxical that we should be discussing world trade and finance at this spot, a thousand miles from the ocean. But on second thought, it's a tribute to the ever-growing importance of this subject that a conference should be devoted to it here in the midst of the American Heartland.

In my remarks I'll concentrate on some major problems of international banking--especially from the regulatory side. But first, I would like to comment on some developments in what might be called "world banking". To my mind "international banking" covers the standard financing of international trade and investment, such as letters of credit, bank acceptances, foreign-project loans, and so on--activities that have been part of the banking tradition since the Renaissance. But by "world banking" I mean the very recent phenomenon of bankers awakening to the potentials of worldwide operations--of viewing the world's money and capital markets as a whole in regard to the gathering and placement of funds. Whereas "international banking" corresponds to the traditional importing and exporting activities of ordinary manufacturing firms, "world banking" corresponds to the immensely complex activities of multinational corporations. Regulatory changes in the banking field must be assessed against this type of background.

### World Banking and U.S. Banks

The progress of the new age of world banking is rather uneven. So far, only a relatively small number of banks are conducting business on a

truly worldwide scale. In fact, only forty to fifty of the world's largest banks are now doing so. But the total volume of their operations is so large, and the advantages of flexibility that they possess are so great, that we can no longer ignore the implications of their activities for banking as a whole and for central banking in particular.

Foreign branch activities of the largest U.S. banks today account for between one-third and one-half of their total business. First National City, for example, has nearly one-half of its deposits located at foreign branches, and other giants are not far behind. Moreover, U.S. banks abroad engage in a wide range of nonbank as well as banking activities, in contrast to their more restricted commercial-banking operations within our own borders. The operational structure of these giants meanwhile reflects the new realities. Bank of America, which used to relegate its international activities to a single operating division, under a recent reorganization has established a World Banking Division comprised of four separate geographic groups to conduct its sharply expanding operations.

Central banks, as regulators of money and credit flows, have become closely involved in the new era of world banking. At the monthly meetings of the Federal Open Market Committee--such as the one I attended this week--we are continually forced to deal with the impact of world banking on domestic credit markets, on foreign-exchange markets, and on the U.S. balance of payments. International developments have sometimes dominated our discussions, such as during the devaluation crises of the early 1970's and the petrodollar crisis of the past year or so. Increasingly,

central bankers have come to realize that national policies can no longer be conducted in isolation from one another. In monetary policy and in banking policy, we are forced to take into account the myriad interactions among individual national developments, and to seek to minimize any inconsistencies or conflicts.

I have become more and more involved in the international field in the three years that I have served as president of the Federal Reserve Bank of San Francisco. I have done so, not simply because of our general Federal Reserve responsibility in this world-banking era, but also because of a special responsibility we have on account of our Bank's location. In the past six or seven years, the West Coast has risen as an international financial center, with a special interest in the Pacific Basin area. Our Bank has a responsibility for keeping tab on developments in the Pacific Basin countries, especially as those developments affect Western commercial banks that are operating in that region.

Early last year I visited nine Pacific Basin countries on behalf of the Federal Reserve System. On that trip I held over one hundred meetings with foreign officials--including central-bank governors, finance ministers, and economic planners--and also with local representatives of U.S. and foreign banks. My purpose was to exchange views on our foreign-banking legislation--a subject I'll get to in a minute--but in addition, through personal contacts to acquaint myself with foreign views on the role of U.S. banks in their economies.

During my extended trip, I saw the expansion of American banks throughout the Pacific Basin as offering new opportunities as well as possible sources

of conflict. I became convinced that U.S. banks have a great deal to contribute if they learn to forego mere short-term gains and identify their long-run interests with the host countries' national aspirations. More and more attention is being given to the operations of U.S. banks abroad, and you'll be hearing more about this subject as current official studies are completed.

But world banking is a two-way street, and foreign banks have emulated the American example and spread rapidly throughout the U.S. market, especially since the late 1960's. Today more than sixty foreign banks conduct operations inside the United States, with total assets in late 1974 of roughly \$44 billion, compared with less than \$7 billion in 1966. Admittedly, these banks even today account for only about five percent of the U.S. banking market. However, their rapid growth has raised a number of problems, primarily because of the peculiarities of U.S. banking regulations. For instance, our own banks are not allowed to branch interstate, but foreign banks can freely enter a number of states by applying to the individual state-banking authorities. As a nation, we have not had any overall policy on foreign banks' entry into our national market, but rather a patchwork of widely varying state laws and regulations. The lack of any national authority in this matter has also hampered the Federal Government in its negotiations with foreign governments on behalf of U.S. banks abroad.

#### Principles Behind the Foreign Bank Act

For this and other reasons, the Federal Reserve has asked Congress for legislation to bring the foreign banks operating in this country under

effective Federal control. Our bill was first introduced in late 1974, and then reintroduced in March of this year under the title of the Foreign Bank Act of 1975. I don't propose to go into great detail on the provisions of this legislation, but rather I prefer to discuss the reasoning which lay behind the System's proposal.

The legislation is the outgrowth of a two-year study by the Federal Reserve System's Steering Committee on International Banking Regulation, on which I served along with two other Federal Reserve Bank presidents and three members of the Board of Governors. In developing this draft legislation, members of the committee held discussions with foreign governments and with a number of domestic and foreign banks, as I did on my Far Eastern trip. As a result of our committee's work, we have developed a set of principles which should serve as an appropriate long-term foundation for this country's international banking regulations.

The present complex regulatory situation in this country stems from a regulatory situation where individual states determine the entry rights and powers of foreign banks. Almost all foreign subsidiary banks are state-chartered, since national charters are unattractive to them for various reasons. Branch and agency offices of foreign banks, which have roughly four times the assets of foreign subsidiary banks, are also completely under state control. They operate with state licenses rather than charters, and since they are not considered banks, they do not come under the Bank Holding Company Act.

In addition, considerable variation exists among the individual states in their treatment of foreign banks. New York and California grant considerable operational freedom, while Florida and Texas by statute forbid the entry of foreign banks. Only ten states permit entry of any kind, and the laws of the other forty states specifically prohibit entry or are silent on this point.

This situation creates great difficulties in an era when the world's financial institutions are expanding rapidly and becoming increasingly interdependent. No other major country allows foreign banks to operate inside its borders without national regulation. The lack of a national policy on foreign banking operations completely baffles many people who are unfamiliar with the way we conduct our banking in this country--as I can attest from my conversations with Asian central bankers. The Foreign Bank Act is designed to establish the principle of national control over the entry of foreign banks, while leaving room for the states to exercise appropriate controls within the framework of the dual banking system.

#### Nondiscrimination--and Alternatives

Once the question of entry is settled, what ground rules should regulate the operations of foreign banks? Our Steering Committee considered several possible standards, but finally decided on the principle of "nondiscrimination." This means that foreign banks would have the same privileges that are available to equivalent domestic banks in this country, but no more privileges than that. Nondiscrimination would mean the establishment of competitive equality between foreign and domestic banks.

Some observers argue that we should go by the standard of "reciprocity"--which implies "you treat me fairly and I'll treat you fairly in return." The word has a pleasant sound. Who can be against reciprocity? Who can be against fairness? In fact, reciprocity is a very slippery concept which is subject to different interpretations.

One possible interpretation is the so-called "home-powers" standard, which means that foreign banks can do the same things here that they do at home. For instance, U.S. banks under this standard should be permitted to offer personal-checking accounts in Japan, just as they do in this country. Or as it was put to us, French banks should be able to offer the same investment-banking and commercial-bank services in their New York branches that they offer their customers in France. In this view, just because the Glass-Steagall Act forbids U.S. commercial banks from offering stockbrokerage services is no reason why French banks must conform to peculiar U.S. views of banking.

As you can see, the home-powers rule would abdicate to another country the choice of banking privileges open to its banks in the United States. It is one thing to argue that France can combine investment and commercial banking if that suits French financial customs, but it is an entirely different matter to suggest that all French practices are suitable for American banks. The home-powers standard interferes with each country's choice of banking practices, and thus should be rejected.

A second unacceptable alternative is "quid pro quo," which means that foreign banks in the U.S. should have only those powers which are extended

to U.S. banks in their own country. This concept sounds plausible, but again, it abdicates to another nation the decisionmaking for banking in this country. Under this rule, a foreign bank's activity here would be determined by foreign decisions and not by U.S. needs. I would argue that the rights of foreign banks in this country should be determined by the needs of the American financial system, and that their treatment of our banks abroad is a separate question.

Reciprocity supposedly would force foreign countries to give our banks more privileges, but it's a rather crude means of bringing about the result. Indeed, even if a foreign country wanted to conform to this standard, which of the individual state laws should it try to match? Proponents of reciprocity probably hope that foreign countries would not reciprocate, thus justifying restrictions on foreign banking operations in the U.S. Two years ago in California I testified against state legislation of this kind, arguing that it would simply eliminate foreign competition here and would not help those California banks operating abroad. The real test of the effectiveness of this approach as a means of forcing more liberal foreign banking laws is the attitude of U.S. banks with foreign offices. They are uniformly opposed because of the threat of retaliation--and in any war of retaliation, we have more to lose, because our banking operations abroad are much larger than foreign operations in this country. And of course, any policy of competitive retaliation would work against the long-standing U.S. goal of removing unnecessary barriers to world trade and finance.

Nondiscrimination, in contrast, is a good rule which can be applied universally in the field of international banking regulation. Further-

more, we think nondiscrimination is such a good principle that our bill gives the Federal government powers that would help in negotiations for nondiscriminatory treatment. Each country would choose its banking powers on the basis of what is most suitable for its own needs, and all banks operating within its borders would then conform to those rules. Under the principle of nondiscrimination, U.S. banks would not have special privileges in any foreign country, but they would have rights similar to those of domestic competitors in the host countries.

In practice, I would modify the principle to recognize differences in the financial development of various countries. Unregulated entry of U.S. banks in less-developed countries could swamp local financial institutions, so in those countries we should accept policies aimed at strengthening local institutions. But the general principle should still apply to operations in the major industrial nations. Although the result would be some expansion of foreign banks' activities, we would still expect domestic banks to dominate the financial scene in each country. French banks or German banks, for example, would have permanent advantages in their own countries that foreign banks probably could not overcome, and the same would be true in the United States. The Foreign Bank Act would not affect the present dominance of American-controlled banks in the U.S. banking system.

#### Reasoning Underlying the Bill

Nondiscrimination avoids the danger of competitive restrictionism, but without giving foreign banks special privileges. Nondiscrimination does not imply that U.S. banking laws are appropriate for other countries, or that their laws are appropriate for us. On the other hand, it does mean that foreign banks in this country should have roughly the same

privileges as their domestic competitors. This basic principle runs through all of our thinking on the Foreign Bank Act. Now let me illustrate how this principle underlies all the major provisions of the Act.

Federal banking licenses. Since nondiscrimination is a form of reciprocity, we must expect nondiscriminatory treatment of our banks in other countries. Therefore, the Federal government should have licensing powers here to encourage foreign countries to reduce their own unreasonable restrictions. Let me emphasize again that at present our bargaining power is weakened when the individual states control entry but cannot effectively negotiate with foreign countries on behalf of their own state-chartered banks. Only the Federal government can effectively negotiate with other countries, and in banking matters the bill gives the Federal government a "club in the closet" to use if negotiations are unsuccessful with foreign governments.

Specifically, the Federal government would be able to prevent the establishment of new foreign-banking operations in this country. The Act specifies that each new foreign bank or branch would require a Federal banking license issued by the Comptroller of the Currency. The Comptroller would consult with both the Federal Reserve and the Department of State in regard to each application. If after consultation, the Secretary of the Treasury rules that approval of an application is not in the national interest, the license would not be issued. This is the club in the closet, and merely by being there, I hope its use may be avoided.

Redefinition of branches and agencies as banks. To establish non-discriminatory treatment in domestic operations, we redefine branches

and agencies of foreign banks as "banks" for purposes of the Bank Holding Company Act. Since these offices now hold no separate charters and are thus not even regarded as banks, they presently escape those laws (state or Federal) which prevent interstate expansion by domestic banks. But with all foreign banks redefined as bank holding companies, entry into new states would be prevented until the states involved give equivalent interstate-expansion powers to domestic banking organizations. At the same time, foreign banks (as bank holding companies) would be able to open nonbank subsidiaries across state lines in those fields of activity approved for domestic holding companies. But a foreign bank entering this country for the first time would find its new banking operations limited to one state, and its branching or acquisition privileges also limited to that one state.

Federal branches and national bank charters. To establish nondiscriminatory treatment for foreign banks, we offer them the option already available to domestic banks of operating under either state or Federal law. The Federal Reserve bill would allow as many as one-third of a national bank's directors to be foreign citizens, thus increasing the attractiveness of national-bank chartering. The bill would offer Federal branch status as a separate alternative, with each Federal branch having the same powers as a national bank except that its lending power would be based on the parent bank's capital. (Internationally, most banking operations already are conducted through branches of the foreign parent and not through locally-chartered subsidiary banks.) Some state banking supervisors have opposed this provision, partly because of fear of losing foreign banks from their jurisdictions. But I can't see why defenders of the dual-banking system for domestic banks would oppose the application of

that system to all banks. Nondiscrimination implies that foreign banks, like domestic banks, should have the freedom to choose between Federal and state status.

System membership and other provisions. The Foreign Bank Act would make Federal Reserve membership compulsory for all foreign-controlled banks (including branches and agencies) whose worldwide assets are \$500 million or more. The object here is to impose the same type of controls in the U.S. that most foreign central banks exercise over U.S. banks' foreign operations--and also to insure that any future growth of the foreign banking sector in this country does not erode domestic monetary control. The \$500-million cutoff point was chosen to insure competitive equality, because most domestic banks of that size or larger are already System members. Foreign banks thus would gain the privileges of membership but would also take on the reserve-requirement burden carried by similar U.S. banks. In addition, the principle of nondiscrimination underlies the provisions allowing foreign branches and agencies to gain FDIC insurance, and giving foreign banks the right to form Edge Act corporations. The latter provision gives foreign banks an important opening into interstate operations, since their activities traditionally are concentrated in the international-banking field.

Grandfather rights. This raises the question not only of nondiscrimination, but also of legislative tradition and international law. I grant that liberal grandfather rights would confer advantages on foreign banks, primarily in confirming their interstate operations. However, our tradition is to grandfather existing rights whenever we change banking laws. Under the Bank

Holding Company Act of 1956, some domestic holding companies were allowed to keep their existing interstate banking networks, and under the 1970 amendments to that Act, similar provisions covered nonbank subsidiaries. Since the interstate offices of foreign banks were established in conformity with existing law and in good faith, the same precedent should apply.

The Foreign Bank Act would grandfather all branches and agencies brought under the Bank Holding Company Act and in existence on December 3, 1974, the date the bill was first sent to Congress. These offices would retain any existing rights to expand under state law, and a shift to Federal status would not affect such rights. Securities affiliates of certain European banks would also be grandfathered, but without provision for additional offices.

Grandfathering, I should add, would remove any possibility of violation of our international treaty obligations, and for this and other reasons, would reduce foreign governments' objections to our bill. Most governments probably would prefer the status quo, but they're willing to withdraw their objections to our bill provided that existing banking and securities operations are protected. The proposed grandfather clause appears to avoid the possibility of retaliation that is always a danger when new legislation affects other countries.

#### Concluding Remarks

To conclude, the new era of world banking requires new regulatory approaches to govern the ever-expanding flows of money and goods across

international borders. No longer can the individual states, by themselves, govern such an important sector of our financial system. The Foreign Bank Act has been carefully constructed to equalize competitive treatment of foreign banks in the United States without generating unwelcome restrictions on U.S. banks' foreign operations. Moreover, the bill is designed to increase our government's bargaining power in international banking negotiations. In your future consideration of this subject, I hope you remember why we adopted some approaches and rejected others in drafting this piece of legislation. Your analysis of the principles underlying this bill will, I hope, result in your support.

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