INTERNATIONAL BANKING: A CENTRAL BANKER'S VIEW

Remarks of
John J. Balles, President
Federal Reserve Bank of San Francisco

International Bankers Conference
Seattle Branch
Federal Reserve Bank of San Francisco

Seattle, Washington

November 11, 1975
I would like to extend to all of you a warm personal welcome to this conference sponsored by the Seattle Branch of our Bank. I would also like to say congratulations for a job well done to Bill Donovan and Jim Curran, who conceived and organized this conference. I think they have put together a first-rate program, and I am glad that you could all participate. It is good that people with a common interest in international banking can get together to take stock of recent developments in the field, and to exchange views with each other and with persons in the regulatory agencies.

We at the San Francisco Fed are glad to be able to host this conference. Too often, people view government agencies at worst as harmful meddlers, and at best, as influential but disagreeable old uncles whom one has to humor occasionally, but normally would hope to avoid. That imagery of government bureaucracy, I suspect, holds true throughout history and in all lands. However, I should hope that in our democratic society, it holds less true than in others. Certainly as a Federal Reserve Bank President, I intend to emphasize and enlarge the positive role our institution plays in serving our community. We are sponsoring this conference in Seattle today, and next week we shall hold a foreign exchange seminar in San Francisco. Through these and other means, our Bank seeks to be a prime mover in bringing together experts like yourselves to discuss topics in national and international finance. In the process of establishing good communications with the financial community, we hope to acquire a better understanding and thereby improve our services to the community.
Growth of World Banking

Recently, in a speech I gave at the A.B.A.'s School for International Banking at Boulder, Colorado, I drew a distinction between "international banking" and "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 viewing the world's money and capital markets as a whole in the gathering and placement of funds. International trade is as old as history--but only in recent decades have business firms broadened their outlook to consider the world as a whole in making their production and marketing decisions. We are now seeing the dawning of a parallel movement in the world of banking, with worldwide banking organizations operating as the counterparts of industry's multinational corporations. This conference, in a small way, bears witness to the emergence of world banking in this part of the world, the great Northwest gateway to the Pacific and beyond.

World banking, in the sense I have in mind, requires a certain minimum size that is quite beyond what the majority of the banks in this country can hope to attain. Nonetheless, 125 American banks now operate abroad, with some 730 branches and with net foreign assets amounting to more than $125 billion. Within this single Federal Reserve District, as Hang-Sheng Cheng reported this morning, there are 18 banks with foreign operations, and they have more than 130 overseas branches and hold a
total of more than $30 billion in foreign assets. Thus, contrary to the common view, world banking is not the exclusive reserve of the banking giants. Indeed, quite a few medium-sized banks here on the West Coast and elsewhere are now engaged in this activity.

The expansion of world banking has been nothing short of spectacular, as several recent studies indicate. Total foreign assets of the world's commercial banks nearly quadrupled from $108 billion to $410 billion during the first half of this decade. This high expansion rate brought in its wake a remarkably high rate of growth of earnings from foreign operations. Over the last five years, the overseas earnings of a group of nine U.S. bank-holding companies increased at a 37-percent annual rate, compared to only a 3-percent rate of growth in their domestic earnings. In 1974, international earnings accounted for 42 percent of their total earnings before security gains. Individually, for Citicorp, international earnings accounted for nearly two-thirds of its total earnings, and for BankAmerica Corp, the ratio was about 40 percent.

Problems of World Banking

Thus, both in terms of absolute size and as a source of earnings, world banking has become very important for our major banks, and hence for the nation's entire banking system. The world's central bankers may have been content in the past to watch passively the growth of world banking, but its rise has been so phenomenal that we must now devote some hard thinking to what all this means for the national and international economy.

Now, as soon as I mention "hard thinking," you might conclude that I'm about to propose some rigid controls over this type of activity.
That's not what I mean. Like most of you, I believe that a lot of good has come from this upsurge of growth. World banking has been the result of a remarkable burst of ingenuity on the part of private bankers in an environment relatively free of government restrictions. It has greatly enhanced world competition in the provision of financial intermediation services, and improved the allocation of funds for the world as whole. Moreover, in the past two years, this market has demonstrated remarkable strength and adaptability in coping with the unprecedented problems of petrodollar recycling and wide exchange-rate fluctuations.

At the same time, the spread of world banking has raised a number of difficult issues for the world's central-banking authorities. The close integration of international capital and money markets has made effective monetary control in each individual country much more difficult. Moreover, central bankers are not certain how much to take offshore private liquidity into account in setting monetary-policy targets. With the tremendous growth of such funds to more than $220 billion today, it seems odd that they are not included in any country's money supply, and are not taken into consideration in the determination of any country's monetary policy.

These and other policy issues arising from the growth of world banking are very much on central bankers' minds today. At the monthly meetings of the Federal Open Market Committee, we are frequently called on to consider the impact of world banking on domestic credit markets, on foreign-exchange markets, and on the U.S. balance of payments. We are in frequent consultation with foreign central bankers, trying to analyze the myriad interactions among policy actions and market developments.
in the major nations. But I would be less than candid if I left you with the impression that central bankers have definitive answers to all the monetary-policy questions I've mentioned. In fact, we do not. That is why I said, some hard thinking on those questions is very much needed.

The Foreign Bank Act

Some of our thinking has already borne fruit in the form of the Federal Reserve's proposal 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 am a member of the Federal Reserve System Steering Committee which developed this bill, and I would like to discuss the reasoning which lay behind the System's proposal. You've already heard the details of the legislation from Bob Johnston.

The present complex regulatory framework in this country stems from a 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, operate with state licenses, and since they are not considered banks, they do not come under the Bank Holding Company Act.

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 many 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. The bill also would strengthen the ability of the Federal government to negotiate with foreign governments on behalf of our banks.

Nondiscrimination—and Alternatives

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." Who can be against fairness? Yet in spite of its apparent simplicity, 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. Under this standard, 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. 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 banking. 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. The powers of a foreign bank in the United States would vary according to country of origin. Under this rule, foreign banks' 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 on a uniform basis by the needs of the American financial system. Other countries' treatment of our banks abroad is a separate question and a matter for negotiation, not fixed rules.

Reciprocity supposedly would force foreign countries to give our banks more privileges, but it's a rather crude means of bringing about that result. Some proponents of "reciprocity" probably hope that foreign countries would not reciprocate, thus justifying restrictions on foreign banking operations in the U.S. However, this in turn would bring the threat of retaliation. Let me remind you that in any war of retaliation, we have more to lose, because our banking operations abroad are much larger than foreign operations in this country. Retaliation would also mean your own plans for possible expansion into international finance could be blocked.
Nondiscrimination, in contrast, is a good rule which can be applied universally in the field of international-banking regulation. Because it appears to be such a good principle, our bill would grant the Federal government certain powers to negotiate for nondiscriminatory treatment, at least among the developed industrial nations. In practice, we would recognize that unregulated entry of U.S. banks in less-developed countries could swamp local financial institutions, and so in those countries we could accept policies aimed at strengthening local institutions.

Nondiscrimination in Practice

In brief, nondiscrimination avoids the danger of competitive restrictionism, but without giving foreign banks special privileges. It means that foreign banks in this country should have roughly the same privileges as their domestic competitors. Now let me illustrate how this principle determined some of the more important provisions of the Foreign Bank Act:

(i) Redefinition of Branches and Agencies as Banks

We bring branches and agencies of foreign banks into equality with domestic banks by redefining them as "banks" for purposes of the Bank Holding Company Act. This would bring them under the same laws which prevent interstate expansion by domestic banks. 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. Similarly, existing foreign banks could not expand banking operations across state lines.
(ii) Federal Branches and National Bank Charters

We support nondiscriminatory treatment for foreign banks by offering 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 to a state license.

(iii) Grandfather Rights

The question of grandfather rights involves not only nondiscrimination, but also legislative tradition and international law. The interstate offices of foreign banks were established in conformity with existing law and in good faith. Moreover, elimination of these offices might violate our international treaty obligations as well as our tradition of grandfathering existing banking operations whenever laws are changed. For these reasons, 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. I might emphasize that a liberal grandfather clause is essential in overcoming foreign governments' objections to our bill.

(iv) Federal Banking Licenses

Finally, since we think nondiscrimination should be adopted by other countries, the Federal government would be given licensing powers over foreign banks to encourage foreign countries to reduce their own unreasonable restrictions. 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 Act requires that each new foreign bank or branch would apply for a federal banking license issued by the Comptroller of the Currency. If, after consultation with the Federal Reserve and the Department of State, the Secretary of the Treasury rules that approval of an application is not in the national interest, the Comptroller would not issue the license. This is the club in the closet, and merely by being there, I hope its use may be avoided.

**Concluding Remarks**

From my remarks, I hope you've gotten some flavor of the reasons for the rapid expansion of world banking—a quadruple expansion during a brief half-decade. Obviously, in an age of multinational corporations, there is a need for a parallel development on the financial side. World banking has improved the worldwide allocation of funds, and it has won its spurs in meeting the critical problems of the past several years.

I hope you've also seen why the new era of world banking requires new regulatory approaches. Just as the individual states, by themselves, can no longer expect to control such an important sector of our financial system as the foreign banks, individual nations must face the need for international cooperation to control world banking. You can expect greater cooperation among foreign governments in banking regulation that would parallel their exchange of information on monetary policies. The Foreign Bank Act would strengthen the powers of the Federal government in its right to exchange information with other nations. Greater coordination among regulators to monitor the liquidity of international
banking operations, joint ventures, and, perhaps, foreign-exchange dealings is on the horizon. But although you may face greater control and the costs of regulation, the same process may establish greater stability and greater uniformity in the competitive groundrules. On balance, the functioning of the system of world banking should be improved by international coordination in the regulatory area.

To conclude, no doubt exists in my mind that world banking activities will become an increasingly important influence on the operations of U.S. banks overseas. The other side of the coin from U.S. banks' expansion abroad is more foreign banking competition here. Still, I think you will agree that an equitable environment in our home market is essential for our own banks' overseas expansion.