



FEDERAL RESERVE BANK OF SAN FRANCISCO
Office of the President

THE INTERNATIONAL BANKING ACT

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

**The Federation of Bankers Associations of Japan
Tokyo, Japan**

November 11, 1976

The International Banking Act

I feel honored to have the opportunity of addressing this distinguished group on the subject of American banking legislation, a matter of deep concern to all of us. In the past several years, the world's major industrial powers learned from their earlier mistakes and cooperated closely in fighting the worldwide problems of inflation and recession. This spirit of working together bodes well for our future attempts to overcome international financial problems. I hope that meetings such as this will increase mutual understanding and thus enhance the possibility of future cooperation.

As you know, the American Congress has been considering legislation that would impose new Federal controls on foreign banks operating in the United States. The "International Banking Act" was approved by the House of Representatives in the session just ended, but the Senate failed to vote before adjournment. This legislation undoubtedly will be re-introduced next year--and probably in similar form, because it embodies features common to other proposals, such as those of the Federal Reserve System.

Implications of Dual Banking System

Before we look at the details of the International Banking Act, I would like to review certain features of the American banking system that must be kept in mind in assessing any future banking legislation. Unlike most countries, the United States allows the fifty state governments to share regulatory powers over banking with the Federal government. This reflects the

fact that commercial banking grew up under state law, so that state banking systems were well developed when the National Bank Act was passed in 1864 to provide for a Federal system of chartering. Despite expectations to the contrary, the state banks have survived alongside National banks.

Although Congress has the constitutional authority to impose a uniform system, it has chosen not to, and in certain areas (specifically in branching privileges) Congress has actually delegated its authority over National banks to the states. National banks cannot branch across state lines, and state law specifies their branching powers within each state. At one time, holding companies were allowed to acquire banks in several states, but this loophole was closed in 1956 by the Bank Holding Company Act, which followed the precedent of the National Bank Act in delegating to the states the power to control inter-state bank acquisitions.

As a consequence, state- and Nationally-chartered banks co-exist in a dual banking system, and under this system, domestic banks are effectively kept out of interstate banking. The states have chosen to prohibit entry by out-of-state domestic banks--and in some cases, for example Illinois, they have even forbidden branching. This system also affects membership in the Federal Reserve System. Although National banks are required to become member banks, state banks are not required to do so. As a practical matter, most state banks remain outside the Federal Reserve System--and although they

are generally smaller banks, state non-members control over one-quarter of the bank deposits in the United States.

In these circumstances, many foreign banks have entered the United States, but largely under state regulations. None of the Japanese-controlled subsidiary banks with domestic charters are members of the Federal Reserve System. Not that you are alone; most European-controlled bank subsidiaries do not belong either. The only Federal control is exercised through the Bank Holding Company Act, but this affects only the original acquisition of a U.S. bank and does not involve Federal Reserve membership. Foreign banks can also operate, in addition to subsidiary banks, separate branches or agencies in various states. For purposes of Federal law, these operations are not "banks". Their entry and their powers are determined by the individual states. States can either allow them or forbid them, regardless of the rules they apply to banks with domestic charters. Consequently, foreign banks (unlike domestic banks) can maintain branches and agencies in several states, if the states concerned give permission. As you know, the major financial centers--New York, California and Illinois--all allow branches or agencies.

Under these groundrules, foreign banks have built up substantial banking operations inside the United States. Their standard banking assets have grown from \$18 billion in November 1972 to \$45 billion in June 1976, reflecting the value of the services that they have been able to offer in the American marketplace. Yet their growth

has occurred largely outside the control of the Federal government and its agencies. Furthermore, foreign banks have obtained more privileges than domestic banks in several different respects. I know of no other country where such a situation exists. You can thus understand why our Federal authorities believe that there should be uniform Federal control over foreign banks, in order to equalize the competitive situation.

With this in mind, Congress accepted the Federal Reserve-Treasury view that the appropriate legislative principle is "non-discrimination". This means that foreign banks, once admitted, should have the same powers and obligations as equivalent domestic banks, but not more powers. This also means that foreign banks will gain some new privileges but meanwhile lose some old privileges.

Provisions of International Banking Act

Now let me review the major provisions of the proposed International Banking Act. First of all, existing state-chartered banking subsidiaries would not be affected, although foreign branches, agencies, and so-called New York investment trusts would be brought under Federal control. Unlike the Federal Reserve proposal, compulsory membership would not be required for subsidiary banks with state charters. The Bank Holding Company Act would not be changed, so that nonbank operations of holding companies would be left alone. In this connection, I'd like to re-emphasize that Holding Company Act provisions restricting nonbank subsidiaries apply only to those in the United States; subsidiaries whose principal operations are elsewhere would not be

affected. Furthermore, existing Federal Reserve regulations automatically exempt all noncontrolling external investments whose principal business is outside the United States. (With respect to Japanese banks, the Federal Reserve Board ruled in late 1971 that the relationship some of you maintain with your industrial customers in the form of minority shareholdings do not amount to "control" within the meaning of the Act.)

Secondly, the National Bank Act would be amended to allow non-citizens to serve as bank directors. The majority, however, would have to be citizens. This makes a Federal charter a true alternative for foreign banks for the first time. I think this option could be valuable, because at present your bank subsidiaries are under state control, and thus always subject to the possibility of local protectionist legislation. An example was an attempt by some California banks in 1973 to promote legislation that would have restricted expansion by foreign-controlled banks. The proposal was defeated-- I testified against it in the California legislature--but it could arise again in any state.

Third, Federally-licensed branches and agencies would be permitted with the same powers as National banks--except that the lending limits in each case would be based on the size of the parent, not domestic capitalization, as is the case with a subsidiary. Entry of a Federal branch or agency could still be prohibited by state law, although at the moment only ten states have such specific prohibitions.

Fourth, Edge Act corporations also would be allowed to have foreign citizens as directors. I should add that Edge Act corporations now represent an exception to the usual rule against interstate operations, because they can be established in any state to conduct international-banking activities.

Fifth, a foreign bank could conduct branch operations in only one state, except for those interstate branches already operating as of May 1, 1976, which would be "grandfathered." However, banks could continue to open agencies in several states with state approval. The rationale is that agencies do not accept domestic deposits and hence are the equivalent of loan-production offices of domestic banks.

Sixth, branches would be required to maintain amounts equivalent to FDIC insurance in securities or pledged assets. However, this would permit them to compete more readily for domestic deposits.

Seventh, in a major change, branches and agencies would be subject to Federal Reserve System reserve requirements, with the Federal Reserve determining which liabilities would be defined as deposits. At the same time, branches and agencies would have access to Federal Reserve services, such as borrowing privileges and wire-transfer facilities. They would also be subject to Federal Reserve examination. Only those relatively few banks whose world-wide assets are under \$1 billion would be exempt from this provision.

Eighth, securities affiliates of foreign banks would be restricted to the powers allowed National banks, except where the transactions were for foreign customers. This would mainly affect

European banks which are not now under the Bank Holding Company Act. Japanese banks generally have no such affiliates, or else they hold (or will hold) less than the 5-percent maximum share specified in the Bank Holding Company Act.

Finally, the International Banking Act would require the Secretary of the Treasury to establish guidelines for the entry and expansion of foreign banks. The guidelines would help ensure that foreign banking operations are conducted in accordance with the nation's competitive and foreign economic-policy goals.

Impact on Japanese Banks

From what I have said, you can see that the principal change for Japanese banks would be the extension of reserve requirements to branches and agencies. Most of your offices are agencies, which have a relatively small deposit base, so that the cost of these reserves should be small. But the determination of which liabilities are regarded as deposits would be left to the Federal Reserve Board of Governors--and for the moment, I cannot be more specific than that. Of course, you would also gain access to Federal Reserve services.

Again, with your reliance upon the agency form, you could continue to operate such offices in several different states. In fact, your interstate expansion powers would actually be increased. You could obtain Federal licenses to enter states which do not specifically prohibit agencies, even though they are not issuing

state licenses now. Even in the states which specifically prohibit foreign banks--for example, Texas and Florida--you could use Edge Act corporations to develop international banking operations.

At this point, perhaps I can anticipate a question that was asked on my last visit to Japan in 1974: instead of restricting foreign banks, why not simply allow U.S. banks the same privileges? I happen to think that existing barriers to interstate banking prevent the development of a more effective and competitive National banking system. But the political realities--a combination of states' rights, regionalism, local protection, and distrust of large banks--make it difficult to overcome the barriers to reform. At present these views seem to be accepted by Congress, and I see little prospect that they will be modified soon. Therefore, foreign banks hold a competitive advantage with their interstate branching privileges, so that U.S. banks can be placed on the same footing only through the elimination of such privileges.

Foreign banks also would gain a measure of security against the protectionist forces found in some state legislatures. For example, state-licensed banks could avoid any such restrictions by shifting to federal charter or license. On the other hand, Federal agencies with their new guidelines could take action against the U.S. banking operations of any countries that restrict the activities of American banks overseas. The Act would permit discretion in the application of any guidelines, since it does not require strict reciprocity.

Another major source of controversy concerns foreign banks' securities affiliates. At Senate hearings this year, the Federal Reserve System advocated maintenance of the powers of existing offices, but not future expansion. However, the problem is not very important to this audience, because most such affiliates are tied to French, Swiss and German banks.

Concluding Remarks

The International Banking Act will have to be resubmitted to the next Congress, and it is quite possible that changes will be made in the new version. Although the Federal Reserve supported the 1976 version, it would prefer to have its reserve requirements extended to state-chartered subsidiaries. Also, there might be more interest in restricting the interstate operations of agencies, in view of the retirement of the subcommittee chairman who opposed that restriction. But in the event such curbs are imposed, Edge Act corporations could still serve as vehicles for interstate international-banking operations, just as they do for domestic banks.

Altogether, I believe that Congress' acceptance of the principle of nondiscrimination in the International Banking Act provides a good foundation for your operations in the United States. Under the Act, you would have the same powers and face the same rules as U.S. commercial banks. Yet because of the skills and resources you exhibit in the field of international finance, I am certain that Japanese banks will continue to grow and contribute to the increased efficiency of the U.S. financial system.

#

