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

Finance Section
American Chamber of Commerce
Tokyo, Japan

November 12, 1976
I'm delighted to have the opportunity to bring you up-to-date on what's going on at home. No, I'm not going to mention our just-completed quadrennial tribal rites; there were few prizes for economic literacy handed out during the long period that stretched from New Hampshire's primary to last week's finale. I'll also skip over any discussion of the U.S. business outlook; after surmounting the severe problems that faced us when I was last here two and a half years ago, I think we should have few doubts about our ability to overcome the problems of the late 1970's.

Instead, I shall concentrate my remarks on two humdrum but important questions of banking regulation—specifically, the regulation of American banks overseas and the regulation of foreign banks in the United States. With the expansion of international banking in the past decade, Congress and the regulatory agencies have begun to re-examine existing laws and regulations. This concern has developed in part because of the magnitude of the operations involved, but largely because of the shocks caused to the financial system by the failure of several large banks in the U.S. and abroad.

Today, U.S. banks have some $150 billion in foreign assets—roughly 16 percent of their total assets. These foreign assets have been a major source of earnings, and losses from international
operations have remained relatively low. Yet we can no longer assume that existing regulatory policies are appropriate; they should be examined now, rather than in a hurry after serious problems develop. The very size of the foreign operations of U.S. banks requires a re-assessment of existing controls. Meanwhile, foreign banks have grown substantially in the United States, and are now a significant part of the U.S. banking system. Their standard banking assets have grown from $18 billion in November 1972 to $45 billion in June 1976. Despite that growth, the U.S. stands out as the only major trading nation whose national government does not exercise control over foreign banking activities. The situation of state-by-state control should soon be changed.

U.S. Banks' Activities Overseas

Let's consider the changing views regarding the activities of U.S. banks overseas. In the past, bank regulators generally felt that U.S. banks should have ample freedom to compete with foreign banks in the foreign arena. Whatever the domestic restrictions on commercial banks, these should not restrict U.S. banks in their operations elsewhere. The rights granted by foreign countries to their own banks should be open to U.S. banks; otherwise our banks would be at a competitive disadvantage. Following up on this view, U.S. banks have moved into certain areas in which they don't operate at home--securities affiliates, trading-company investments, and so on, depending on the laws of the various countries where they operate. Without these freedoms, our banks would not have achieved the leading position they now have in world banking.
Underlying this permissive attitude has been an assumption that foreign countries' regulation and examination procedures would force banks within their jurisdiction to follow sound banking practices. Unfortunately, this has not always been the case, since practices vary by country, from very tight control to no control. (I'm sure you can think of an example of a country with very tight control.) With the current high levels of foreign lending, and with the worrisome losses that have occurred in some cases, the regulatory agencies have had to look again at their practices.

Let me note some major areas of concern. First, nonbanking activities. Expansion into such areas as real-estate finance or merchant banking may appear profitable, but the very diversity of activities under many differing laws makes it difficult to assess risk properly.

Second, joint ventures. American banks have regularly joined with foreign banks, sometimes under government prodding, to form subsidiaries where they share control with others. In joint ventures, however, banks are exposed to potential losses which are difficult to measure. Some American banks here have experienced losses and other problems because of lack of control, so that they've had to mount rescue operations, increasing their investments to save certain enterprises.

The third area of concern is loans to less-developed countries, LDCs in the economists' jargon. Banks everywhere have sharply increased their lending to developing countries, from $6 billion in
1970 to $28 billion today. However, we don't have sufficient data
to assess total loan-servicing burdens, and the financial standing
of some LDCs must be in doubt. Some countries have been forced to
re-schedule their debts, although actual defaults have been rare.
Yet, in view of the magnitudes involved, you can see why regulators
are worried.

Now, what are the regulatory agencies doing in this situation?
First of all, they are increasing their international examination
activities. As you know, National Bank and Federal Reserve examiners
have just completed a review of Japanese branches of U.S. banks.
This is a part of an overall increase in the scope and frequency
of examinations, which reflects the end of our automatic assumption
that supervision by foreign authorities is always adequate. Our
regulatory agencies now tend to believe that an American bank can
engage in a number of financial activities in a host country, even
though they would not be permitted in the U.S., as long as there is
no threat to the bank's overall financial strength. In other words,
freedom to compete abroad is now tempered by consideration of risk
to the parent bank.

The Federal Reserve changed its regulations last February to
require that an application to form a joint venture must include a
statement of the bank's potential investment liability, and not
just its initial commitment. We recognize that when a bank's
affiliate is going under, that bank very rarely exercises its legal
right to step aside and not support the affiliate. In practice,
banks step in to support their subsidiaries as a means of protecting their own reputations. Consequently, where control does not exist, banks must be careful in their investments and their exposure.

This brings us to the sensitive topic of assessing "country risk". Among the regulatory agencies, the Comptroller of the Currency has a formal system for assessing country risk, which can be used to classify loans to foreign governments and public bodies, but the Federal Reserve operates without a rating system of that type. This is a very sensitive area; because of both the technical problems in trying to assess the likelihood of default, and the diplomatic consequences of putting a country on such a list. As I understand the Comptroller's procedures, most of the countries in question have been in South America and Africa, but mere rumors of being listed have caused serious diplomatic reactions in some European countries. Yet a problem of default does exist in some cases, and a resolution of the problem requires sophisticated economic and political analysis. At the moment we do not have the capability for doing this, and I see no easy solution to the situation.

Increased cooperation among regulators may help solve this and other problems. As a rule, the host country should have regulatory responsibility within its own borders, but in practice joint responsibility is sometimes needed. The Bank for International Settlements has sponsored a series of meetings to build a foundation for more effective cooperation and exchange of information among regulators. In addition, one purpose of my present trip is to help
increase contacts with Pacific central banks. Already, as a consequence of my earlier trip in 1974, I've received information from several central banks about the attempts of certain individuals to buy U.S. banks. I expect our examiners to share information about their findings with foreign central banks, and I'll appreciate getting similar help from foreign countries.

Foreign Banks' Activities in the U.S.

Now let's turn to the prospects for control of foreign banks in the United States. The International Banking Act passed the House this session but became lost in the pre-adjournment rush in the Senate. But the bill will be reintroduced next term, so it's worth our while to analyze it here.

This legislation has been designed to give the Federal government control over the entry of foreign banks and to establish competitive equality with domestic banks in the U.S. market. The aim is nondiscrimination; foreign banks would have no more power than domestic banks, and no less power either. This Act is not protectionist, and therefore it provides no excuse for foreign retaliation against U.S. banks. In fact, U.S. banks operating abroad may benefit from the legislation, because Federal agencies could consider how our banks are treated by foreign countries before approving the entry of foreign banks in the U.S. market.

At the moment, entry of foreign banks is effectively controlled by the states and not by Federal authorities, so that foreign banks in certain areas have more powers than U.S. banks. Subsidiary banks--
those with domestic charters—are subject to the same rules as
domestic banks, but branches and agencies are not regarded as "banks"
and thus can be established across state lines. At the moment,
these branches and agencies have three times the assets of sub-
sidiary banks, so there is good reason for bringing them under
Federal control.

One important provision of the legislation would subject branches
and agencies (but not state-chartered subsidiaries) to Federally-
imposed reserve requirements on their deposits. At the same time,
these branches and agencies would gain access to Federal Reserve
services.

The legislation also would permit Federal licensing of branches
and agencies, providing a Federal alternative to state licensing.
However, in states that specifically prohibit foreign branches or
agencies, Federal licenses could not be issued. National banks,
and Edge Act corporations also, could have a minority of non-citizen
directors.

Under another provision, branches would be limited to only one
state, except that multi-state branches existing as of May 1, 1976
would be grandfathered. On the other hand, agencies would be able
to operate in several states, because they don't accept deposits
and thus are the equivalent of loan production offices.

I should mention also the provision requiring the Secretary
of the Treasury to establish guidelines for the operation and
entry of foreign banks, which utilizes this banking legislation to
foster the nation's international economic policies. Congress has not been specific on this point, but one of our important international policies is the reduction of restrictions on American firms operating abroad. Therefore, I read this clause as giving the Treasury powers that would help it negotiate on behalf of U.S. banks overseas.

Concluding Remarks

Whenever problems develop in any rapidly growing area, pressures are likely to develop for tighter and more consistent regulation. So it is today in the field of international banking. Regarding the activities of U.S. banks overseas, our regulatory authorities are simply being prudent in looking into such areas as nonbanking activities, joint ventures and loans to LDCs. And as for the U.S. operations of foreign banks, the authorities are simply trying to equalize competitive advantage and not to impose new burdens. For example, I favor the Fed's original proposal to impose Federal Reserve membership on foreign bank subsidiaries if their parent has more than $500 million in assets, and I also think that agencies should not be allowed interstate banking privileges except where existing offices are grandfathered. Until the domestic groundrules are relaxed for U.S. banks, I feel that foreign banks' interstate operations should be just the same as those permitted U.S. banks, Edge Act corporations, loan production offices, and nonbank subsidiaries permitted under the Bank Holding Company Act. In sum, I believe that an increasingly interdependent world will benefit from the growing trend toward uniformity of financial regulatory practices.