Statement by

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Federal Reserve System

before the

Subcommittee on Financial Institutions

of the

Committee on Banking, Housing and Urban Affairs

United States Senate

on H.R. 10899

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I am pleased to appear before this Committee today to present the views of the Board of Governors on H.R. 10899, the International Banking Act of 1978.

Before commenting on the specific provisions of the bill as enacted by the House of Representatives, I should like to review some of the reasons why the Board has for several years supported legislation that would provide a Federal presence in the regulation and supervision of the operations of foreign banks in the United States. These reasons lie in the growth in number and size of foreign bank operations, and their ever-increasing importance to the structure of the banking system and to the functioning of money and credit markets. The latter has obvious implications for the conduct of monetary policy.

The Federal Reserve has welcomed the entry and activities of responsible foreign banks in this country. Some of them are long-time residents here; others are relative newcomers to international banking and to the American market. They have contributed to a more competitive environment in our banking markets and to the more efficient functioning of our money and credit markets. The banking and financial services available to the American consumer and businessman have been enlarged by their presence. In addition, they have behaved responsibly and have given little cause for

supervisory concern. The Board's support for Federal legislation to regulate foreign banks has never been intended to curb their ability to operate in this country. Rather, it has been motivated by the desire to provide a secure framework, at the Federal level, in which foreign banks might operate here and which would be fair and equitable to all participants in our banking markets.

I said that one of the reasons why the Federal Reserve has sought legislation in this area has been the growth in the number, size and importance of foreign bank operations in this country. Let me review briefly some of the dimensions of that growth.

When the Board was developing its legislative proposals at the end of 1973, there were about 60 foreign banks operating banking offices in the United with combined assets of about $37 billion. Growth of these operations had been swift in the preceding years and, as the Board stated at the time, that trend was clearly bound to continue. Those expectations have been more than fulfilled. As of April 1978, 122 foreign banks operated banking facilities in the United States with total assets of $90 billion.

Appended to this statement are a series of charts illustrating the growth of the U.S. operations of foreign banks. Since the figures for total assets exaggerate the dimensions of foreign bank activity because of inter-company and clearing transactions,

the charts also present data on "standard banking assets," which omit these items. By either measure, as the charts indicate, growth of foreign bank activity is not abating. Additional foreign banks continue to enter the United States and foreign banks with existing facilities here are continuing to expand their activities.

One sector of foreign bank operations underlines their success in penetrating U.S. banking markets. I refer to their commercial lending. The expansion of foreign banks in this segment of the credit market is shown in Chart 4. As of April, U.S. offices of foreign banks had more than $26 billion in commercial and industrial loans. This amount equals about one-fifth of similar loans by large banks that report weekly to the Federal Reserve. In New York, the proportion of commercial and industrial loans accounted for by foreign banks was twice as large. Other aspects of current operations are contained in the Statistical Appendix that has been provided with this statement.

In sum, foreign banks in this country can no longer be characterized as specialized institutions engaged principally in foreign trade financing on the periphery of our banking system. Those days are long since past. On the contrary, what we have today is a diverse array of institutions operating on a very large scale in a wide range of markets for banking services in this country.

At the wholesale level, the foreign banks are competing directly and successfully for the business of multinational corporations. Foreign banks are important participants in U.S. money markets and are also major traders in the U.S. foreign exchange market. And at the retail level, foreign banks are becoming increasingly important, notably in California. In this connection, it is worth remembering that of the 122 foreign banks operating here, 45 have worldwide assets of more than $10 billion, and all but a handful have worldwide assets of more than $1 billion. These institutions are thus to be compared with the largest of our domestic banking organizations.

It is incongruous that institutions such as these can operate on such a scale in this country without being subject to Federal regulation of their entry and activities and without being subject to the rules of the central bank. These institutions are really not a part of our dual banking system. As the dual banking system has evolved in this country, there is some degree of Federal supervision over virtually every bank in the United States. And in practice, the largest banks are member banks of the Federal Reserve System. The Federal Reserve believes that the correction of the anomalous position of foreign banks is overdue.

The Federal Reserve's legislative recommendations on foreign banks have consistently been grounded on the principle of

national treatment or nondiscrimination. That principle has a long and respected history in the affairs of this nation. It provides for fair and equitable treatment for all. Currently, by contrast, foreign banks have certain advantages over our indigenous institutions. The Federal Reserve continues to believe that the foreign banking community should be incorporated into the U.S. banking system on an equal footing with domestic banks.

Now I would like to turn to the specific provisions of H.R. 10899. The Board welcomes the achievement of the House of Representatives in passing this Act and believes that it represents considerable progress toward the goal of appropriate legislation in this area. At the same time, the Board believes that the bill is deficient in several respects when viewed against the standard of national treatment. Also, improvements can be made in a number of provisions as they are now drafted. We have already furnished the Committee with detailed suggestions for changes in the bill. I shall not go over them here. Rather, in the remainder of my remarks, I would like to focus on two key sections of the bill: Section 5, dealing with interstate banking, and Section 7, dealing with the Federal Reserve's authority.

Interstate banking has been and is a controversial topic. Opinions differ widely about the wisdom of the existing national policy that bars banks from operating full-scale offices across State

lines. It is not surprising, therefore, that Section 5 of the International Banking Act has proven the most controversial. What has been surprising was that, in enacting H.R. 10899, the House of Representatives chose to perpetuate the present situation where foreign banks, but not domestic banks, can operate banking offices on a multistate basis.

As of this April, there were 63 foreign banks operating banking facilities in more than one State. Thirty-one of these institutions were operating in three or more States, through agencies, branches, and subsidiaries. There can be no doubt that these multistate facilities give foreign banks a considerable advantage over their domestic competitors. Under the House-passed bill, these multistate operations are certain to grow further. Additional States have passed legislation to allow branches or agencies of foreign banks to begin operations, and the foreign banks will take advantage of those opportunities sooner or later.

Another oddity of the present structure is that a domestic banking institution, by changing to foreign ownership, can become part of a banking organization with multistate facilities. This possibility is highlighted by the recent announcements by three foreign banks of proposed acquisitions of large domestic banking institutions. The three foreign banks involved already have multistate facilities.

The national policy of barring interstate banking, as embodied in the McFadden Act, needs review. Banking has changed. The structure of the economy and its financial needs have also changed since the McFadden Act was passed over 50 years ago. Pending completion of that review, however, it is inconsistent with the principle of national treatment and unfair to domestic banks to allow foreign banks to continue to expand offices across State lines.

The Board therefore believes that Section 5 of H.R. 10899 should be amended in two respects: first, to provide that the McFadden Act shall apply to Federal branches and agencies; second, to impose on State branches the same geographical restrictions that State laws impose on domestic State banks. Put in this way, the provision would allow foreign banks operating State branches to benefit from any reciprocal arrangements that the States might enter into with regard to interstate banking.

The Board fully appreciates the States' interests in promoting their foreign commerce and foreign investment within their borders. As part of this effort, a number of States have amended their banking laws in recent years to allow foreign banks to operate agencies. These agencies are generally empowered to provide international banking services but not to compete in local deposit banking.

The International Banking Act, as the Board envisages it, would not interfere with the availability of these kinds of facilities

in the States. The legislation has always contained a provision to allow foreign ownership of Edge Corporations. As members of the Subcommittee are aware, Edge Corporations were authorized by the Congress as a means of enlarging the international banking facilities available throughout the country without impinging on purely domestic lending or deposit business. Besides allowing foreign banks to own Edge Corporations, the Board would go further and permit them to operate agencies on a multistate basis so long as their business was confined to international operations such as those to which Edge Corporations are limited. This seems to the Board to be a reasonable compromise between the interests of the States and the national interest.

The compromise just mentioned is the approach that is preferred by the Board. Nonetheless, some States contend that this is too restrictive: that foreign banks will not establish limited agencies in their States and that consequently they will be deprived of international financial services. Accordingly, these States do not wish any restrictions on the activities of agencies other than those in State laws. One of their arguments is that even without restrictions, the activities of agencies will be basically of an international character. The Board does not agree with these arguments and believes that the position they advocate is inconsistent with the principle of national treatment. However, the Board would not oppose the legislation if this position on State agencies were followed.

Section 7 of the bill is deficient, in the Board's judgment, in two respects: the coverage on reserve requirements and the supervisory authority of the Federal Reserve.

As enacted by the House, the bill gives the Federal Reserve authority to impose reserve requirements on the deposits and similar liabilities of branches, agencies, and commercial lending companies of foreign banks. Omitted from that authority is the ability to impose reserve requirements on the deposits of their subsidiary banks. This omission evidently stems from the mistaken belief that these subsidiary banks are comparable to the domestically-owned State-chartered banks that have the option of being members of the Federal Reserve System.

I stated earlier that one of the features of the dual banking system, as it in fact operates in this country, is that all the large banks are directly subject to the rules of the central bank. The foreign banks operating in the United States are very large banks, whether measured by their global activities or by the totality of their activities in this country. The operations of their subsidiary banks are now an important segment of those activities, collectively and individually. Total assets of these subsidiaries are about $19 billion while individual subsidiaries range up to $2 billion in size.

Foreign banks operate their agencies, branches, and subsidiaries in this country as an integrated organization. There is little logic, therefore, in subjecting agencies and branches to reserve requirements but exempting subsidiary banks. The latter account for about one-fifth of total foreign bank activity here. In the case of one of the largest foreign bank operations here, nearly half of its activities are conducted in subsidiaries. Foreign bank interest in U.S. subsidiary banks is at a high level. That interest will be encouraged if reserve requirements can be avoided simply by shifting business to a subsidiary.

The other aspect of Section 7 that deserves amendment concerns the Federal Reserve's supervisory authority. As the section now reads, that authority is not commensurate with the responsibilities assigned to the Federal Reserve. The emphasis is on purely State supervision of foreign bank operations, although the Federal Deposit Insurance Corporation would have examining authority under the provisions of Section 6. The Federal Reserve would have no direct examining authority.

The need for a direct Federal presence in the examination of foreign bank operations is patent. These institutions are operating in several States and the banking authorities of individual States are not and can not be equipped to judge the soundness of their operations on a nationwide basis. Furthermore, these are worldwide

institutions and their supervision entails dealing with the parent institution overseas and its political and regulatory authorities.

The Board believes that the Federal Reserve should be given the primary examination authority at the Federal level to meet this need. The Federal Reserve possesses the international banking expertise required to fill this role as a result of its regulatory responsibilities for the international operations of member banks, and it already has close working relations with foreign central banks. Moreover, the Act gives the Federal Reserve authority to lend to foreign banks maintaining reserves. In extending credit to domestic member banks, the Federal Reserve relies on the examination process for information on the condition of the borrowing institution and in policing the use of the discount window. Further, the Act gives the Federal Reserve authority and responsibility to employ cease and desist orders dealing with unsafe and unsound banking practices in U.S. offices of foreign banks. Detection and analysis of those practices come out of the examination process. Finally, under the Act, the Board is required within two years to submit legislative recommendations for additional requirements to be made applicable to foreign banks. Informed recommendations will require the kind of firsthand knowledge of the operations of these offices that is obtained through the examination process. For these reasons the Board urges that Section 7 be amended to give the Federal Reserve adequate supervisory authority over foreign bank operations.

This suggestion, it should be noted, parallels the situation of State member banks. In that case, the Federal Reserve has the primary examining authority at the Federal level with the Federal Deposit Insurance Corporation having residual examining authority. The States have their examining authority as well.

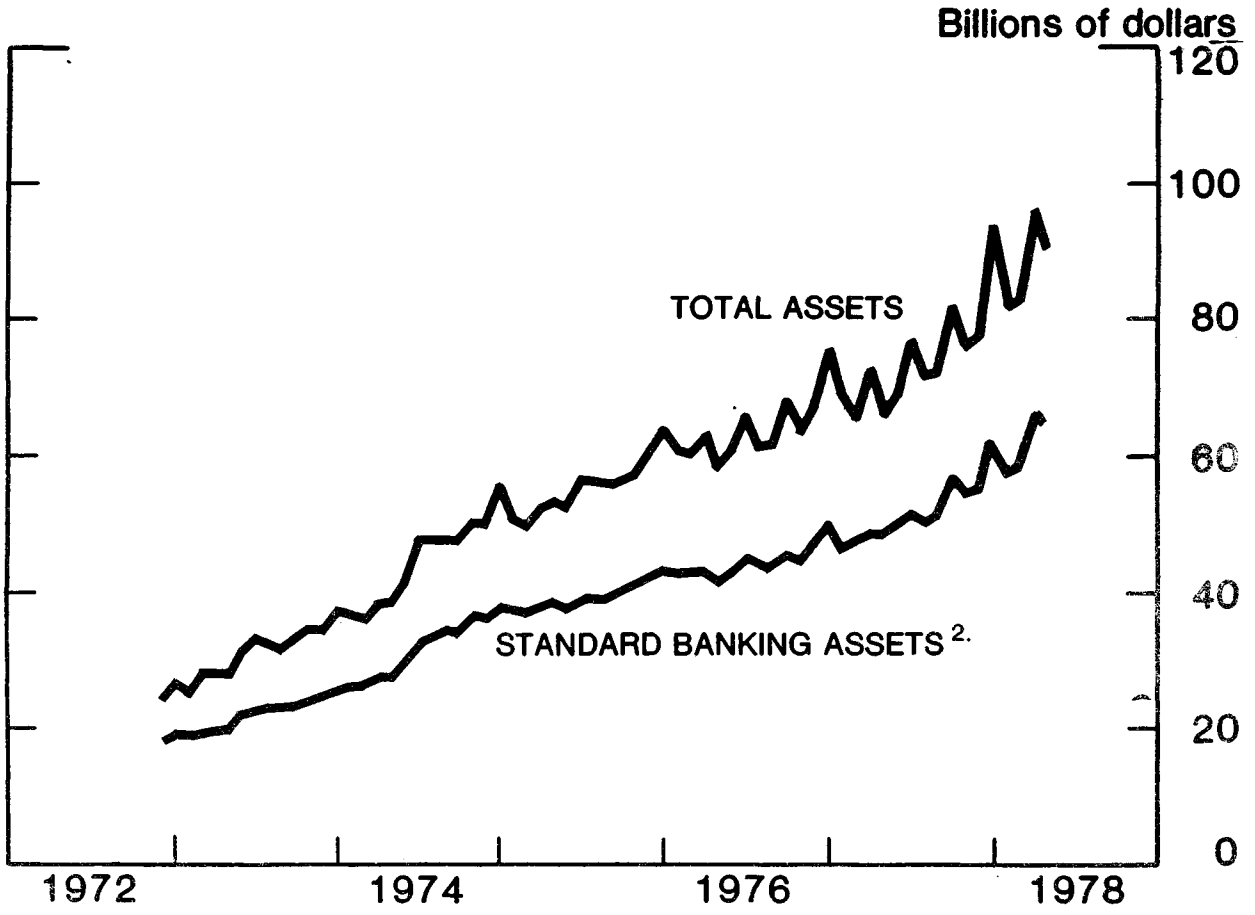
Mr. Chairman, today I have emphasized again the Board's belief in the need for legislation to regulate foreign banks in this country and that the basis for that legislation should be national treatment. Developments since the discussion of the role of foreign banks in this country was initiated have confirmed the growing importance of foreign bank activity in our economy and our financial markets. The issues have been explored and debated at length. The main outlines of the legislative provisions have been determined. In the Board's judgment, this is the year in which action should be taken.

The Federal Reserve has suggested a number of amendments to the legislation. In this statement I have focused on the two main areas in which we believe changes should be made. These changes would be consistent with the principle of national treatment and would provide for adequate supervision of foreign bank activities in the United States. With the amendments that we have suggested, the Board believes that the International Banking Act would equitably resolve the problems that have been raised and would meet the public need.

Chart 1

U.S. Banking Institutions Owned by Foreign Banks

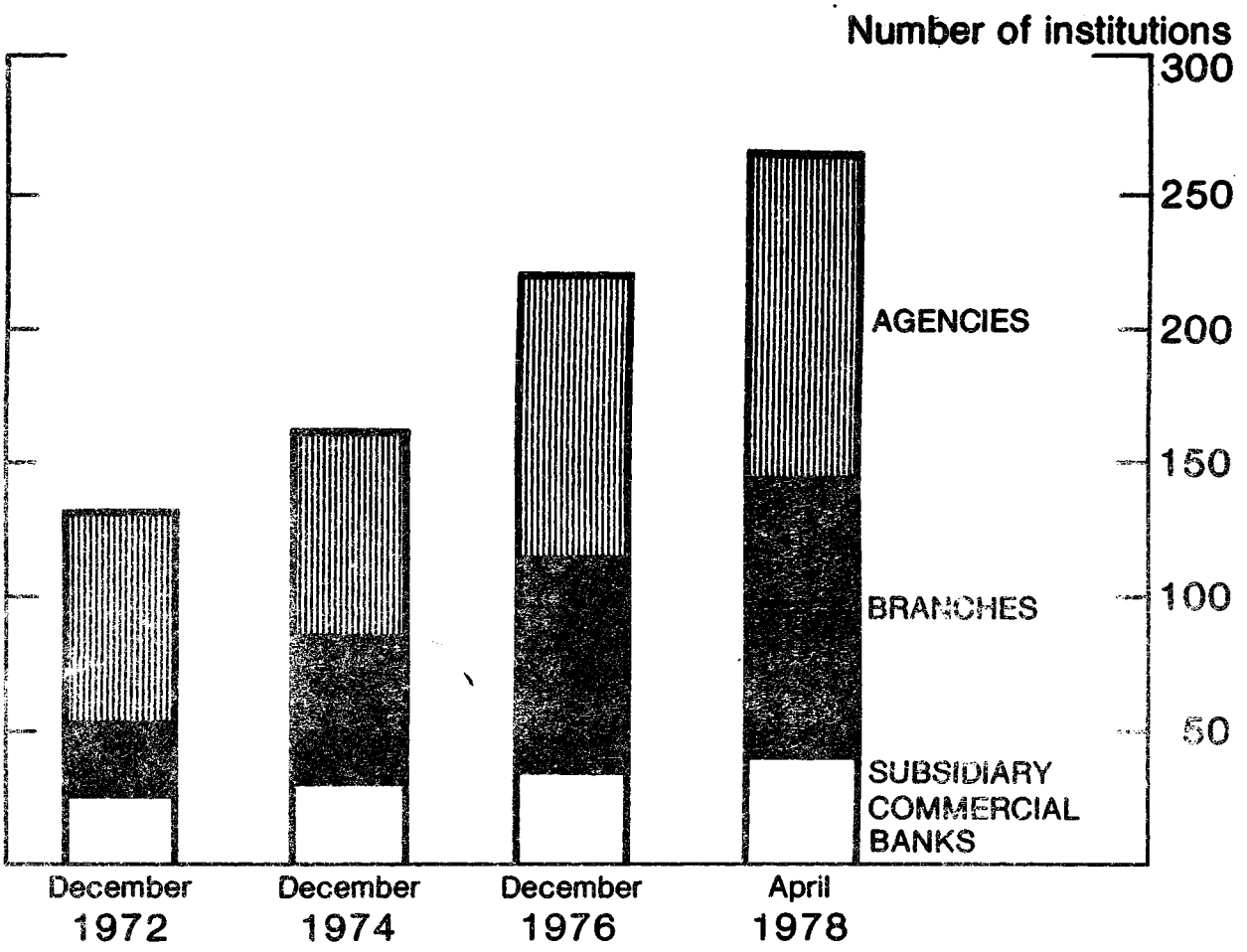
All Institutions [1.]



1. Includes agencies, branches, subsidiary commercial banks, Investment Companies and Agreement Corporations.
2. Standard banking assets include loans, money-market assets, and securities, and exclude claims on related institutions and clearing balances.

Chart 2

Number of U.S. Banking Institutions Owned by Foreign Banks[1]

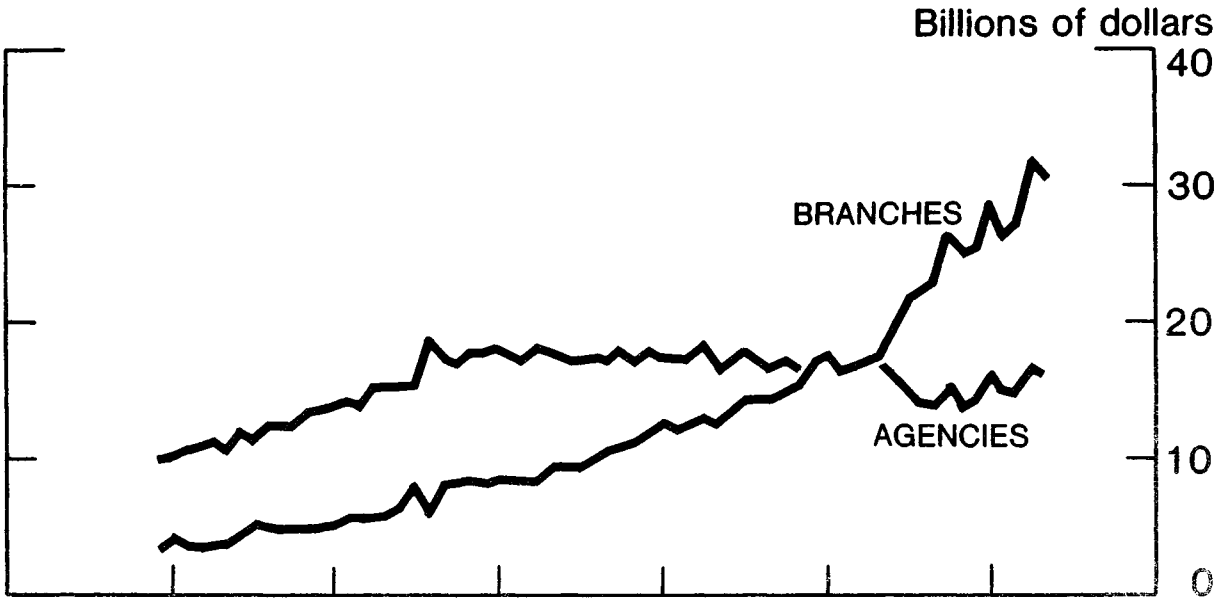


1. Does not include Investment Companies and Agreement Corporations. As of April 1978, foreign banks operated 5 Investment Companies and 2 Agreement Corporations.

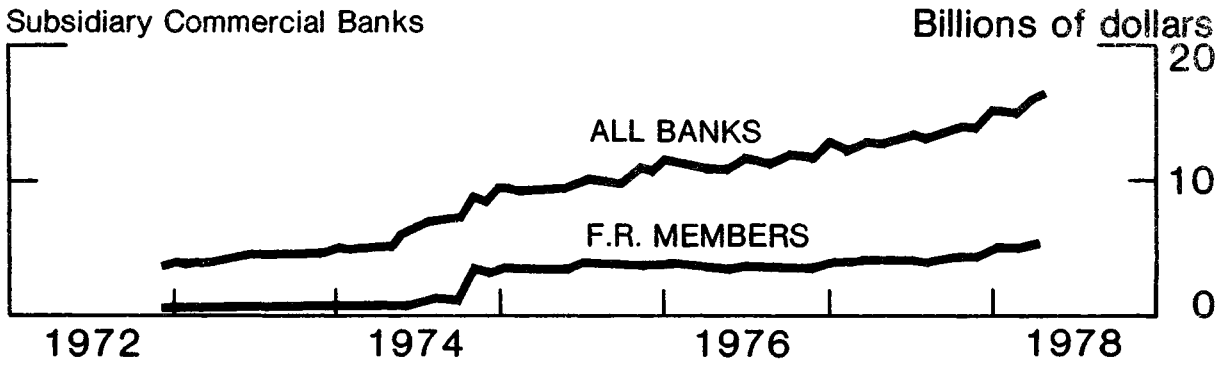
Chart 3

Standard Banking Assets by Type of Institution

Agencies and Branches



Subsidiary Commercial Banks



1972 1974 1976 1978

Chart 4

U.S. Banking Institutions Owned by Foreign Banks

Commercial and Industrial Loans

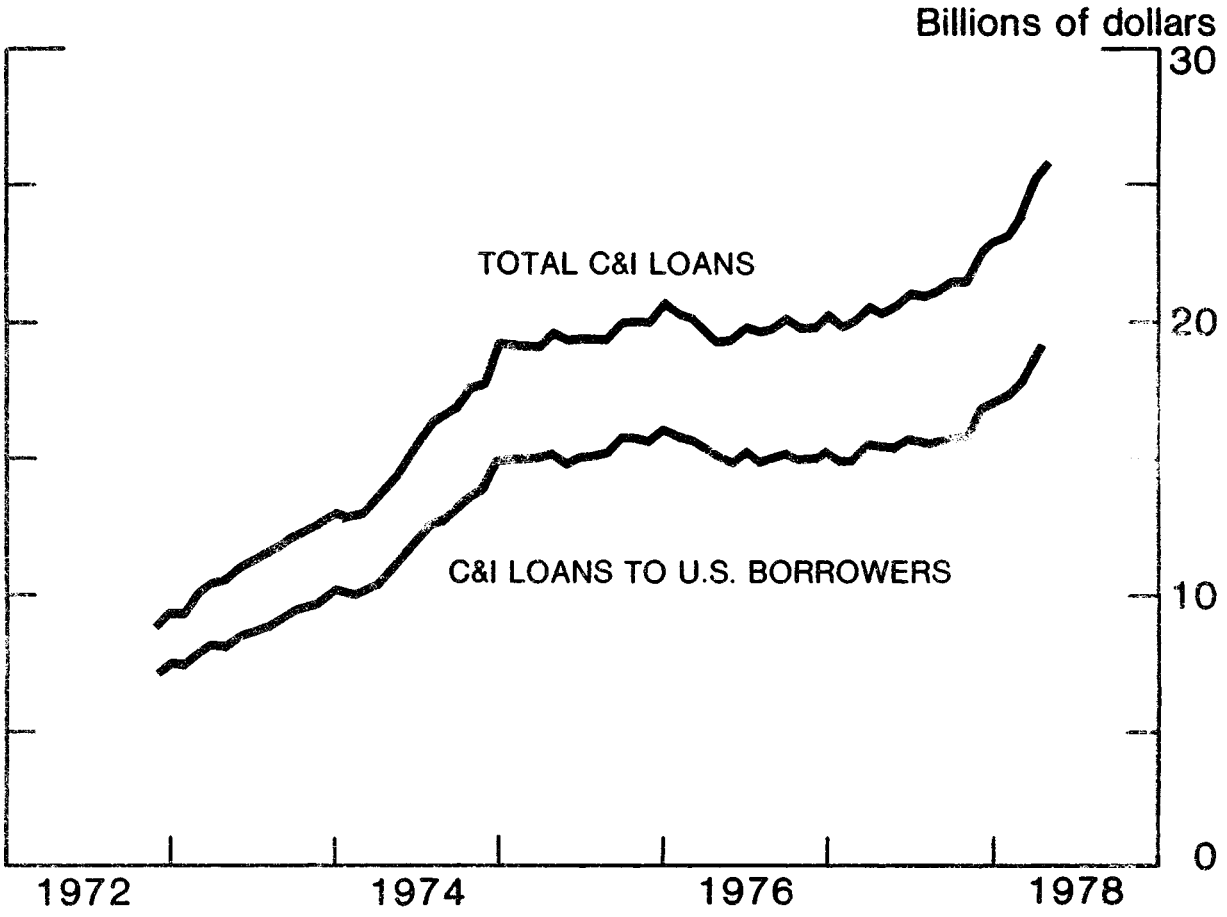
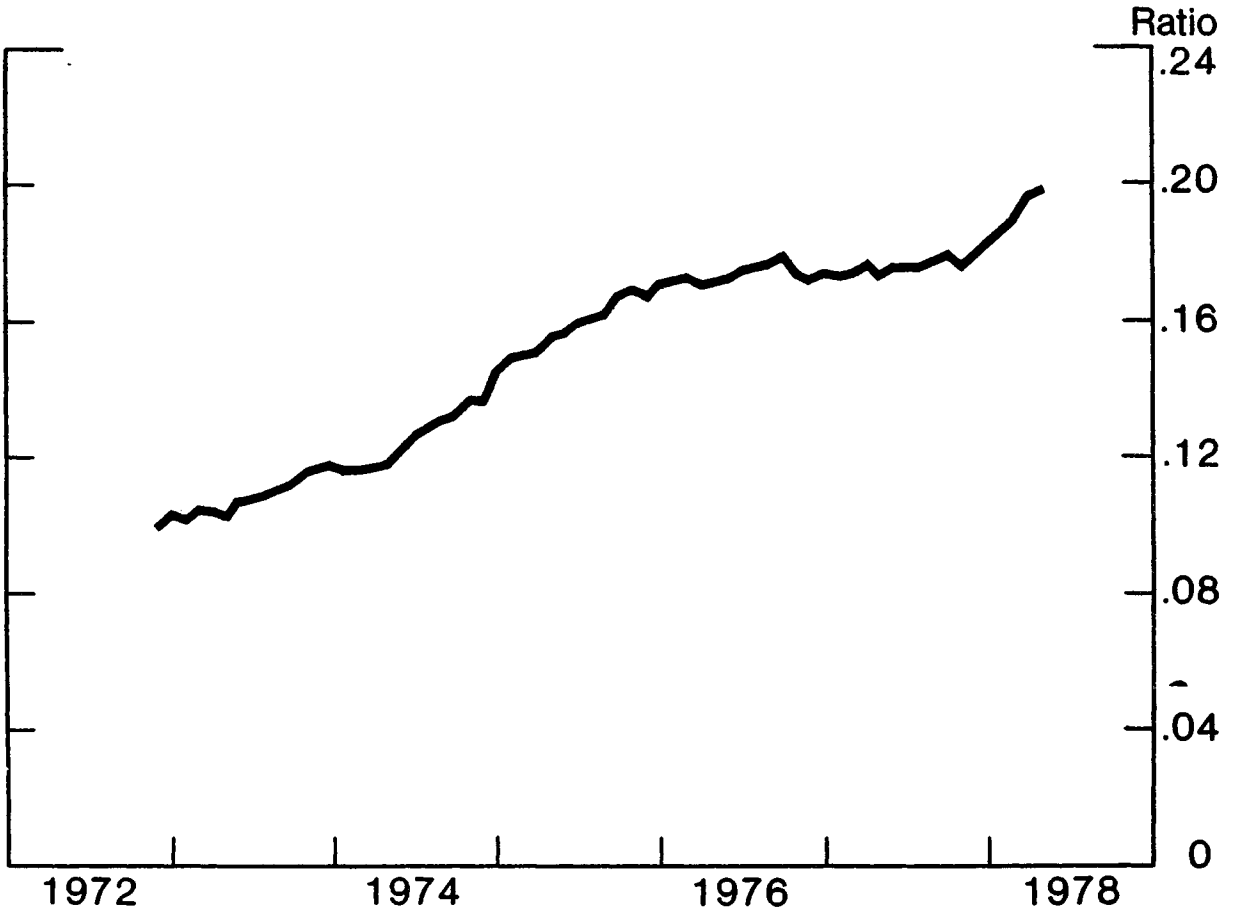


Chart 5

Ratio of Commercial and Industrial Loans at U.S. Offices of Foreign Banks to Similar Loans at Weekly Reporting Banks[1].

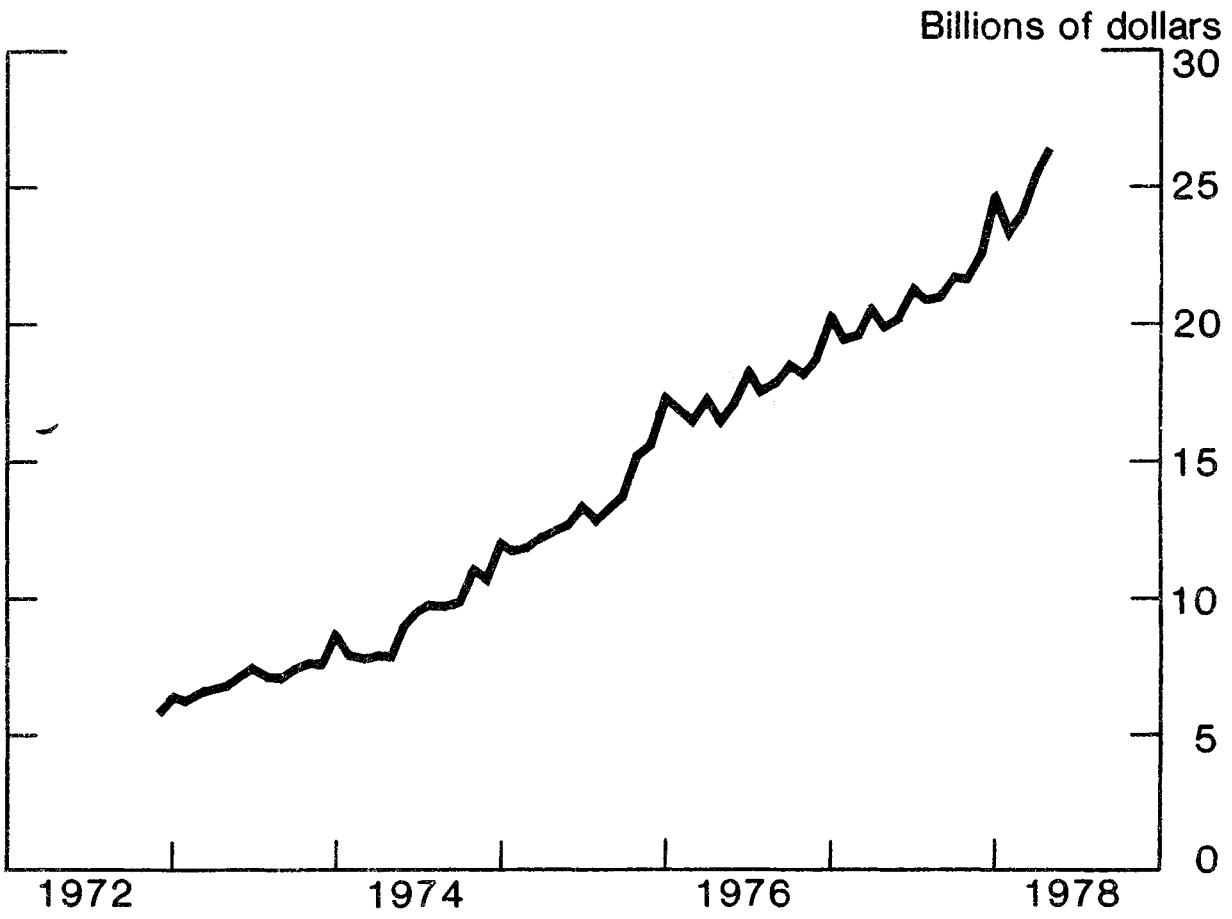


1. There are 315 large banks that report weekly to the Federal Reserve and account for slightly more than one-half of total assets of all insured commercial banks.

Chart 6

U.S. Banking Institutions Owned by Foreign Banks

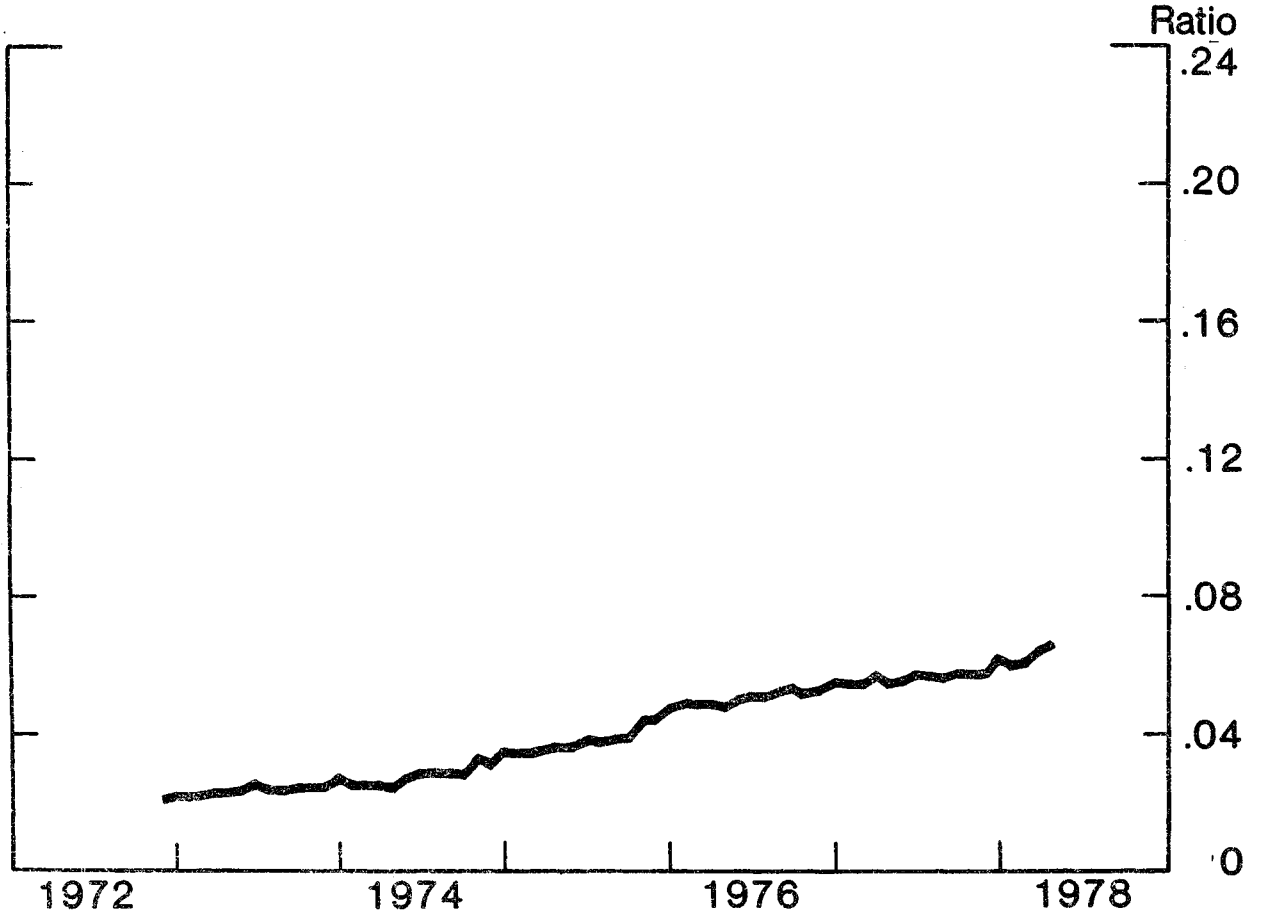
Deposits From Nonbanks [1]



1. Includes credit balances and excludes officers' checks and deposits from banks.

Chart 7

Ratio of Deposits from Nonbanks at U.S. Offices of Foreign Banks to Similar Deposits at Weekly Reporting Banks[1]

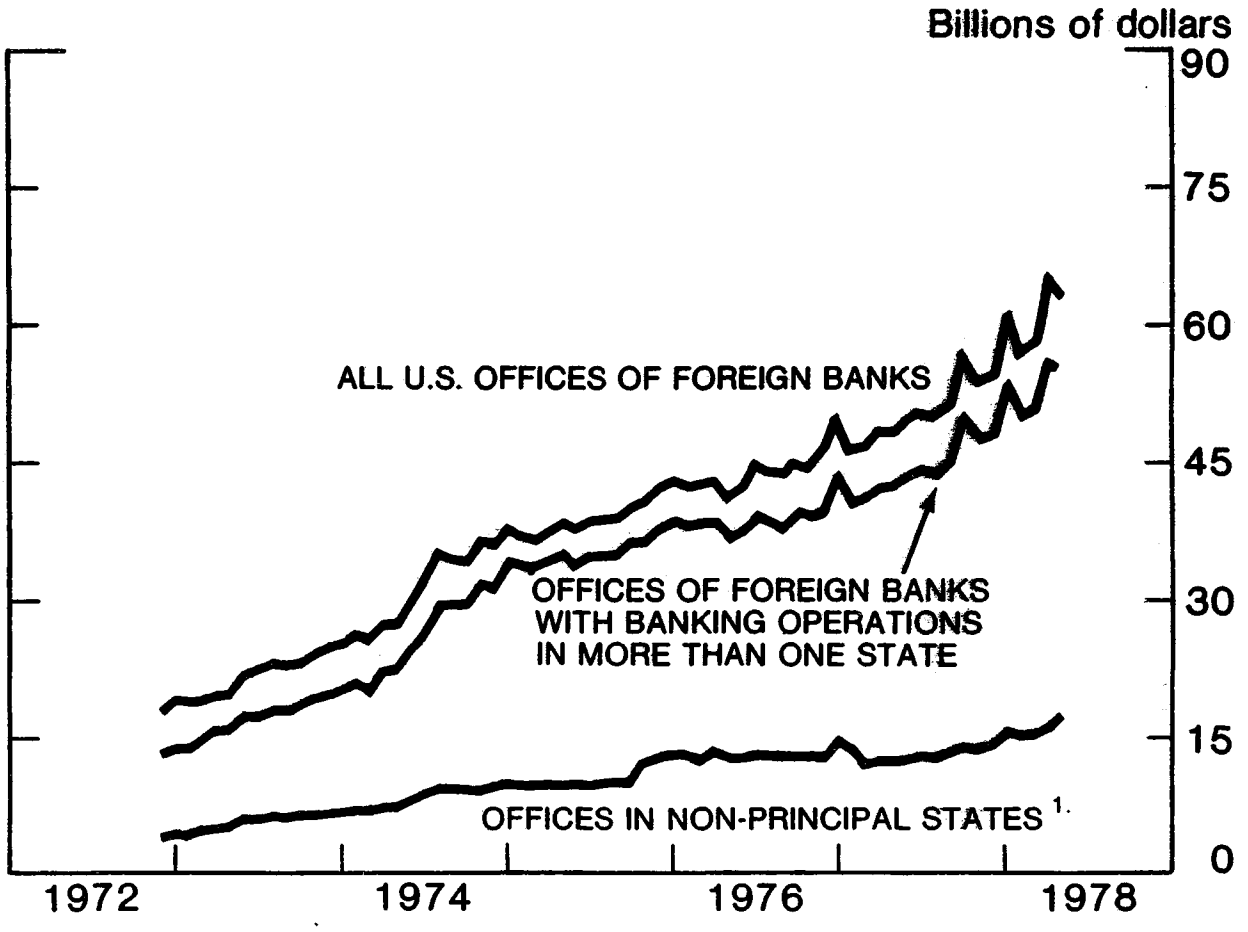


1. Includes credit balances and excludes officers' checks and deposits from banks.

Chart 8

Standard Banking Assets of Foreign Banks In the United States

Multi-state Activity

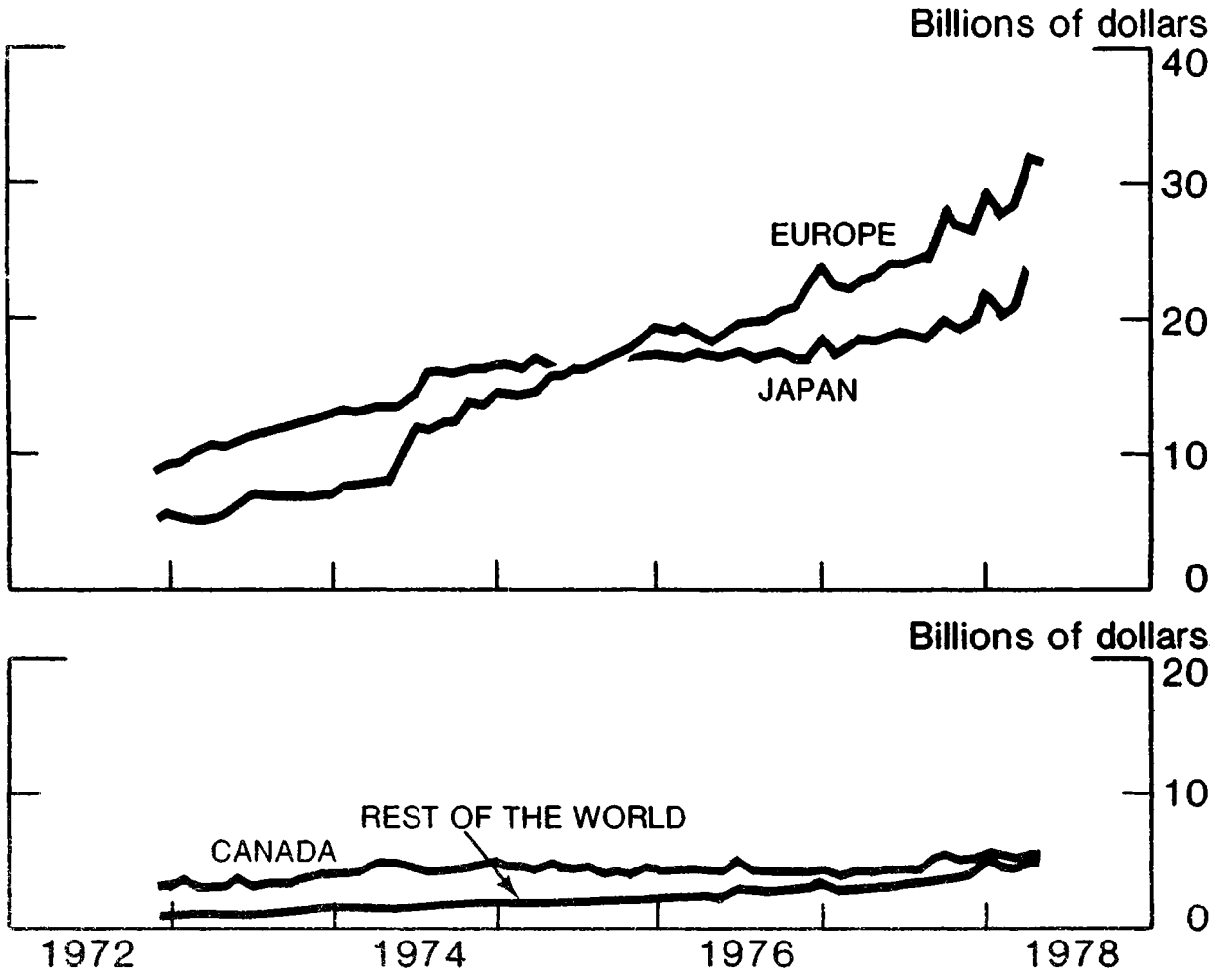


1. Principal state established using total asset criterion.

Chart 9

U.S. Banking Institutions Owned by Foreign Banks

Standard Banking Assets by Country of Parent



U.S. Banking Institutions Owned by Foreign Banks

Standard Banking Assets by State