

FEDERAL RESERVE BANK  
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# ECONOMIC REVIEW

## **International Banking**

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### CALIFORNIA ENERGY STUDY

Eleven economists from a variety of educational and research institutions present their views on the energy problem in the report, "California Energy: The Economic Factors," which will be published in early May by the Federal Reserve Bank of San Francisco. This publication is designed to provide information on the economic aspects of energy usage and energy technology, with special emphasis on California nuclear power.

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The following changes should be noted in title and frequency of publication:

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# International Banking

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The One World dream of a generation ago has now become reality, and nowhere is this more true than in the sphere of international trade and finance. The growth of a worldwide financial network has brought cheaper commercial credit to developing countries and higher living standards to everyone, and in the process it has created many profitmaking opportunities for the world's bankers and businessmen. This issue of the *Economic Review* discusses several aspects of this banking achievement, including the impact on the banking system itself of an increasingly interdependent world economy.

Robert Aliber suggests two possible theoretical approaches to this subject. One approach, based on industrial organization theory, assesses the market structure of banks in different countries through comparisons in mark-ups or spreads between borrowing and lending rates. Another approach, based on international trade theory, emphasizes comparative costs of banking in different countries and "barriers to trade" which prevent costs from being equalized, such as banking regulations and exchange-market controls. Aliber suggests that an analysis of banking based on such underlying cost differences could be more appropriate for future research efforts than analyses based on trends in lending flows or numbers of banking offices.

Industrial organization theory suggests that inferences about the relative efficiency of banks in different countries may be obtained from a comparison of the spreads between the interest rates paid on bank liabilities and the rates earned on bank assets. The narrower this spread, the more efficient is a country's banking system, and the greater is its potential for further growth.

Trade theory, however, suggests that free trade in money would cause depositors to shift funds to those banks paying the highest interest rates, while causing borrowers to shift to the banks charging the lowest rates. Banks with higher markups would be forced out of business, eliminating observed differences in spreads across countries.

Aliber notes that the persistence of sharp differences in spreads would indicate that "barriers to trade" in money exist, permitting evaluation of the underlying efficiency of each country's banks. These differences would be independent of business-cycle trends or changes in exchange rates, because interest rates paid on liabilities and assets would be equally affected. The trade theory and industrial organization approaches thus are complementary ways of viewing the phenomenon of international banking.

A related theme is discussed in the second article, which analyzes the growth of a major international financial center — the U.S. West Coast. As Hang-Sheng Cheng relates, the West Coast has become a major center within the span of only a brief half-decade. For example, foreign assets of West Coast banks rose from \$7 billion to \$32 billion between the end of 1969 and the end of 1974, at which point they accounted for one-fourth of the foreign business of all U.S. banks. This expansion went hand-in-hand with the growth of other types of institutions, such as Edge Act corporations (for foreign-trade financing) as well as foreign banks' agencies, branches and subsidiaries.

Cheng notes that economic theory has largely ignored the phenomenon of regional financial centers. However, recent studies have empha-

sized the central role of financial markets in promoting economic growth, in both developed and developing economies. Regional financial centers have evolved in both types of economies to provide important links between national money and capital markets on the one hand and broader world markets (such as the Euro-currency market) on the other. With the expansion of the West Coast's commercial-banking community, a growing number of banks in the past half-decade have attained a size sufficiently large to reap the benefits of portfolio diversification through international operations. Moreover, the rapid growth of the West Coast's foreign trade has attracted many Edge Act corporations and foreign banks to the region.

A separate theme concerns the rapidly growing role of commercial banks as a source of finance to developing countries (LDC's). Commercial-banking credits today account for one-fifth of the total net flow of resources to developing countries, compared with a very modest share as late as 1960. Reviewing this development, Nicholas Sargen finds a significant narrowing of the differential between what developed countries pay and what developing countries pay on their borrowings.

Yet Sargen asks, "Are commercial banks vulnerable to LDC defaults?" The answer apparently is no, despite the rapid growth of LDC trade deficits and despite the debt problems of individual developing countries. The danger is less than it might seem because of the slower growth of debt in real than in nominal terms, the availability of funds from non-bank sources, and the heavy concentration of commercial-bank lending in developing countries which have a relatively strong economic base.

Sargen goes on to ask, "Are commercial banks adequately compensated for the added

risks incurred in lending to developing countries?" Apparently they are, even though the differential rate of return between developed and developing country loans appears low by historic standards. Commercial banks are aware, of course, of higher risks in some cases, but they have responded through above-average increases in spreads to major borrowers and to the largest debtors, and also through the curtailment of new lending to those LDC's with debt problems. Also, governments of creditor nations have played an important role in mitigating the possibility of LDC defaults.

Turning to the regulatory side of this question, Robert Johnston analyzes in detail various legislative proposals that have been made to increase Federal control over the foreign-bank segment of the international-banking community. These proposals have gained new urgency because of the rapid growth of foreign banking inside this country. The number of U.S. banking institutions owned by foreign banks rose from 85 to 104 between 1965 and 1972, and then accelerated to reach 181 by September 1975. But this expansion has taken place under rules laid down by state law, not Federal law.

Johnston notes that the several pieces of legislation now being debated in Congress follow the principle of nondiscrimination—equality of national treatment—in their approach toward foreign-banking operations, but that they all have the same goal of establishing effective Federal control over such operations. "Whichever approach is taken, the era of regulatory dominance by state regulators is coming to an end. In the process, foreign banks will lose some privileges and gain others, but the trend will be to national treatment under the primary control of the Federal government."

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# Towards a Theory of International Banking

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Robert Z. Aliber\*

In the next few years, the geographic scope of the market for individual banks will increase sharply with the growing use of electronic funds transfer mechanisms. The costs and the inconvenience of using banks based in distant locations will decline. Inevitably, the change in the technology of payments will enlarge the market for major banks across the national borders; U.S. banks will find it easier to attract foreign customers and foreign banks will find it easier to attract U.S. customers and international banking will expand.

Currently over one-hundred U.S. banks have foreign branches or offices; five have sizable branch networks. More than 60 foreign banks have set up one or more branches in the United States and several have established branch networks in California. The assets of U.S. banks

operating abroad are about 15 percent of domestic U.S. bank assets, although 70 percent of the foreign assets involve off-shore transactions in dollars. Foreign banks now account for nearly 7 percent of bank assets in the United States.

This article presents two theoretical approaches for viewing the phenomenon of international banking. One approach, based on international trade theory, emphasizes comparative costs of banking in different countries and "barriers to trade" which prevent costs from being equalized. The second approach, based on industrial organization theory, assesses the market structure of banks in different countries through comparisons in mark-ups or spreads between borrowing and lending rates.

## Trade Theory Approach

One set of hypotheses about the competitive position of banks in different countries is based on theories of international trade. Thus, banking will be most substantial in those countries which have a comparative advantage in producing bank products in those countries' services.

Imagine that there were free trade in money and in loans, convenience (e.g., bank office location) would be much less important to borrowers and depositors in choosing among competing banks. The market share of the

more efficient banks would increase. If the less efficient banks set their interest rates to maintain their market share, their profit rates and the rate of growth of their capital would decline. The efficient, low-cost banks would be able to attract capital and increase their market shares, while the higher-cost banks—and the banks most susceptible to loss charge-offs—would incur declines in market shares.

Several questions arise when competition among banks is examined in an international context — as an international industry, with firms based in different countries competing in the same market or in overlapping segments

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of various national markets. One is the comparative cost of production of banks based in different countries, which concerns the relative efficiency of banks operating in different countries; this is the standard international-trade question of comparative advantage. Answering this question requires a model of the inputs, outputs, and the production function in banking. A related question involves the impact of national regulation on the costs of producing bank services; in part the rapid growth of offshore banking results from efforts to circumvent the costs of national regulation. A final question is whether firms based in some countries have advantages in owning banks overseas—the traditional international-investment question.

One analogy to competition in international banking is provided by the international automobile industry. Currently about 15 companies supply the world market for autos. Most countries import autos. Trade in autos is extensive, even among the producing countries; the Swedes buy many Fiats and the Italians buy some Volvos. Over the last 20 years, competition in national and international markets has led to a sharp decline in the number of automobile firms. Within the United States, old-line firms such as Studebaker, Packard, Hudson, and Willys have disappeared, as have Citroen, Sunbeam, Audi, Simca, Wolsey, and Maserati abroad. It is a truism that the defunct firms have not been able, given the level of mar-

ket prices, to earn the profits necessary to maintain their capital position.

Banks face a similar problem—if they are less efficient than their competitors, they are less able to acquire the capital necessary to finance their expansion and maintain their market share. But if they raise their selling prices to realize a higher rate of return, their market share may fall.

The reduction in the number of firms noted in the world automobile industry has already occurred in most national markets for banks. In the Netherlands banking is dominated by two firms; in France, by four firms; in Canada, Great Britain, and Japan by about ten. Within the United States, in contrast, the combination of anti-trust legislation and limits on branch banking across state boundaries has resulted in much less concentration.

International trade in money is less extensive than international trade in autos, even though the apparent costs of trade in automobiles are larger. The national markets for bank products are segmented by the costs of using the foreign-exchange market. Segmentation of national money markets also may result from the inconvenience of using distant banks. As these costs fall further, competitive pressures should insure that buyers of bank products and users of bank services shift to the more efficient banks, even if national borders must be crossed.

### **Industrial Organization Approach**

Another set of hypotheses about the competitive potential of banks is based on industrial organization studies. Profits and the numbers of firms are inversely related; the smaller the number of firms in the industry, the higher their profit rates. The implication is that banks based in countries with high concentration ratios would be more profitable—and better able to satisfy capital expansion needs—than those in countries with lower concentration ratios. Thus the margins of banks—the spread between the interest rates they receive on loans and the interest

rates they pay on deposits—would be higher in the countries in which the concentration ratios are high. High margins provide the necessary condition for high rates of profit, but not the sufficient condition; the less extensive competition may have led to higher wage rates and costs and less pressure for efficiency. To some extent, differences in margins may reflect differences in costs of reserve requirements.

A comparison of the efficiency of commercial banks in several countries requires an answer to the question, “What do commercial

banks produce?" The experts do not agree on an answer, in part because the output of banks, in contrast to that of auto companies, is not visible.<sup>1</sup> In the absence of clarity about the inputs and outputs, comparisons of efficiency across national frontiers are likely to be futile.

Commercial banks are one class of a family of financial intermediaries. All financial intermediaries perform similar functions — they issue liabilities to primary lenders, largely households, and use the funds to buy the securities issued by primary borrowers, largely firms and governments. The interest income paid by the borrowers exceeds that on the liabilities issued by the financial intermediaries.

The liabilities issued by financial intermediaries differ from those issued by primary borrowers in several respects; for instance, they are more liquid, in that they can be more readily exchanged into money at a fixed price. In addition, the liabilities issued by financial intermediaries are less subject to default risk, since intermediaries hold a diversified group of primary securities. Moreover, the liabilities issued by some financial intermediaries are guaranteed by the government. Finally, the liabilities issued by financial intermediaries sometimes have attached associated services: life insurance policies provide a fixed payment contingent on death, while annuity and pension policies provide a variable payment contingent on living. Demand deposits are used for money payments.

Financial intermediaries are grouped by the unique types of *financial* liabilities they produce. Commercial banks produce demand deposits—by definition any institution which produces demand deposits is a commercial bank.

At any time the size of the commercial bank sector relative to the size of every other type of financial intermediary depends on the primary lenders' demand for the risk, return, and service attributes of liabilities of each type of intermediary. The reserve requirements applied to commercial banks provide an upper limit on the volume of the liabilities at any time, given the volume of their reserves created by the central bank. Moreover, the re-

serve requirements reduce the interest that banks can pay on their deposits, since they constrain the interest income earned by banks. Banks and non-banks acquire similar types of assets, although not necessarily in the same proportions. The interest rates that each type of intermediary can pay on its liabilities will—in the absence of regulatory constraints—depend on how successful it has been in acquiring assets whose returns are high related to their risks.

Each financial intermediary performs two different functions. On the one hand, each intermediary sells its liabilities and buys money; on the other hand, each buys loans and sells money. The more successful the intermediary is in selling liabilities, the larger volume of interest-bearing assets it can acquire. Intermediaries in marketing their liabilities attempt to optimize the risk-return aspects of their assets.

For financial intermediaries as a whole, the acquisition of liabilities of primary borrowers must equal the sale of liabilities to primary lenders. But this statement is not necessarily true for each bank, or for each life insurance company, nor is it true for banks as a group or for life insurance companies as a group, or for any other sub-set of financial institutions. At any time, some commercial banks may be more successful in selling liabilities than in finding attractive loans; these banks can "sell" or lend their excess money to other banks. If some banks have an excess supply of deposits, then other banks must have an excess supply of assets or loans. Transactions among banks would clear the market.

Once an individual bank has sold an additional deposit to a primary saver, it compares the prospective return and risk from acquiring additional primary securities with the return and the risk from lending to other banks. Most financial institutions specialize in either selling deposits or in buying loans. The implication is that there are significant economies of scale in grouping the liability transactions and the asset transactions in one institution.

Nevertheless the loans of some banks exceed

receipts from sale of deposits to primary lenders, their funds being obtained by borrowing from other banks and other large lenders; such banks are known as wholesale banks. Specialization by banks in the liability function may partly be a function of geography and of restrictions on branching; the large wholesale banks are located in the major cities where most of the large borrowers also are based. Perhaps more importantly, the wholesale banks may have an advantage in acquiring information about primary borrowers which other banks find it costly to replicate.

At every moment, each bank compares the return available on acquiring additional primary assets with the return from selling deposits to

other banks. The interest rate at which deposits are traded among banks can be used as a transfer price to determine the distribution of the gross income of the bank between its two activities.

In fact, at any moment a family of transfer prices exists; these prices differ by maturity—one on Federal funds, one on short-term certificates of deposit, another on longer-term certificates of deposit, one on longer-term government bonds.<sup>2</sup> Moreover, the prices for each maturity may differ in the foreign money markets and in the external currency market, because risk attributes for foreign and domestic securities differ.<sup>3</sup> The bank must decide which interest rates are most relevant for the internal transfer price.

## Conclusion

The two approaches outlined in this paper view commercial banking as an international industry. Industrial organization theory suggests that inferences about the relative efficiency of banks based in different countries may be obtained from a comparison of loan-deposit spreads. The difference between the interest rates paid on bank liabilities and the interest rates earned on new assets covers the banks' costs and provides them with the profits necessary to finance their expansion. Trade theory, however, suggests that free trade in money would cause depositors to shift funds to those banks paying the highest deposit rates, and cause borrowers to shift business to the banks charging the lowest interest rates. Banks with the higher markups would be forced out of business,

eliminating observed differences in spreads across countries.

The persistence of very large differences in such spreads would indicate that "barriers to trade" in money exist, permitting assessment of the underlying efficiency of each country's banks. These differences would be independent of inflation or recession or changes in exchange rates, because interest rates paid on liabilities and assets would be equally affected. The trade theory and industrial organization approaches, thus, are complementary ways of viewing the phenomenon of international banking. In a world of integrated financial markets, an analysis of banking based on underlying cost differences could be more appropriate for future research efforts than one based on trends in lending flows or numbers of banking offices.

## FOOTNOTES

1. See W. F. Mackara, "What Do Banks Produce?" *Monthly Review*, Federal Reserve Bank of Atlanta, May 1975, pp. 70-75.

2. Note the choice of the relevant transfer price is independent of how much banking risk the firm should acquire—that is, to what extent the bank should mismatch the maturities of its assets and liabilities. Once the bank decides on the appropriate mismatch, then it should trade securities whenever the market spreads differ from those it deems offer the best risk-return combination.

3. In a world without transaction costs and political risk neutrality, yields on assets denominated in one currency would differ from those on assets denominated in other currencies by the anticipated rate of change in the exchange rate; all yields in one currency would be a simple transformation of those in every other currency. Bid-ask spreads would be everywhere equal. In the real world, these spreads are not equal. The bank must choose between the transfer price in the domestic market, and that in the foreign market.



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# U.S. West Coast as an International Financial Center

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Hang-Sheng Cheng

The study of regional international financial centers is a long-neglected subject. In the literature on international finance, it is customary to consider the world as consisting of separate national money and capital markets, linked together by international capital flows, with each national market assumed to be a uniform, homogeneous entity. Alternatively, the entire world is regarded as a single market in which competition for national funds takes place through various institutional channels such as banks, international bond markets, etc. By and large, these analytical approaches have served their purposes well. But, with their emphasis on national and international developments, they do not

take into consideration the rise in the last decade or so of regional international financial centers such as Singapore, Panama, and the U.S. West Coast. These new regional centers have contributed importantly to the growth of international finance by being both competitive with, and complementary to, old-established centers such as London, New York, Frankfurt, and Zurich.

A number of studies have now appeared on various regional financial centers, both old and new, but none as yet on the rise of the U.S. West Coast as an international financial center. The purpose of this study is to fill that gap.

## Economic Factors

Despite these recent contributions, a conceptual framework for the study of regional financial centers is still lacking. Regional economics, with its sophisticated theoretical models of locational distribution of industry and intra-urban land use,<sup>2</sup> rarely concerns itself with the location of finance. There appears to be no obvious way to apply the factor-endowment approach (Heckscher-Ohlin) or the distance-from-center approach (von Thunen) used in regional economics to the explanation of regional financial centers. On the other hand, a growing literature on the pivotal role of money and capital markets in economic development<sup>3</sup> leaves largely unexplored the question of the location of financial centers and the functional links among these centers.

It is beyond the scope of this study to develop a rigorous theoretical framework for analyzing the factors underlying the rise and fall of regional international financial centers. Nevertheless, it would be useful to consider briefly a few relevant hypotheses in economic literature that might throw light on the subject.

First, we may consider the portfolio-balance theory of finance, as used in the analysis of international diversification of asset-holdings and international capital flows.<sup>4</sup> In essence, it states that an asset-holder (say, a bank) that desires maximum return from his investment portfolio with minimum risk can improve his welfare through international diversification of his asset holdings, and that his gains are the larger the less (algebraically) the returns from the various as-

sets are correlated with one another. This paper contains partial evidence suggesting that, in the 1973-74 environment, an internationally diversified portfolio apparently assisted a number of West Coast banks in improving their overall earnings.

Second, we may consider economies of scale. The portfolio-balance theory, while accounting for banks' desire for international asset diversification, can not tell us why, at one particular juncture in the early 1970's, so many West Coast banks initiated or expanded international activities. Obviously, overseas branching is costly, requiring a certain minimum scale of operations to undertake. In this respect, it may be pertinent to note that loans and investments of all commercial banks in the San Francisco Federal Reserve District nearly doubled from \$51 billion in 1967 to \$101 billion in 1974, increasing at an average rate of 10 percent per year.<sup>5</sup> Presumably, during this period a number of West Coast banks must have attained a size sufficiently large for them to initiate profitable international operations.

Third, growth of international banking is related to that of international trade. Between 1967 and 1974, the total value of West Coast foreign trade (exports plus imports) rose three and a half times to \$37 billion<sup>6</sup>—at an average growth rate of 24 percent per year. About two-thirds of this trade was conducted with the

booming economies of the countries located around the Pacific Basin.<sup>7</sup>

Fourth, insights obtained from studies of industrial structure might throw some additional light on the subject. Among the West Coast banks now active in international banking, by far the largest are California banks. Besides its substantial economic base, California is also noted for a liberal banking law that permits statewide branching. Presumably, the resultant sharp competition among banks may have driven profits from domestic operations down to a level that provided a strong incentive for expansion in areas where competitive conditions were less severe, as in the less-developed areas of the world.

Keeping these factors in mind, we may now turn to an examination of the rise of the West Coast as an international financial center during the 1970's. Following a quick overview, we will look into the various components of the growth process: the overseas expansion of West Coast banks, the activities of Edge Act corporations on the West Coast, and the activities of foreign banks in the region. One section analyzes the experience of West Coast banks during the turbulent 1974-75 period, and another the profitability of international operations. Finally, some preliminary conclusions are drawn concerning the future of the West Coast as an international financial center.

### Overview of Growth, 1969-75

Table 1 summarizes the growth of West Coast international banking from 1969 to 1975. Not all the series are available for the entire period, but the overall impression of rapid growth is unmistakable.

Between 1969 and 1974, total foreign assets of West Coast banks increased from \$7 billion to \$32 billion.<sup>8</sup> Moreover, there was a broad participation of West Coast banks in this rapid expansion. In 1969, only five West Coast banks had more than \$100 million in foreign assets;<sup>9</sup> by 1974, the number has increased to eleven.<sup>10</sup>

Five of these banks—Bank of America, Security Pacific, United California, Wells Fargo, and Crocker—each had more than \$1 billion in foreign assets; together the five accounted for \$30 billion of the \$32 billion of total foreign assets of all West Coast banks in 1974.

The number of banks having branches abroad increased from nine in 1969 to twenty in 1975. The number of branches rose from 102 to 138, and the number of representative offices from 28 to 61, while foreign-branch assets jumped from \$5.6 billion to \$35.7 billion.

**Table 1**  
**Growth of West Coast**  
**International Banking**  
**1969-75<sup>a</sup>**

	<u>1969</u>	<u>1975</u>
<b>Total foreign assets of</b>		
<b>West Coast banks</b>		
(billions of dollars)	7.0	32.0
<b>Overseas Branches</b>		
Number of West Coast		
banks	9	20
Number of branches	102	138
Branch assets (billions		
of dollars)	5.6	35.7
Number of representative		
offices abroad	28	61
<b>Edge Act Corporations</b>		
Number of Edge		
corporations	7	23
Total assets (millions		
of dollars)	80	930
<b>Foreign Banks</b>		
Number of agencies		
and branches	16	50
Agency assets (billions		
of dollars)	0.7	9.0
Number of subsidiary banks	7	15
Subsidiary bank assets		
(billions of dollars)	0.9	4.5

<sup>a</sup>Data for total foreign assets are as of end-1969 and end-1974; overseas branch data, end-1969 and end-1975; Edge corporation data, end-1969 and mid-1975; and foreign bank data, mid-1969 and mid-1975.

Sources: Based on subsequent tables.

Increased activities of Edge Act corporations also testified to the growth of international banking in the region. The number of such corporations increased from 7 in 1969 to 23 in 1975, while their total assets increased more than 11 times from \$80 million in 1969 to \$930 million in 1975.

Another measure was the expansion of foreign banks' activities on the West Coast. Agencies and branches of foreign banks increased from 16 in 1969 to 50 in 1975, and foreign-owned state-chartered banks increased from 7 to 15. The total assets of these foreign banking offices increased from \$1.6 billion in 1969 to \$13.5 billion in 1975.

The growth phenomenon was also reflected in a substantially enlarged volume of international capital flows reported by West Coast banking institutions. Over the 1974-75 period, U.S. capital outflows reported by West Coast banks (measured by changes in U.S. foreign assets) averaged \$3.2 billion per year, or about 18 times the average rate of the 1969-70 period. Foreign capital inflows reported by West Coast banks (measured by changes in U.S. foreign liabilities) averaged \$740 million per year during the 1975-75 period, or about three times the average 1969-70 rate. U.S. capital outflows through West Coast banks accounted for 20 percent, and foreign capital inflows 6 percent, of the respective total flows reported by all U.S. banks during the 1974-75 period. By coincidence, these percentages were almost the same as the West Coast banks' shares at the end of 1975 in the total U.S. claims on foreigners and liabilities to foreigners reported by banks—20 percent and 7 percent, respectively.<sup>11</sup>

### Overseas Branch Activities

West Coast banks were relatively late starters in overseas banking. As late as 1968, Bank of America was the only West Coast bank with branches abroad, although a few others—Bank of California, Crocker, United California, Wells Fargo, Security Pacific, and National Bank of Commerce of Seattle (now Rainier)—maintained representative offices and interests in joint

ventures in a handful of foreign countries.<sup>12</sup>

Bank of America opened its first foreign branch in 1931, but did not add another until 1947. It added a total of 21 foreign branches in the 1947-63 period. But then, in a burst of expansion covering the 1964-68 period, it opened another 64 branches—more than one new overseas branch a month on the average. Despite a

**Table 2**  
**Growth in Overseas Operations of Individual Banks**  
**1969-1974**

(Deposit and loan volume in millions of dollars)\*

		1969	1974	Ratio: 1974/1969
<b>Bank of America</b>				
Deposits:	Total	21,509	45,348	2.11
	Overseas	5,040	18,110	3.59
	Percent Overseas	23%	40%	
Loans:	Total	13,842	27,649	1.99
	Overseas	2,402	8,459	3.52
	Percent Overseas	17%	31%	
<b>Security Pacific</b>				
Deposits:	Total	4,474	10,047	2.25
	Overseas	20	2,276	113.80
	Percent Overseas	0%	23%	
Loans:	Total	3,873	8,612	2.22
	Overseas	36	1,068	29.67
	Percent Overseas	1%	12%	
<b>United California</b>				
Deposits:	Total	3,934	7,098	1.80
	Overseas	270	1,799	6.66
	Percent Overseas	7%	25%	
Loans:	Total	2,709**	5,114	1.89†
	Overseas	87**	598	6.87†
	Percent Overseas	3%	12%	
<b>Wells Fargo</b>				
Deposits:	Total	4,542	9,065	2.00
	Overseas	101	1,670	16.53
	Percent Overseas	2%	18%	
Loans:	Total	3,386	7,336	2.17
	Overseas	29	941	32.45
	Percent Overseas	1%	13%	
<b>Crocker</b>				
Deposits:	Total	4,169	7,896	1.89
	Overseas	283	1,431	5.06
	Percent Overseas	7%	18%	
<b>Seattle First</b>				
Deposits:	Total	1,612	3,118	1.93
	Overseas	2	354	177.00
	Percent Overseas	0%	11%	
Loans:	Total	1,187	2,317	1.95
	Overseas	3	117	39.00
	Percent Overseas	0%	5%	
<b>Rainier††</b>				
Deposits:	Total	1,078	1,861	1.72
	Overseas	90	298	3.31
	Percent Overseas	8%	16%	
Loans:	Total	683	1,271	1.86
	Overseas	11	130	11.82
	Percent Overseas	2%	10%	

\*Daily or weekly average balances.

\*\*1970

†Ratio, 1974/1970.

††Excluding Edge Act subsidiaries.

Sources: 1974 Annual Reports of the respective banks.

later slowdown in the expansion pace, it maintained at the end of 1975 a network of 107 overseas branches and 13 foreign representative offices, with \$33 billion in weekly average assets in the bank's World Banking division—about 54 percent of the bank's total average assets.<sup>13</sup>

Other West Coast banks started overseas branching in 1968, with the opening of a London branch by National Bank of Commerce of Seattle. As shown in Table 1, by the end of 1969 there were nine West Coast banks with overseas branches,<sup>14</sup> with total branch assets amounting to \$5.6 billion. However, aside from Bank of America branches, all were located in either London, the Bahamas, or Luxembourg. During the six years 1970-75, 11 other West Coast banks opened branches abroad.<sup>15</sup> The combined assets of the foreign branches of all West Coast banks increased to \$35.7 billion at the end of 1975.<sup>16</sup> During this period, they undertook extensive branching activities in Japan and other countries in the Far East.

These aggregate data reveal little about the operations of individual banks. However, seven individual banks report considerable detail in their annual reports to stockholders (Table 2). Over the 1970-74 period, total loans and deposits of each of seven major West Coast banks about doubled; but in all cases, their overseas loans and deposits grew at a much faster pace. Overseas operations more than tripled for Bank of America, an established international-banking institution, and jumped over a hundred-fold for such newcomers as Seattle First and Security Pacific. As a result, overseas loans and deposits

**Table 3**  
**Total Assets of Foreign Branches**  
**of West Coast Banks, by Region**  
**December 31, 1975**

<b>Region</b>	<b>Total Assets</b> <b>(Millions of Dollars)</b>	<b>Share</b> <b>of Total</b> <b>(Percent)</b>
Europe*	23,188	65
Caribbean	5,619	16
Pacific Basin <sup>1</sup>	6,863	19
<b>Total</b>	<b>35,670</b>	<b>100</b>

<sup>1</sup>Japan, Korea, Taiwan, Hong Kong, Philippines, Malaysia, Singapore, Thailand, and Indonesia.

Source: Based on data reported by banks to the Federal Reserve System.

were by 1974 a substantial portion of portfolios for all these institutions—from a high of 40 percent for Bank of America to between 10 and 20 percent at other banks.

Overseas operations have remained heavily concentrated in Europe and the Caribbean (Table 3), reflecting the importance of Eurodollar operations. The only other measurable activity was in Pacific Basin countries—almost entirely in Japan, Singapore, and Hong Kong.<sup>17</sup>

Besides overseas branches, West Coast banks also have invested large sums in foreign affiliates which are engaged in all sorts of banking or near-banking activities. These activities include merchant banking, investment banking, finance companies, leasing, mortgage, trust, factoring, etc. Data on the amounts involved, however, are lacking.<sup>18</sup>

### Edge Act Corporations on the West Coast

Edge Act Corporations are wholly-owned subsidiaries of U.S. banks set up under Section 25(a) of the Federal Reserve Act to facilitate international banking activities. They may be established in states outside their parent banks' home states, and therefore represent an exception to the usual barriers against interstate branching by U.S. banks. This provision enables banks which are located outside major fi-

nancial centers to engage in international banking in such centers; on the other hand, it also permits banks which are located in one major financial center to participate in international banking in other centers. The establishment of a large number of out-of-state Edge corporations in a region is, therefore, a good sign of the region's growing importance as an international financial center.

In addition to their international banking activities, Edge corporations may also make equity investments in foreign corporations which do not transact business in the United States—an activity which their parent banks are prohibited by law from doing. Hence, many banks which are located in an international financial center may set up Edge corporations in the same locale, often on the same premises, for conducting international equity-investment businesses. These Edge corporations are commonly referred to as “investment Edges,” in contrast to the “banking Edges” described above.

Edge activity on the West Coast was quite modest until recently. As late as 1965, there were only three such corporations: a banking Edge in Seattle (International Bank of Commerce) and two investment Edges in San Francisco (Crocker International and Bank of California International). In 1967, First National City Bank of New York opened a banking Edge in San Francisco—the first representative from outside the region—and then five West Coast banks (Security Pacific, Bank of America, U.S. National of Oregon, Seattle First, and Union) established investment Edges. By the end of

1969, seven Edge corporations were operating on the West Coast, but with total assets of only \$80 million.

The big wave hit the West Coast in 1973 and 1974, when ten new Edge corporations were established—mostly from outside the region—raising the total number to 23 and their aggregate assets to \$1 billion. The wave then appears to have subsided, as the total assets fell to \$930 million by mid-1975,<sup>19</sup> and the number dropped to 22 with the merger of two investment-Edge subsidiaries of Crocker in August 1975. Today, there are 13 banking Edges—8 from New York, 3 from Chicago, and 1 each from Boston and Seattle—along with 9 investment Edges which all represent West Coast institutions.

Measured by asset size, the banking Edges are far more important than investment Edges. At mid-1975, banking Edges had total assets of \$841 million, compared to only \$88 million for all investment Edges. Activity is largely concentrated in San Francisco (\$418 million in assets) and Los Angeles (\$500 million), with the balance about equally distributed between Portland and Seattle.

### Foreign Banks on the West Coast

Most foreign banks on the West Coast use the agency form, rather than the branch form of organization.<sup>20</sup> The latter is effectively barred from California, because the state requires all domestic deposits to be insured by the FDIC, and the FDIC insures only U.S.-chartered banks. A similar situation exists in Oregon, although the branches of two foreign banks—Bank of Tokyo and Canadian Imperial—have “grandfather” privileges there. The state of Washington permits branches of foreign banks, but with domestic deposits severely limited by law, the branches in effect act much like agencies. The most effective arrangement has evolved in California, where foreign banks have established both agencies and full-service state-chartered subsidiary banks, in an attempt to obtain flexibility in both lending limits and deposit-

accepting capabilities.<sup>21</sup> In fact, each of the 15 foreign banking subsidiaries in California, except for Lloyds, operates in tandem with an agency of the same parent bank.

Foreign banks came early to the West Coast. Canadian Imperial Bank of Commerce opened an agency in San Francisco in 1902, and Bank of Montreal established a subsidiary bank in San Francisco in 1918 and an agency there in 1934. Other Canadian and Far Eastern banks followed in the 1930s and after the Second World War. Yet by mid-1969, there were only seven foreign subsidiary banks and sixteen agencies and branches of foreign banks on the West Coast, with assets totaling about \$1.5 billion.

The pace of expansion was relatively slow until mid-1971. But within the next four years, 29 new agencies and 8 banking subsidiaries

opened in California and 4 new branches opened in Seattle. At mid-1975, agency and branch assets totaled \$9.0 billion and subsidiary-bank assets \$4.5 billion—13 times and 9 times their respective sizes only six years earlier. Within the same period, their share of all commercial-bank assets within the San Francisco Federal Reserve District increased from 2.1 percent to 9.8 percent.

Foreign banks prefer California to any other state (except New York) as a place to conduct business. As of last September, 66 branches and agencies were located in New York, 43 in California, and 35 elsewhere; while 16 subsidiary banks were in New York, 15 in California, and only 2 elsewhere. New York accounted for 68 percent, California 26 percent, and other regions only 6 percent, of the \$56.5 billion total assets of all the foreign banking offices in the United States.<sup>22</sup>

Banks from thirteen foreign countries in Asia,

Europe, and the Americas are now represented on the West Coast. The Japanese banks account for a full two-thirds of the \$13.5 billion total assets of all foreign banking offices in California; four British banks account for 15 percent; six Canadian banks for 9 percent; and seventeen other foreign banks for the other 9 percent.<sup>23</sup>

Foreign banks bring to a region financial expertise and special ties with foreign business partners which local banks do not possess. Their comparative advantage in this respect enables them to overcome the cultural and business barriers of entry into a (for them) foreign environment. Being complementary to the indigenous banks, foreign banks help to broaden and strengthen a region's institutional base as an international financial center. In addition, as they become established in the new market, they help to enhance competition by offering local savers and borrowers a greater choice of financial services.

### Recent Developments

Nineteen seventy-four was a particularly turbulent period for international banking. The lifting of U.S. capital controls in January 1974 coincided with the liberalization of controls over international capital flows by other major industrial countries. This coordinated shift in policy occurred just as the world's major banks were called upon to help manage the huge flows of international oil payments. At the time, there was widespread concern over the banks' ability to handle such flows and to bear the risks involved. Then in May, 1974, came the Franklin National failure, followed soon after by the Herstatt debacle and a series of other international banking failures and near-failures. On top of it all, inflation became rampant worldwide, causing interest rates to soar and the world bond market to decline during a time of large international-payments imbalances. From late 1974 on, a spreading business recession engulfed the world, with declining export markets, falling commodity prices, and continually rising import costs seriously undermining the payments posi-

tions of a number of developing nations and forcing them to seek substantial loans from the banking system. Through it all, international banking underwent considerable strains while offering unprecedented opportunities as well.

How did West Coast banks manage through that period of perils and opportunities? In response to the lifting of capital controls and to the world-wide demand for the financing of oil deficits, West Coast banks stepped up their foreign lending very sharply during the second quarter of 1974, both at their head offices and through their foreign branches, as shown in Table 4. Following the Herstatt debacle, they drastically reduced their lending activities, leading to a substantial net liquidation of head-office loans during the third quarter and of foreign branch loans in the fourth quarter of 1974. Subsequently, however, foreign lending recovered momentum, and head-office lending even surpassed the 1973-74 pace.

Thus, in fact, West Coast banks did not undergo as much of a "consolidation and retrench-

**Table 4**  
**International Activities of**  
**West Coast Banks and Their**  
**Foreign Branches**  
**Quarterly, 1974-75**  
(Millions of dollars)

Period	West Coast Banks		Foreign Branches
	Change in Foreign Assets	Change in Foreign Liabilities	Change in Total Assets
1973 <sup>1</sup>	515	173	1,944
1974 I	537	260	1,199
II	2,138	186	4,458
III	- 705	766	1,887
IV	487	391	- 191
1975 I	1,123	68	394
II	587	- 143	528
III	780	- 88	458
IV	1,529	41	2,403

<sup>1</sup>Quarterly average.

Source: Based on data reported by banks to the Federal Reserve System and the U.S. Treasury.

ment" in 1974 as was alleged in the financial press. Reports of "an age of expansion in international banking coming to an end" were unfounded. Measured by banks' foreign claims, any retrenchment was quite brief—lasting no more than one quarter of a year. Foreign lending resumed growth at both head offices and foreign branches in 1975, although the foreign-branch expansion was at a slower pace than previously.

#### Profitability of International Operations

The feature attracting banks to international operations must be their profitability. Indeed, a recent industry study shows that the international earnings of a group of nine major U.S. banks increased at a 37-percent annual rate over the 1970-74 period, compared to only a 3-percent rate of gain for domestic earnings.<sup>24</sup> Comparable data for West Coast banks are not available for that period, but scattered data for 1973 and 1974 show the same type of upsurge in overseas earnings (Table 5). In the three cases shown, earnings from international operations grew considerably faster than domestic earnings between those two years. Thus Bank of Amer-

**Table 5**  
**Assets and Earnings of Selected Individual Banks**  
**1973 and 1974**  
(Millions of dollars)

	Assets			Earnings		
	1973	1974	Changes	1973	1974	Change
<b>Bank of America</b>						
Total	49,400	60,400	+22%	219	257	+17%
International	18,000	25,000	+39%	70	100	+43%
Domestic	31,400	35,400	+13%	149	157	+ 5%
<b>Security Pacific</b>						
Total	9,756	12,069	+24%	60.0	56.0	- 7%
International	808	1,068	+32%	5.4	6.7	+24%
Domestic	8,948	11,001	+23%	54.6	49.3	-10%
<b>Seattle First</b>						
Total	3,595	4,190	+17%	25.5	29.5	+16%
International	89	117	+31%	1.5	3.4	+127%
Domestic	3,506	4,073	+16%	24.0	26.1	+ 9%

Source: Estimated on basis of data in 1974 Annual Reports



ica's international earnings increased 43 percent, compared to only 5 percent for domestic earnings; those of Seattle First increased by 127 percent, compared to only 9 percent for domestic earnings; and those of Security Pacific by 24 percent, compared to an 11 percent decrease in domestic earnings.

To a large extent, the faster increase in international earnings can be attributed to a greater growth rate in international assets than in domestic assets. Indeed, between 1973 and 1974, Bank of America's international assets grew by 39 percent, compared to 13 percent for domestic assets; while the comparable figures were 31 to 16 percent for Seattle First and 32 to 23 percent for Security Pacific.

If the average rate of return is measured by the ratio of earnings to assets, then changes in the profitability of an operation can be measured by the difference between the earning-growth rates and asset-growth rates. Thus, on the basis of the data in Table 5, the profitability of Bank of America's international operations appears to have improved slightly between 1973

and 1974; while Seattle First's improved enormously, and Security Pacific's declined somewhat. In contrast, the three banks' domestic profitability all declined sharply, apparently as a result of the U.S. recession in 1974. Thus, in two of the three cases examined, increased profitability in international operations provided a cushion against the decline in profitability of domestic operations. Even in the third case, where international profitability also declined, the absolute increase in such earnings helped to offset the decline in domestic earnings.

A similar picture is presented by recently published 1975 data for Bank of America (Table 6). Clearly, the 23-percent growth in its international earnings in 1975 remained considerably above its 12-percent growth of domestic earnings. (The comparable growth figures for 1974 were 43 percent and 5 percent, respectively.) When deflated by the respective growth rates in earning assets, the bank's international profitability continued to improve, and its domestic profitability to deteriorate in 1975.

**Table 6**  
**BankAmerica Corporation**  
**Growth in Earnings and Assets**  
**International and Domestic**  
**1974-1975**

	Average Earnings			Average Earning Assets		
	1974	1975	Increase	1974	1975	Increase
	(Million \$)		(Percent)	(Billion \$)		(Percent)
Total	257	302	17.5	43.5	49.3	13.3
International <sup>1</sup>	136	167	22.8	23.9	27.1	13.4
Domestic	121	135	11.6	19.6	22.2	13.3

<sup>1</sup>World Banking Division. Data differ from the corresponding figures presented in Table 5, because of "profit center changes, changes in international allocation of overhead expenses and risk changes and improvements in building block system."

Source: BankAmerica Corporation, *Annual Report 1975*, p. 50.

## Conclusion

As stated at the outset, the rise of regional financial centers has been one of the most interesting developments of the past decade in international finance. These newly-developed centers both complement and compete with old-established centers in the allocation of the world's financial resources. To the extent that these centers have provided closer contacts between international and regional sources and users of funds, they have enhanced the efficiency of international financial markets. Moreover, they have undoubtedly added to the prosperity and economic growth of the regions in which the centers are located.<sup>25</sup>

This paper has traced the rise of the U.S. West Coast as an international financial center. The rise has been remarkably rapid since 1969. In terms of both the volume of capital flows and the worldwide financial interests represented, the West Coast has become today a significant factor in international finance.

Economic theory has largely ignored the phenomenon of regional financial centers. Yet, for both regional economics and development economics, it should be a topic of considerable interest. Recent contributions to economic analysis have emphasized the central role of financial markets in promoting economic growth. To a large extent, the analysis should be applicable to both developed and developing economies. Regional financial centers have evolved in both types of economies to provide important links between national money and capital markets on the one hand and broader world markets (such as the Euro-currency market) on the other. Further, the regional clustering of international banking institutions suggests that the optimal

geographic size of financial markets is perhaps smaller than a large country (such as the United States) and larger than most small countries.

At the present stage of knowledge, this paper is more concerned with *what* has occurred than with *why*. Nevertheless, the brief discussion of economic factors suggests that as commercial banking expanded on the West Coast, a growing number of banks in the past decade attained a size sufficiently large to reap the benefits of international portfolio diversification. Available profits data appear to reinforce the impression that banks were indeed able to reap such benefits by balancing declining domestic loan demand (due to the U.S. recession) with increased international loan demand (due to large payments deficits abroad).

Another key factor has been the rapid growth of West Coast international trade, which has attracted many Edge corporations and foreign banks to the region while inducing domestic banks to start or expand their own international operations. In 1975, the growth of trade slowed down considerably as a result of the worldwide recession. Nevertheless, as many as seven new agencies and branches of foreign banks were opened on the West Coast, and nine new branches of West Coast banks were established abroad. Thus, it appears that the banking industry's interest in international banking on the West Coast remained undaunted by the recession. Both domestic and foreign banks apparently saw the need to maintain their present stake in the market, and thus set the groundwork for further profitable operations in the years ahead.

## FOOTNOTES

1. Charles P. Kindleberger, *The Formation of Financial Centers: A Study in Comparative Economic History*, Massachusetts Institute of Technology, Department of Economics, Working Paper No. 114 (August 1973). Harry G. Johnson, "Panama as a Regional Financial Center," *Economic Development and Cultural Change*, (January 1976), pp. 261-286. Robert F. Emery, *The Asian Dollar Market*, Board of Governors of the Federal Reserve System, International Finance Discussion Papers, No. 71 (November 1975). The older literature includes Margaret C. Myers, *The New York Money Market* (New York: Columbia University Press, 1931); Frank Tamagna, "New York as an International Money Market," *Banca Nazionale del Lavoro Quarterly Review*, (June 1959), pp. 201-234; Sidney M. Robbins and Nestor E. Terleckyj, *Money Metropolis* (Cambridge: Harvard University Press, 1960).
2. A useful survey of the literature on the subject is Gerard S. Goldstein and Leon N. Moses, "A Survey of Urban Economics," *Journal of Economic Literature*, (1973), pp. 471-515.
3. Raymond W. Goldsmith, *Financial Structure and Development* (New Haven: Yale University Press, 1969); Arnold W. Sametz, editor, *Financial Development and Economic Growth* (New York: New York University Press, 1972); Ronald I. McKinnon, *Money and Capital in Economic Development*, (Washington, D.C.: Brookings Institution, 1973); Edward S. Shaw, *Financial Deepening in Economic Development* (New York: Oxford University Press, 1973).
4. Herbert G. Grubel, "Internationally Diversified Portfolios: Welfare Gains and Capital Flows," *American Economic Review*, (December 1968), pp. 1299-1314.
5. Federal Reserve Bank of San Francisco, *Western Economic Indicators*, January/February 1976, p. E-4.
6. *Ibid.*, p. A-8.
7. Raymond Jallow, "World Trade in the West," *California Business*, (May 16, 1974), p. 2.
8. By convention, a bank's total foreign assets equal the difference between its global consolidated total assets and its domestic assets. Global-asset data are published annually in *Rand McNally International Bankers Directory* (Chicago: Rand McNally & Co.). Domestic asset data are reported weekly by large commercial banks to the Federal Reserve System.
9. The five were: Bank of America, United California, Crocker, Wells Fargo, and National Bank of Commerce of Seattle (now Rainier).
10. The newcomers were: Security Pacific, Seattle First, Bank of California, Bank of Tokyo of California (now California First), U.S. National of Oregon, and Sumitomo Bank of California.
11. At the end of 1975, the claims on foreigners reported by West Coast banks amounted to \$12.0 billion, and the liabilities to foreigners \$6.4 billion.
12. *American Banker*, February 29, 1968.
13. BankAmerica Corporation, *Annual Report*, 1969, and *Annual Report*, 1975.
14. The nine banks were Bank of America, Bank of California, Crocker, First Western, Security Pacific, Union, United California, Wells Fargo, and National Bank of Commerce of Seattle. *American Banker*, February 27, 1970.
15. The eleven were Arizona Bank, First of Arizona, Valley National, Lloyds of California, Tokyo of California, Sumitomo of California, Barclay of California, First of Oregon, U.S. National of Oregon, Seattle First, and First of Hawaii. *American Banker*, February 27, 1976.
16. Data reported by banks to the Federal Reserve System.
17. However, the data do not include assets of a) European branches whose total liabilities payable in U.S. dollars amount to less than \$10 million, and b) those elsewhere (except Bahamas) whose total liabilities payable in U.S. dollars are less than \$30 million. Such foreign branches are exempted from reporting their monthly assets and liability positions on FR 502.
18. For a listing of these activities at the end of 1974, see *American Banker*, February 28, 1975.
19. Data on total assets understate the Edge corporations' operations. Since their loan limits are tied to the size of their capital, it is common practice for Edge corporations to generate loans and then sell them or pass them on to their parent banks. There may have been about \$425 million outstanding in such loans at West Coast banking Edges in 1975.
20. The differences between the various types of organizations are discussed elsewhere in this issue. Robert Johnston, "Proposals for Federal Control of Foreign Banks."
21. U.S. Department of Commerce, *Foreign Direct Investment in the United States*, Interim Report to Congress (October 1975), Volume 2, Appendix VIII: "Foreign Banking in the United States," esp. pp. VIII 5-10.
22. George W. Mitchell, Vice Chairman, Board of Governors of the Federal Reserve System, *Statement Before the Subcommittee on Financial Institutions of the Senate Banking Committee*, January 28, 1976, Appendix, Tables 1-6.
23. Two banks each from France, Italy, Switzerland, Brazil, Mexico, and Hong Kong; and one each from Germany, the Netherlands, Korea, and the Philippines; plus a multinational bank, the European American Banking Corporation.
24. Cited in C. Frederic Wiegold, "Overseas Earnings in Sharp 5-Year Rise," *American Banker*, October 20, 1975, page 1.
25. See Harry G. Johnson, *op. cit.*, for an attempt at measuring the welfare gains from the rise of a regional financial center.

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# Commercial Bank Lending to Developing Countries

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Nicholas Sargen

Throughout the earlier part of the postwar era, the majority of developing countries had only limited access to international capital markets, and instead had to rely on official sources to supply the bulk of their external financing requirements. In the early 1960's, bilateral official assistance accounted for over 60 percent of the total net flow of resources to developing countries, while multilateral assistance averaged about 6 percent. Funds supplied by private sources—the remaining third—consisted almost entirely of direct investments and suppliers' credits.

Over the last fifteen years, however, several developments have occurred to make commercial banks an important financing source to developing countries. They include (1) rapid economic growth in the developing countries and failure of official assistance to keep pace with this growth; (2) emergence of the Eurocurrency market as a funding source; and (3) the impact of the oil crisis and the worldwide recession on the external payments positions (and hence the credit demands) of the devel-

oping countries. Consequently, commercial-bank credits today comprise approximately 20 percent of the total net flow of resources to developing countries, bringing the share of private financing to nearly half of the total.<sup>1</sup>

This article reviews the factors contributing to the rapid growth of commercial-bank lending to developing countries—primarily the non-OPEC countries—and addresses itself to two basic issues. First, how exposed are commercial banks to potential default or rescheduling problems? Second, to what extent are commercial banks compensated for added risks they incur in lending to developing countries? The principal finding is that the differential rate of return commercial banks receive from investing in developing countries vis-a-vis developed countries is low by historic standards. However, this does not imply that the differential is insufficient to cover the added risk of default, given the long-run prospects of the major recipients of commercial-bank credits and given the institutional arrangements available for handling their debt problems.

## Rise of Commercial-Bank Lending to Developing Countries

As a group, the developing countries (LDCs) have amassed an impressive economic record over the last fifteen years. During the 1960's, their real national product rose 5.5 percent annually, in the aggregate, and in the first half of the 1970's their annual growth approached 6 percent. These figures far exceed rates in the first half of the century, when

growth in real output averaged two percent, and less than one percent in per capita terms.<sup>2</sup>

Economic growth was far from uniform, however. Nearly half of the lower-income countries (per capita incomes of \$200 or less, 1972 prices) recorded growth rates of less than one percent per capita in 1960-72, whereas over 60 percent of the higher-income countries

**Table 1**  
**Gross Publicized Eurocurrency Credits**  
**to I.B.R.D. Member Countries**  
(\$ millions)

<b>Country Category</b>	<b>1971<sup>a</sup></b>	<b>1972<sup>a</sup></b>	<b>1973<sup>a</sup></b>	<b>1974<sup>b</sup></b>	<b>1975<sup>b</sup></b>
Developing Countries	1,475	4,080	9,116	9,605	11,530
of which:					
Oil Exporters	432	1,117	3,013	773	3,137
Higher-income	918	2,632	5,280	6,980	7,216
Middle-income	62	94	507	1,562	1,105
Lower-income	63	130	317	291	71
Industrial Countries				16,915	4,627
	2,645	3,771	11,125		
Other				2,103	3,373
Total, IBRD Member Countries	4,120	7,851	20,241	28,624	19,530
Non-IBRD members <sup>c</sup>				1,108	2,530

**Major Developing Country Recipients**

<b>Country Category</b>	<b>1971</b>	<b>1972</b>	<b>1973</b>	<b>1974</b>	<b>1975</b>	<b>cumulative '71-'75</b>
<b>Oil Exporters</b>						
Algeria	120	275	1,352	—	500	2,247
Indonesia	—	98	478	348	1,536	2,460
Iran	224	461	712	114	245	1,756
Venezuela	78	258	63	58	200	657
<b>Higher-income</b>						
Argentina	50	264	87	559	34	994
Brazil	212	577	715	1,668	2,069	5,241
Greece	60	330	600	438	239	1,667
Mexico	140	509	1,572	1,478	2,159	5,858
Peru		209	734	366	423	1,732
Spain	420	253	467	1,169	931	3,240
Yugoslavia	10	255	235	549	73	1,122
<b>Middle or Lower-income</b>						
Philippines	—	61	—	883	213	1,157
South Korea	40	30	142	264	312	788
Zaire	55	90	287	71	27	530

<sup>a</sup>Source: OECD, Development Assistance Committee, *Development Co-operation Review*, 1973-74. Data on Eurocurrency loans are based on tombstone advertisements, which were not as commonly used in 1971-72 as in later years.

<sup>b</sup>Source: IMF Survey, February 16, 1975.

<sup>c</sup>Primarily represents lending to Socialist Bloc countries and Hong-Kong. Major 1974-75 recipients are Poland (\$894 million), USSR (\$750 million) and Hong Kong (\$715 million).

(over \$375 per capita) had growth rates of more than 3 percent per capita. As bilateral assistance became increasingly scarce in the 1960's, a larger percentage of the restricted flow was concentrated in the poorest countries. Consequently, a number of the higher-income developing countries were forced to seek alternative sources of financing to sustain their high growth rates. Multilateral lending institutions were able to narrow the gap by extending credits through their "hard loan" windows, but they could not completely satisfy the large loan demands of these rapidly growing countries.

Commercial banks in the Eurocurrency market and in the United States began lending to developing countries on an extensive basis in the early 1970's. The developing countries benefited from a change in Eurocurrency market conditions, from a phase of strong demand for funds at high interest rates in 1969-70 to a phase of rapidly increasing supply in 1971. The shift reflected the large-scale replacement of funds previously borrowed by banks in the

U.S., as well as intensification of controls on capital inflows in the major European countries and Japan, which affected borrowings of their residents from the Eurocurrency market.<sup>3</sup>

The flow of medium-term credits from banks operating in the Eurocurrency market (including credits syndicated and funded by foreign branches of U.S. banks) has grown rapidly since 1971. The amount of Euro-credits with maturities over a year, for example, increased from an estimated \$1.5 billion in 1971 to an estimated \$11.5 billion in 1975 (Table 1). Flows from banks in the U.S. market, on the other hand, have increased from less than \$1 billion in 1971 to about \$7 billion in 1975 (Table 2). Most of this growth in U.S. bank (head-office) claims on LDC's, however, reflects increases in short-term credits (a year or less), which are related to trade financing, whereas U.S. long-term credits have grown at a slower pace. Excluding short-term loans, developing countries received about 45 percent of the commercial bank credits extended abroad since 1971. The latter have

**Table 2**  
**Claims on Foreigners Reported by Banks in the United States<sup>a</sup>**

(\$ millions)

**Long Term Claims**

Region	Long term Claims Outstanding As of Dec. 31, 1975	changes in long term claims				
		1971	1972	1973	1974	Nov. 1975
Developing Country Total <sup>b</sup>	6,134	274	821	658	685	1,446
Total, all countries	9,393	589	1,287	933	1,172	2,199

**Short Term Claims**

Region	Short term Claims Outstanding As of Dec. 31, 1975	changes in short term claims				
		1971	1972	1973	1974	Nov. 1975
Developing Country Total <sup>b</sup>	18,492	608	907	1,473	5,963	5,432
Total, all countries	49,683	2,368	2,199	5,049	18,307	10,653

<sup>a</sup> Long term claims are those over a year, while short-term claims are those a year or less.

<sup>b</sup> Total for Latin America (except Bahamas, Panama, Netherlands Antilles), Asia (excluding Hong Kong and Japan), Africa, and Greece, Portugal, Spain, Turkey, and Yugoslavia.

Source: U.S. Treasury Bulletin, February 1976.

been heavily concentrated in a small number of higher-income developing countries. Three countries in this group—Brazil, Mexico, and Spain—received nearly 40 percent of the long-term credits extended to developing countries since 1971, and roughly half of the credits made in the last two years.

Federal Reserve data collected from 21 large U.S. banks indicate that about two-thirds of total U.S. bank lending to the non-OPEC developing countries is concentrated at the six largest

banks—Bank of America, Citibank, Chase Manhattan, Morgan Guaranty, Manufacturers Hanover, and Chemical (Table 3). As of December 31, 1975, the six banks had almost \$12 billion in loans outstanding to a select group of developing countries, representing about 5 percent of their total assets. Claims on Mexico and Brazil were each about 1½ percent of total assets of the six largest banks, whereas claims on all other developing countries were less than one-half of one percent.

**Table 3**  
**Comparison of Claims on Selected Non-OPEC LDC's with**  
**Total Loans and Total Assets of 21 Large U.S. Banks: December 31, 1975<sup>a</sup>**  
(millions of dollars)

Developing Country	Total Claims		Claims over a year	
	21 Banks	6 <sup>b</sup> Largest Banks	21 Banks	6 Largest Banks
Mexico	5,810	3,573	2,614	1,480
Brazil	5,540	3,734	2,980	1,924
South Korea	1,473	972	313	184
Argentina	1,071	725	242	144
Peru	1,066	665	492	311
Colombia	756	571	157	111
Philippines	740	597	237	181
Taiwan	677	397	143	78
India	197	178	105	105
Egypt	177	162	31	26
Zaire	162	123	120	116
Zambia	99	99	18	18
Uruguay	54	54	—	—
Pakistan	51	51	—	—
Guatemala	38	23	23	12
Total claims on 15 countries	17,911	11,924	7,475	4,690
<b>Memorandum</b>				
Total Loans	218,397	136,078		
Total Assets	394,094	237,621		

<sup>a</sup>Data are for 21 banks reporting foreign assets and liabilities for Senate Subcommittee on Multinational Corporations (Church Committee). These data include claims held by head offices and significant branches and pro-rata share of claims held by significant majority-owned subsidiaries with intra-bank claims netted out; the data exclude claims guaranteed by any agency of the U.S. Government (such as the Export-Import Bank), and claims on which reporting banks believed they had an enforceable guarantee from a U.S. corporation.

<sup>b</sup>Bank of America, Citibank, Chase Manhattan, Morgan Guaranty, Manufacturers Hanover, and Chemical.

Source: "Memorandum on Foreign Assets and Liabilities of U.S. Banks" prepared for Subcommittee on Multinational Corporations by staff of the Federal Reserve Board.

## Impact of the Oil Crisis and World Recession

Until recently, this trend towards increased commercial-bank financing was generally applauded as a means whereby LDCs could become less dependent on official assistance. In the wake of the oil-crisis and worldwide recession, however, many analysts have begun a critical reappraisal of the situation. According to OECD estimates, the combined current-account deficit of all non-OPEC developing countries reached a record \$38 billion in 1975, compared with \$26 billion in 1974 and \$9 billion in 1973, so that a question has arisen regarding the ability of at least some of these countries to continue accumulating debt at such a rapid rate without defaults or reschedulings.<sup>4</sup>

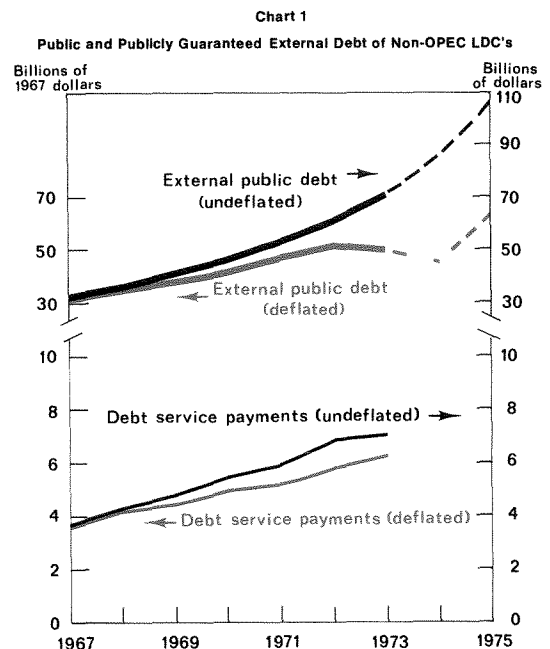
Both structural and cyclical forces help account for the pronounced deterioration in the trade situation of non-OPEC developing countries over the last two years. The initial impact was structural, as the developing countries encountered considerable problems adjusting to the higher price of OPEC oil. With their consumption of petroleum relatively unchanged (Chart 1), they have had to spend \$10-11 billion more annually for oil imports than in 1973.<sup>5</sup> Their annual exports to OPEC countries, on the other hand, have increased by only \$1 billion. In addition, food and fertilizer supply shortages and price increases for other imports in 1973-74 posed further problems, especially for the worst-hit countries in Asia and Africa. Altogether, oil, food, and fertilizer imports cost non-OPEC developing countries about \$14 billion more in 1974 than in 1973, and this represented more than 80 percent of their current-account decline.

In contrast, most of the \$12.5-billion trade deterioration in 1975 reflected cyclical influences, as developing countries lagged the industrial countries into recession. The volume of non-OPEC developing country exports to OECD countries rose far less rapidly in 1974 than in 1973 (8.5 percent vs. 16.5 percent), and then actually declined in 1975. Their import volume from OECD countries, however, did not begin to slow down until well into the second half of 1974. Prices of raw commodi-

ties—the staple exports of developing countries—also began to fall in the latter part of 1974 from their earlier peak levels, while OECD export prices continued to rise, and these softening terms of trade accentuated the deterioration in their trade balance.

### External Debt Accumulation

Prior to the oil crisis (1967-72), the external public debt of non-OPEC developing countries (public and publicly guaranteed external debt over a year's maturity) grew at a steady rate of 14 percent per annum, while debt service grew at an annual rate of 13 percent (Chart 2). There was a noticeable acceleration in debt outstanding and debt service in 1973, but this was offset by extraordinarily high commodity prices. Thus, when deflated by the LDC export-price index, excluding oil (1967= 100), the 1973 figures show no acceleration in growth of "real" debt service payments, and a decline in "real" debt outstanding. Similarly, other debt-burden indicators (e.g., debt service as a percent of exports



Source: World Bank, *World Debt Tables*, Vols. I-II. World Bank data excludes all debts with maturity of one year or less as well as private non-guaranteed external debt. The price deflator used is the LDC export-price index, excluding oil. (1967 = 100). Extrapolations are based on OECD estimates of net long-term borrowings of oil-importing countries. (See text.)



or of GNP) indicate no dramatic changes in 1973 compared with other periods.

Although World Bank data are not available beyond 1973, it is possible to make rough estimates of the external public debt of developing countries from OECD balance-of-payments data. On this basis, net long-term borrowing of the oil-importing countries was about \$15 billion in 1974 and \$20 billion in 1975.<sup>6</sup> These figures, added to external debt outstanding in the previous year (disbursements basis), yield total debt estimates of \$87 billion in 1974 and \$106 billion in 1975.

These 1974-75 estimates are not exactly comparable with World Bank data for earlier periods since they include total net commercial bank credits from the Euro-currency and U.S. markets with over one year's maturity, whereas World Bank data omit private debt which is not publicly guaranteed.<sup>7</sup> Precise comparisons thus cannot be made, but it is still fairly evident that there has been a marked acceleration in LDC external debt in nominal terms. Our estimates, for example, suggest an annual rate of increase of over 20 percent in the last two years.

It is less apparent what has happened to the LDC debt burden in real terms. Real debt outstanding probably declined substantially in 1974 as a result of favorable export price movements, but increased in 1975 when commodity prices fell. Our estimates, based on fragmentary export price data for 1975, indicate an accelerated growth of real debt outstanding—an annual rate of about 11.5 percent in 1974-75, compared with 8 percent in 1967-73. This means, however, that debt has grown much more slowly in real terms than in nominal terms.<sup>8</sup>

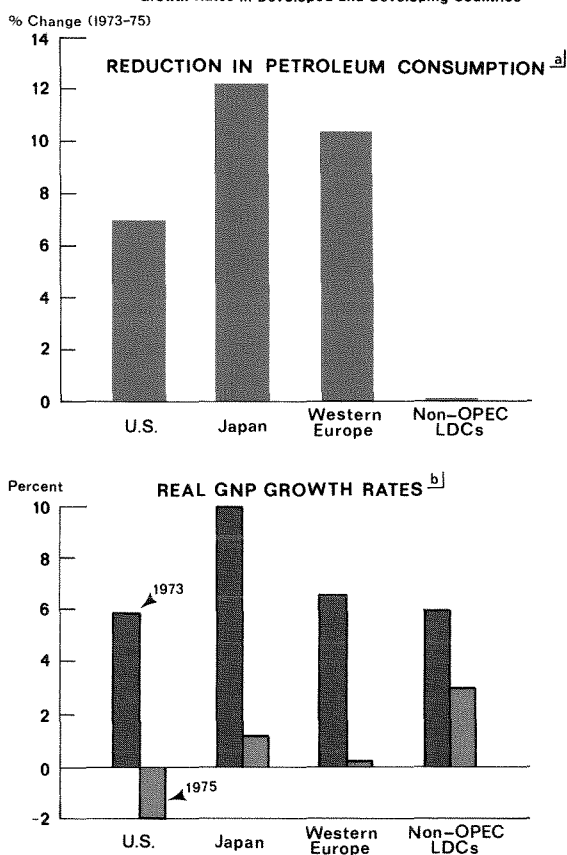
### Balance of Payments Prospects

From the commercial-bank standpoint, the relevant issue is how readily the countries with substantial bank debts can adjust to higher oil prices and world business-cycle fluctuations. Among the key areas to watch are the twelve countries shown in Table 4, which account for over 80 percent of long-term outstanding debt owed by non-OPEC developing countries to

private banks. These countries had combined current-account deficits of over \$18 billion in 1974 and \$20 billion in 1975, but their 1975 increase was considerably smaller than the average for other developing countries. Thus, their share of the combined non-OPEC LDC current-account deficit fell from 70 percent in 1974 to about 55 percent in 1975, and it is expected to fall further in 1976.

Six of the countries (Brazil, Republic of China, Greece, Mexico, Spain and Yugoslavia) were able at the least to prevent sizeable deteriorations in their international accounts in 1975 through a combination of reduction in growth rates and stabilization of inflation rates. Three other countries (Mexico, Peru, and the Philippines) recorded substantial increases in their current-account deficits, albeit relatively modest reductions in real growth rates.<sup>9</sup> Finally, three

Chart 2  
Comparison of Reductions in Petroleum Consumption and GNP Growth Rates in Developed and Developing Countries



Sources: For developed countries, F.E.A., *Monthly Energy Review*, January 1976. For developing countries, Wouter Tims, "The Developing Countries," Chapter 5 in *Higher Oil Prices and the World Economy*, Edward Fried and Charles Schultze, eds., Brookings Institution, 1975.

<sup>b</sup> Sources: For Developed Countries: OECD, *Economic Outlook*. For developing countries, 1975.

of the countries (Argentina, Chile and Zaire) each suffered a sizeable reduction in its real growth rate and a substantial deterioration in its trade account.

The debt problems of these three countries, however, were only remotely related to oil. Rampant inflation and political instability contributed to the foreign-exchange crises in Argentina and Chile, where consumer prices have increased over 200 percent and over 300 per-

cent, respectively for 12-month periods ending in late 1975. Inflation and government spending were also factors in Zaire, although the foreign-exchange crisis there was ultimately triggered by a sharp drop in the world price of copper.<sup>10</sup>

None of these three countries has formally defaulted in the sense of repudiating its debt, and all three are now developing programs to improve their long-run balance of payments

**Table 4**  
**Economic Indicators of Twelve Non-OPEC LDC's**  
**With Large Commercial Bank Debts**

Country	Current Account <sup>a</sup>			Growth Rate <sup>a</sup>		CPI Inflation Rate <sup>b</sup>	
	Balance (\$ billion)			of Real Output (percent)		(percent)	
	actual 1974	est. 1975	proj. 1976	actual 1974	est. 1975	actual 1974	est. 1975
<b>Higher-income</b>							
Argentina	0.22	-0.97	-0.05	7.2	2.5	23	258 (Sept.)
Brazil	-7.15	-7.20	-6.0	9.6	4.	27	29
Chile	-0.38	-0.54	-0.3	5.2	2.	585	338 (Nov.)
China, Republic of	-1.12	-0.12	-0.1	0.6	4.	48	3 (Nov.)
Greece	-1.24	-1.35	-1.35	-3.1	0.75	28	14
Mexico	-2.56	-3.50	-3.25	5.2	4.5	22	17 (Sept.)
Peru	-0.68	-1.15	-1.2	6.6	4.0	17	26 (Sept.)
Spain	-3.15	-2.70	-2.0	5.0	0.	16	17
Yugoslavia	-1.20	-1.20	-1.0	7.5	5.	22	24
<b>Middle or lower income</b>							
Philippines	-0.28	-0.85	-0.85	5.8	5.6	34	2 (Nov.)
South Korea	-1.88	-1.60	-1.40	8.7	7.5	24	26
Zaire	-0.17	-0.45	-0.40	3.5	(-2 to -5)	30	31 (Sept.)
Total, above countries	-18.4	-20.4	-15.25				
Total, all non-OPEC developing countries	25.5	(-35 to -38)	(-29 to -34)			29	28 (Sept.)
Industrial countries	-17.5	+10	(+1 to -2.75)			12.6	10.7

<sup>a</sup>Sources: For Greece, Spain, Yugoslavia, OECD *Economic Outlook*, December 1975. For all other countries, Morgan Guaranty Trust Co., *World Financial Markets*, January 1976.

<sup>b</sup>Source: *IFS Survey*, March 1976. 1975 inflation rates in parentheses are percent changes in last 12 months. All others are averages of monthly changes.

prospects. In early 1975, for example, the Chilean government agreed to a set of measures recommended by the International Monetary Fund, which included imposition of new taxes, a freeze on public employment, tightened credit to the private sector, and adoption of flexible exchange-rate policies.<sup>11</sup> Last December, the government of Zaire also requested I.M.F. assistance to develop a stabilization program, and Argentina is expected to follow suit. Meanwhile, Argentine authorities have undertaken a series of extensive devaluations, designed to stimulate the export trade and improve the trade balance.

### Market Assessment of Developing Country Risk

The recent debate over commercial bank lending to developing countries has focused attention on the alleged high risks entailed in LDC loans. Economic theory, however, leads one to expect that commercial banks will require added compensation if they perceive defaults or reschedulings on LDC loans to be greater than those on loans to developed countries. Hence, commercial banks will not necessarily be vulnerable to LDC external-debt problems, provided their perception of LDC lending risk is generally accurate. On the other hand, if commercial banks systematically understate the risks involved in lending to developing countries, the added revenues they receive on LDC loans will not be sufficient to cover the added costs incurred, and their profit and liquidity positions will be squeezed by LDC defaults or reschedulings. In examining developing country lending risk, therefore, it is important to separate two issues: (1) On what basis do commercial banks form their perception of LDC lending risks, and to what extent are they compensated for the added perceived risk? (2) Is the market perception of LDC lending risk "correct"—i.e. is the compensation sufficient to cover added costs?

To answer these questions, we have analyzed data compiled by the World Bank on publicized Eurocurrency credits completed between the third quarter of 1974 and the third quarter of

In sum, prospects for most of the major recipients of commercial-bank loans suggest an improving trend in current accounts. Their export growth rates should revive due to recovery in the OECD nations, while their import growth should continue to slacken as their domestic economies slow down. Even in instances where countries have incurred debt problems, moreover, the causes are largely unrelated to oil but are predominantly related to domestic difficulties. In these cases, the key to an improved long-run trade position is the ability to bring inflation rates back into line with those of other countries.

1975—altogether, 67 loans to developed countries, totaling \$3.8 billion, and 177 loans to developing countries amounting to \$10.0 billion. Information in each case included the borrower and borrowing country; the leading creditor institutions; the month of the loan agreement; the amount of the credit; the commitment period; and the spread over the London Inter-Bank Offer Rate (LIBOR).

### Average premium on loans to LDCs

First, we were interested in the premium investors receive on credits to developing countries compared with their credits to developed countries. This involves an analysis of the most typical form of Euro-credit, a revolving credit at a floating interest rate. Funds are drawn as a short-term advance, usually renewable at the end of three-month or six-month periods (called the "renewal period" or "rollover period") for a designated term (called the "commitment period"). Rates to borrowers are quoted on the basis of the three-month or six-month LIBOR rate plus the "spread." The latter covers overhead cost, profit, and risk, and is determined on the basis of the borrower's creditworthiness and competitiveness of the market when the commitment is made.

The first regression equation in Table 5 illustrates how the spread varied depending (1) on the recipient of the Euro-credit, whether de-

veloped or developing country, (2) on the date of commitment, whether 1974 or 1975, and (3) on the length of the commitment period. Each of the variables is statistically significant, although the maturity of the loan has a relatively small coefficient and small t-statistic. The latter finding is not surprising, however, in view of the variable interest rates on Euro-credits.<sup>12</sup> The regression results show that borrowers from developing countries paid an average spread of about 140 basis points in 1974, whereas developed country borrowers paid about 25 basis points less on average, reflecting the lower perceived lending risks. In 1975, although the spread was about 40 basis points

higher for each of the two groups, the LDC-DC differential did not change significantly. Expressed as a percentage of borrowing costs (LIBOR + spread), the developing-country premium translated into an additional 2-to-3 percent rate of return on investment over that on developed-country loans.<sup>13</sup>

#### Variation in spreads

Further analysis takes into consideration the fact that there are variations within the group of developing countries. Typically, they are separated into prime and non-prime categories, based in part on each country's per capita income. The second regression in Table 5 takes

**Table 5**  
**Regression Results: Variations in Spreads on Euro-credits, 1974.3-1975.3<sup>a</sup>**  
**(t-statistics in parentheses)**

#### (i) Developed (DC) and Developing Country Loans<sup>b</sup>

Spread =	Constant	Average reduction for developed countries	Average 1975 increase	Maturity <sup>d</sup>
$\bar{R}^2$ = .48	1.41	-.25	.40	-.017
D.W. = 1.58	(18.3)	(6.70)	(10.4)	(1.78)
S.E.E. = .25				
D.F. = 240				

#### (ii) Developing Countries Only<sup>c</sup>

Spread =	Constant	Income "effect"	Mexico "effect"	Debt <sup>d</sup> Service Ratio	Inflation <sup>d</sup> Rate	Avg. 1975 increase	Maturity <sup>d</sup>
$\bar{R}^2$ = .54	1.46	.10	-.27	.006	.005	.26	-.04
D.W. = 1.86	(15.9)	(2.80)	(4.40)	(2.35)	(3.80)	(5.58)	(3.96)
S.E.E. = .21							
D.F. = 170							

<sup>a</sup>Data Source: World Bank, *Borrowing in International Capital Markets*, 5 issues, November 1974-November 1975.

<sup>b</sup>Regression equation is of form: Spread =  $a_0 + a_1 \left\{ \begin{array}{l} \text{LDC}=0 \\ \text{DC}=1 \end{array} \right\} + a_2 \left\{ \begin{array}{l} 1974=0 \\ 1975=1 \end{array} \right\} = a_3 \cdot (\text{Maturity})$ .

Hence, the constant term can be interpreted as the average 1974 LDC spread, unadjusted for maturity.

<sup>c</sup>LDC Spread =  $b_0 + b_1 \left\{ \begin{array}{l} \text{High Inc.}=0 \\ \text{Other}=1 \end{array} \right\} + b_2 \left\{ \begin{array}{l} \text{Other}=0 \\ \text{Mex.}=1 \end{array} \right\} + b_3 \cdot (\text{Debt Ser.}) + b_4 \cdot (\text{Inf.}) + b_5 \left\{ \begin{array}{l} 1974=0 \\ 1975=1 \end{array} \right\} + b_6 \cdot (\text{Mat.})$

Hence, the constant term can be interpreted as the average 1974 spread for higher-income LDCs, unadjusted for maturity, debt-service ratio, and the inflation rate.

<sup>d</sup>Coefficient must be multiplied by the value of the variable. Maturities are usually 5-8 years; debt-service ratios are generally between 10-20%; inflation rates are usually in the 15-30% range.

this into account by distinguishing between higher-income countries and lower- or middle-income countries (using World Bank definitions). In addition, we have included a separate dummy variable for Mexico, in view of that country's long experience as a borrower in international capital markets.

The choice of other variables is less clear-cut. For example, banks differentiate between government and private borrowers, but that distinction is not very meaningful if a loan to a private borrower carries a government guarantee, or if the institution is quasi-official. The data also indicate that project risk is less important than country risk in setting spreads<sup>14</sup>—but there is no generally accepted framework for assessing country default risk. In the absence of such a framework, analysts have tended to use those economic indicators which reflect a country's capacity to service its debt, although there is no general agreement as to which indicators are important in this regard. Despite the large number of possible measures, we have limited ourselves to two of the most commonly used; first, the inflation rate, and second, the debt-service ratio, i.e., the proportion of foreign-exchange earnings on current account absorbed by public-debt service.<sup>15</sup>

All the variables included in the regression are statistically significant and have the anticipated signs. The coefficients of the inflation variable and the debt service variable are quite small, however, so that each adds only about 10 basis points to the spread on average, assuming a 20-percent inflation rate and 15-percent debt-service ratio. Lower and middle income countries paid only about 10 basis points more than higher income countries, whereas Mexico paid about 25 basis points less than other higher income countries and about 35 basis points less than lower-middle income countries. In sum, no single factor appears to dominate in explaining variations in LDC spreads, although Mexico clearly is in a separate category from other developing countries.

It is also instructive to note how commercial banks responded to the large LDC trade defi-

cits. The regression indicates that developing country spreads increased about 25 basis points on average between the second half of 1974 and the first three quarters of 1975. Increases in spreads for major Eurocurrency borrowers other than Mexico, however, were well above the developing country average. The spread which Brazil paid, for example, increased from  $\frac{3}{4}$  of one percent on 12-year loans in late 1974 to  $1\frac{3}{4}$  percent for 5-year loans in 1975, while the spread for Spain increased from 1 percent on 8-year loans to  $1\frac{3}{4}$  percent on 5-year loans. Hence, the relatively small difference in spreads between higher-income countries and lower-middle income countries reflects, in part, bankers' revised perceptions of lending risks to heavy borrowers. Countries which incurred debt problems generally paid the highest spreads, in addition to experiencing sharp reductions in new lending flows.

#### Comparisons with earlier periods

Comparisons of Eurocurrency loan premiums over longer time periods are difficult to make, since calculations for earlier periods are based on bond flotations rather than bank loans. The evidence, however, strongly suggests that the premium attached to portfolio investment in developing countries today may well be at an all-time low. The yield premium between developed and developing country bond issues is much lower today than in 1958-65, when the average LDC yield was nearly one-half to two-thirds higher than that of high-grade U.S. domestic corporate bonds, and between one-third and one-half higher than that on Canadian issues.<sup>16</sup> Differential yields in the 1920's were somewhat smaller (40 percent over U.S. corporate bonds and 25 percent over Canadian public issues in the U.S.), but still well above the differential developing countries pay today.

The narrowing LDC premium in part reflects the increasingly impressive economic performance of the higher-income developing countries. While these countries have been adversely affected by the events of the last several years,

their prospects today are still considerably brighter than they were fifteen or twenty years ago. In addition, the banking system has developed various risk-reducing mechanisms, such as variable interest rates, for example, or syndicated bank loans, which provide a means of spreading country risks that are borne by individual banks.

Finally, attitudes towards default have changed considerably since the 1930's and 1940's, when there were massive LDC defaults on bond issues. At that time, developing countries which encountered foreign-exchange crises had little incentive or option to avoid default.

"Prior to the Great Depression, external long-term debt consisted primarily of bond issues floated abroad. Only rarely could a refunding be arranged prior to actual default. Then some agreement had to be reached by the debtor and the bondholders, often represented by committees, which could not bind the bondholders but could merely recommend acceptance of the proposal. In some instances the debtor made a unilateral offer to the private creditors, which they could accept as the alternative to not being repaid at all. The governments of the creditors were not parties to the agreements, though they could use diplomatic means to protect their nationals."<sup>17</sup>

The differences in the post-war period are striking. Since the late 1950's there have been at least 25 instances, involving 15 different countries, where debt arrearages have had to be ne-

gotiated.<sup>18</sup> Governments of creditor and debtor nations were parties to the negotiations, and the outcome in each case was a rescheduling of a country's debt, rather than outright default. Given present institutional arrangements for handling debt problems, the likelihood of a developing country repudiating its debt is now perceived to be quite low.

Past experience suggests that the market's perception of LDC risk has not systematically understated the costs involved. The relevant issue today, though, is whether the developing country debt situation will be the same in the future as in the past. There are few signs to indicate a hardening attitude in creditor government attitudes, although governments of some developing countries have urged a moratorium on foreign debt-service payments. The more likely development is that future reschedulings will involve both official and commercial-bank credits. One can only speculate, however, as to how often countries will have to reschedule, whether bank credits will be rescheduled in proportion to their share of external debt-service payments, and whether credits will be rescheduled at market interest rates. The debt negotiations in Argentina, Chile, and Zaire are significant because they provide the first test cases of reschedulings in countries where commercial-bank credits comprise a sizeable portion of the external debt service. As these negotiations are concluded, it is possible that the market's perception of LDC risk could be altered.

## Conclusion

It is important to separate two issues in the debate over commercial-bank lending to developing countries: (1) Are commercial banks vulnerable to LDC defaults? (2) Are commercial banks adequately compensated for the added risks incurred in lending to developing countries?

On the first issue, our analysis suggests that fears of significant commercial-bank exposure to LDC defaults are grossly exaggerated. Some analysts have focused attention on the record LDC trade deficits and the debt problems of

individual developing countries, and have suggested that developing countries, as a group, are accumulating debt too rapidly. The aggregate trade statistics, however, can be misleading in a number of respects. First of all, the LDC current-account deficits do not translate into comparable increases in net long-term borrowings due to non-bank sources of financing (e.g. official transfers, direct investment, etc.). Second, the distinction between nominal debt accumulation and real debt accumulation is seldom made, even though LDC debt apparently

has grown much less in real terms than in nominal terms. Third, countries which are major recipients of commercial-bank credits are in a far better position to adjust to external shocks than are most other developing countries. Several countries have experienced debt problems, but their difficulty, most likely, is one of rescheduling rather than default. Moreover, their loans comprise a very small fraction of U.S. bank assets.

On the second issue, we find that commercial banks have responded to higher perceived

risks through above-average increases in spreads to major borrowers and to countries with debt problems, and through the curtailment of lending to those with debt problems. Still, the differential rate of return between developed and developing country loans appears low by historic standards. However, this does not imply that the differential is insufficient to cover added lending risks, especially in view of governments' increasing tendency to minimize the possibility of default.

#### FOOTNOTES

1. The total net flow of resources received by developing countries was an estimated \$40.8 billion in 1974, of which commercial bank credits over a year exceeded \$8 billion. OECD Development Assistance Committee, **Development Co-operation** (1975 Review).

2. Historical data are from Paul Bairoch, **The Economic Development of the Third World Since 1900** Berkeley: University of California Press 1975. In large part, the economic growth in the 1960's and 1970's was export-led, a response to the rapid growth of the world economy and its impact on world trade. Thus, the LDC export growth rate averaged about 8.5 percent per annum in 1960-72 compared with less than 5 percent in the preceding 60 years.

3. Azizali Mohammed and Fabrizio Saccomanni, "Short Term Banking and Euro-Currency Credits to Developing Countries," International Monetary Fund, **Staff Papers** 20, 1973, p. 617.

4. In contrast, the combined current-account balance of the major industrial nations reached an estimated \$10-billion surplus in 1975—a \$27-billion swing from the \$17.5-billion deficit of 1974.

5. Consumption of petroleum in the OECD countries, on the other hand, has fallen by 9 percent over the last two years. Given the short time interval, it is difficult to determine how much of this reduction is due to income effects related to the recession, and how much is due to price effects, or to energy conservation measures.

6. These figures are obtained by taking OECD estimates of net aid flows (excluding official transfers), net "other official flows," and net Euro-credits to the oil-importing countries, and adding U. S. Treasury estimates of U. S. long-term banking flows. OECD, **World Outlook**, December 1975, Table 30, p. 65. Estimates of net Euro-currency credits for 1975 have also been revised to reflect more recent data.

7. There is no easy way of extrapolating the amount of publicly guaranteed bank credits. Morgan Guaranty estimates the increase in disbursed government and government guaranteed external debt of over one year's maturity to be about \$30 billion, compared with our figure of \$36 billion. **World Financial Markets**, January 1976.

8. This is in sharp contrast to the experience of the 1930's, when sustained price declines brought about just the opposite effect—a much faster accumulation of debt in real terms than in nominal terms.

9. In the Philippines the trade deterioration was aggravated by sharp declines in sugar prices and copper prices. Over the long run, the country should benefit from the substantial reduction in inflation brought about by recent policies of monetary restraint.

10. Copper prices increased by about 170 percent from the end of 1972 to mid-1974, but lost almost all of that gain over the next eighteen months. In the meantime, Zaire accumulated foreign debt at an extremely rapid rate, more than doubling its outstanding debt in 1974 with net borrowings of \$650 million.

11. Subsequently, Chile formally requested a meeting of its creditors to consider rescheduling \$700 million of debt-service payments due in 1975. In May, seven of the creditor nations agreed to reschedule \$230 million of that amount. Since then, Chile has met all debt-service payments owed to commercial banks.

12. If interest rates were fixed over the term of the loan, one would expect a positive coefficient if the yield curve were upward sloping, and a negative coefficient if the yield curve were negatively sloped. With variable interest rates, however, the term effect should be less pronounced.

13. The figure assumes a LIBOR rate between 8-10 percent, and excludes commitment fees and management fees for syndicated loans, which are usually on the order of  $\frac{1}{4}$  to  $\frac{1}{2}$  of one percent.

14. For example, governments of countries such as Brazil, Mexico, and Spain, which typically finance a large number of projects concurrently, have generally paid about the same spread irrespective of the project. This does not mean that individual projects are unimportant, but rather that the government's ability to repay the loan does not hinge on the success or failure of any single project.

15. This indicator is used because debt service represents a fixed obligation which must be paid out of foreign-exchange earnings; hence, a higher ratio is thought to imply increased vulnerability to any foreign-exchange crisis. However, the indicator has been criticized because a number of countries have been able to sustain high ratios for long periods without incurring debt problems. The intent here is not to resolve this long-standing dispute, but simply to examine empirical evidence about whether commercial banks actually rely on the ratio.

16. The 1958-65 comparison was based on a sample of 14 LDC issues and included both public and privately placed issues. Hang-Sheng Cheng, **International Bond Issues of the Less Developed Countries: Diagnosis and Prescription** (Iowa State University Press, 1969), pp. 46-47.

17. Henry J. Bittermann, **The Refunding of International Debt** (Duke University Press, 1973), p. 4-5.

18. The list of countries includes: Argentina, Brazil, Chile, Turkey, India, Indonesia, Ghana, Liberia, Peru, United Arab Republic, Uruguay, Philippines, Yugoslavia, Tunisia, and Pakistan. These cases are reviewed in detail in Bittermann, *op. cit.*

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# Proposals for Federal Control of Foreign Banks

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Foreign banks have operated in the United States for over a hundred years, but they have begun to attract attention only recently, primarily as the result of the rapid expansion of their activities in the nation's major financial centers. In the past few years, foreign banks have become an important part of the national banking scene, and yet this growth has taken place under rules laid down by state law, not Federal

law. The entry of foreign banks into specific markets has been determined primarily by the laws of the various states, so that foreign banks have been able to escape almost entirely from Federal banking control. Consequently, a series of Congressional proposals have been made to bring foreign-bank operations under effective Federal control.

## Growth of Foreign Banks

Until the late 1960's, most foreign banks were located in New York City, being attracted there by the advantages of direct access to the New York money market and by the ability to offer New York facilities to their international customers. Apart from New York, California was the only state at that time with any significant number of foreign banks. Most of California's foreign banks specialized in serving international and business customers, but some differed from their New York counterparts by gradually building up a retail banking network.

The foreign-bank sector expanded rapidly in the early 1970's, in terms of both numbers and operating volume. The number of U.S. banking institutions owned by foreign banks rose from 85 to 104 between 1965 and 1972, and then accelerated to reach 181 by September 1975. This growth was fostered by their ability to establish an interstate banking network in a form denied to U.S. domestic banks. Because of legal organizations open to them under various state laws, foreign banks can establish banking offices across state lines (see appendix). In contrast, their domestic competitors are limited to their

home states, except for international banking subsidiaries operating as Edge Act Corporations. Foreign banks can open branches or agencies in as many states as will license them. These branches and agencies are not separately incorporated but are legally offices of the foreign banks, so that the usual prohibitions against interstate branching or acquisitions do not apply, as they would to domestic banks.

Many foreign banks come under the Bank Holding Company Act (BHC Act), but this Federal statute affects only those controlling domestically-chartered banks. A foreign bank controlling a banking subsidiary — that is, a *commercial bank* with a state (or more rarely) national charter—must register as a bank holding company, and as such it is prohibited from making interstate acquisition of additional banks. But *branches* and *agencies* are not “banks” for purposes of this Act, which means that these holding companies can expand across state lines through new branches or agencies. Moreover, a foreign bank that limits its U.S. banking operations to branches or agencies is not subject to Federal banking laws,



and it can also engage in nonbanking activities closed to U.S. banks and to those foreign banks which do come under the BHC Act.

Only ten states explicitly permit some kind of foreign banking, but this group of ten includes New York, California, and since 1973, Illinois. The ability to operate in the nation's three largest financial markets gives foreign banks a useful advantage over their domestic competitors. Currently, 44 foreign banking organizations have offices in at least two states, and 20 of them operate in three or more states. The growth of these interstate banking operations — a privilege denied domestic banks — helps explain the pressure behind the proposals for expanded Federal control.

Another reason for such pressure is the growing importance of foreign banks in the nation's credit markets, as shown in recent Congressional testimony by Federal Reserve Governor George Mitchell.<sup>1</sup> Between November 1972 and September 1975, "standard" banking assets of these institutions (after adjustments for clearing and transactions with the foreign parent bank or its affiliates) jumped from \$18 billion to \$41 billion. Their commercial and industrial loans doubled in this period from \$11 billion to \$23 billion, equalling one-fifth the business-loan volume of large domestic banks. Furthermore, three-quarters of their business loans were made to domestic (not foreign) borrowers. Yet despite these developments, total "standard" assets of foreign banks amounted only to about 5 percent of the total assets of all

U.S. banks last year.

To a large degree, the foreign banks' rapid expansion in the U.S. reflects the worldwide growth of international banking. Foreign banks, in a sense, are following the U.S. banks' example by expanding overseas. For competitive reasons, foreign banks have had to follow their domestic customers to this country, since a major international bank must have at least one U.S. office if it expects to match the range of services offered by competing institutions. With the rapid development of international banking, foreign banks have become active in many national banking markets besides the U.S.—but in no other major country do national monetary and regulatory bodies have such little control over the foreign banks operating within their boundaries. Most such operations here are not subject to Federal Reserve System reserve requirements. Federal regulatory supervision is limited to subsidiary banks, and does not extend to the more important branches and agencies.

Further pressure for federal regulation arises from the recognition that the U.S. government is at a disadvantage in negotiating with foreign governments on behalf of U.S. banks, because effective control of foreign banking in the United States is in the hands of the individual states. A Federal presence in the control of such operations would increase the U.S. bargaining power when discussing banking issues with other governments.

### Federal Legislative Proposals

Legislation to modify the present situation must consider domestic banking policy but also recognize possible international consequences. New regulations for foreign banks would affect the pattern of domestic competition, but changes which limit existing rights of foreign banks could result in new restrictions against U.S. banks operating abroad. Indeed, American banks and their customers would have more to lose in any such situation; the assets of U.S. banks abroad (\$135 billion) are three

times greater than foreign banks' assets here.

Legislation now being considered in Congress would eliminate discrimination by following a policy of uniform or national treatment. Foreign banks would have no more rights than U.S. domestic banks; both would operate under the same regulatory standards. A policy of non-discriminatory treatment, even where it has restrictive effects, is clearly easier to justify to foreign governments and less likely to result in retaliation.

The treatment of existing but nonconforming activities always presents a policy question, with several different legislative answers. Existing activities could be forced to conform fully to new regulations, but on the other hand, banking legislation commonly exempts or "grandfathers" existing operations, applying the new law only to operations begun after a specified date. A good example is the Bank Holding Company Act. Each interstate bank holding company existing when the Act became effective in 1956 was allowed to keep the banks it owned outside its principal state of operations, but future acquisitions were forbidden. In 1970, when the BHC Act was revised, grandfather rights were given to certain nonbanking subsidiaries. In the present context, grandfathering could be advocated because foreign banks originally established their operations legitimately under state statutes, and elim-

ination of these existing rights might be regarded as a violation of our international treaty obligations.

Congress is now considering three separate bills that would establish Federal regulation of foreign banks. They all have the common aim of achieving equality of treatment between domestic banks and their foreign competitors while establishing more effective Federal control. The first is the Federal Reserve System's proposal, the Foreign Bank Act, originally introduced in December 1974 and reintroduced in March 1975. This bill deals only with foreign banking. The Financial Reform Act of 1976, while aimed generally at a general reform of financial institutions, contains a section dealing specifically with foreign banks. The third bill, the International Banking Act of 1976, in many respects resembles the Foreign Bank Act.

#### **A. Foreign Bank Act of 1975**

The Foreign Bank Act is based upon the principle of nondiscrimination: foreign banks in the United States should have the same powers as equivalent U.S. banks but no more than that. The bill came about as a result of Federal Reserve discussions with foreign banks, foreign governments, and U.S. banking organizations. Its provisions are detailed and in many sections very complex, but its goals are clear—to establish equal treatment consistent with established rights of foreign banks, and to achieve effective Federal control over this growing sector of the banking system.

##### **Control of branches and agencies**

The Foreign Bank Act deals with the question of interstate expansion by simply redefining all branches and agencies as "banks" for purposes of the Bank Holding Company Act. Foreign parent banks not presently covered would be regarded as bank holding companies. All interstate expansion by way of branches or agencies would be stopped. Since the BHC Act forbids interstate acquisition of "banks," foreign banks would be limited to their existing

states of operation. But within those states, foreign banks could (with Federal Reserve permission) establish new branches or agencies and bank subsidiaries, on the same basis as domestic banks. Foreign banks entering the United States for the first time would be limited to a single state—in practice, probably either California or New York.

The BHC Act contains a clause allowing interstate acquisitions if state law gives specific permission and if the right is available to both domestic and foreign banking organizations. Only Maine to date has passed such legislation, although enabling bills have been introduced on occasion in both the California and New York legislatures. In brief, foreign banks would be unable to open branch offices across state lines until such time as domestic bank holding companies are allowed interstate acquisitions.

With all foreign banks brought under the BHC Act, their activities in nonbanking businesses also would come under Federal regulation. The BHC Act limits nonbanking activities to those approved by the Federal Reserve Board of Governors as being closely related to

banking. Consequently, foreign banks would have to conform to the same set of rules which govern the nonbanking activities of domestic bank holding companies. For some foreign banks, particularly those involved in the securities business, this provision would cause problems, but for others it would confirm their right to engage in approved lines of domestic financial services.

### **Federal Reserve membership**

Membership in the Federal Reserve System would be compulsory for all U.S. offices of foreign banks whose world-wide assets are above \$500 million. This provision would bring almost all foreign banks under domestic monetary control.

### **Federal branches and national banks**

At present, foreign banks have little choice except to operate under state license, whereas under the dual banking system, domestic banks have the choice of operating either under national or state regulations. To make dual banking an effective option, the Foreign Bank Act would permit up to one-third of each national bank's directors to be foreign nationals and would remove the present provision of the National Bank Act requiring U.S. citizenship for all directors. Secondly, the Act would establish a Federal equivalent to the state-licensed branch, and would permit conversion of state-licensed branches or agencies to Federal status. Each foreign branch would have all the privileges of a national bank, except that its lending limits would be based upon the capital of its foreign parent. For these reasons, a Federal branch clearly would represent an important new option for foreign banks.

### **FDIC insurance**

FDIC insurance, currently available to bank subsidiaries of foreign banks, would be made available to branches and agencies as well. Actually, FDIC insurance does not appear to be necessary now for most branches, which are engaged mostly in wholesale-banking business, but under the principle of competitive

equality, insurance coverage for branch deposits should be allowed. In California, this provision would permit agencies to assume the equivalent of branch status; at present, California law does not permit foreign agencies to accept deposits of domestic customers, because their deposit accounts cannot be insured by the FDIC.

### **Federal licensing**

Federal authorities would establish effective control over the entry of new banks and the expansion of existing offices by requiring any foreign bank entering the United States to apply for a Federal license. Foreign banks already here would only have to register, but licenses would be required for all future acquisitions or mergers involving other banks, or for the opening of additional branches or agencies. The only exception would be *de novo* offices of bank subsidiaries, because such offices are not regarded as separate "banks." The Comptroller of the Currency would issue licenses, after applying the usual regulatory standards and consulting with the Federal Reserve, the Treasury and the Department of State. The Secretary of the Treasury could instruct the Comptroller not to issue a license, if it was "not in the best interests of the United States," whenever it appeared necessary to block entry for foreign-policy reasons.

### **Grandfather rights**

The Foreign Bank Act follows the precedent of the BHC Act in allowing liberal grandfather rights. In doing so, it resolves most objections to the bill expressed by foreign governments, and thus minimizes the danger of retaliation. The Foreign Bank Act would grandfather all existing offices of foreign banks as of the date the bill was first introduced (December 3, 1974). Within its principal state of operations (measured by total assets), each foreign bank would be allowed to expand according to rights presently existing for domestic banks under state law. In other states, it could make no more new acquisitions, but could maintain any existing branching rights.

In the special case of investment-banking

subsidiaries, only existing offices would be grandfathered and no further expansion would be permitted. This would conform with the provisions of the Glass-Steagall Act, which separates commercial from investment-banking operations—in contrast to the situation in Europe, where the two activities are commonly combined. Because of the limited number and size of the securities affiliates controlled by foreign banks, grandfathering of existing offices would appear to be the most acceptable solution. Current rights would be protected, but future expansion in violation of the intentions of the Glass-Steagall Act would be expressly prohibited.

### **Other provisions**

The Foreign Bank Act allows foreign banks, for the first time, to establish Edge Act Corporations (see appendix). Edge Act subsidiaries could be established in other states as well as abroad, but U.S. offices would be limited to a purely international banking business. Because of the international specialization of many foreign banks, Edge Act subsidiaries would represent a reasonable alternative to the present agency form of organization as a mechanism for conducting business in other financial centers—and they would represent an alternative already open to U.S. banks.

In its original form, the Foreign Bank Act excluded from Federal regulation two forms of organizations used by foreign banks to operate in the United States—joint-venture banks operated by foreign banks, with none owning more than 25 percent of the outstanding shares,<sup>2</sup> and New York State-chartered investment companies which can conduct a banking business. The exception was made because of

the very small number of these banking organizations, and because of the possible impact on domestic nonbank corporations of changing the BHC Act definitions of control. However, a number of foreign banks have recently applied for permission to form joint-venture banks or New York State investment companies, subsequent to the introduction of the Foreign Bank Act. In view of the potential for evasion of Federal control, the Federal Reserve has now proposed several limiting amendments. Future investment companies chartered in New York to engage in commercial banking would be subject to the same provisions applicable to branches and agencies. As for joint ventures, the definition of control would be changed to cover cases where shareholders, as in consortia banks, act in concert to control a domestic bank. This restriction would apply to domestic cases of joint control as well as to foreign banks.

### **Summary**

The Foreign Bank Act would bring foreign banks in the United States under comprehensive Federal control. Federal supervisory and examination procedures would be applied to insure that appropriate banking practices are followed. Federal Reserve membership would be required to insure that an important sector of the banking industry is brought under national monetary control. Foreign banks would lose certain privileges, principally in multi-state banking, but generally would exercise the same rights as domestic banks. Federal licensing procedures on entry and acquisitions would help strengthen the Federal governments' ability to obtain nondiscriminatory treatment for U.S. banks operating overseas.

## **B. Financial Reform Act of 1976**

The Financial Reform Act of 1976 is the companion piece in the House to the Financial Institutions Act passed by the Senate in December 1975. This legislation reflects proposals contained in the recent Congressional study, Financial Institutions and the Nation's Economy (the FINE study), as well as the extensive hear-

ings on that study. The FINE study was designed as a general reform of the nation's financial system — including activities of foreign banks — and the subsequent legislation represents a thoroughgoing, though more limited, revision of the system.

Chapter 4 of Title I of the Financial Reform

Act deals with foreign banks. Although based on Title VI of the FINE study, this chapter has been substantially revised as a result of proposals made by Federal Reserve representatives and others at Congressional hearings on this subject. Chapter 4 is designed to establish competitive equality between domestic and foreign banks, but the treatment of foreign banks is markedly different from that proposed in the Foreign Bank Act.

The following provisions of Chapter 4 would affect foreign banks' activities in this country:

#### **Grandfather rights**

There would be no permanent grandfather rights for nonconforming banking offices and for securities affiliates controlled by foreign banks.

#### **Federal licensing for entry**

The entry of foreign banks would be subject to Federal licensing requirements. Consultation with the Treasury Department and the Secretary of State would be required. This provision is similar to the corresponding one in the Foreign Bank Act, except that state-licensed branches and agencies would not be covered.

#### **Treatment of branches and agencies**

Federally-licensed branches would be permitted, except in states which prohibit such branches. Federal branches would maintain a surety deposit with the FDIC sufficient to give coverage such as that provided by FDIC insurance. Interstate expansion by either state or Federal branches would be prohibited.

#### **National Bank Act**

Foreign banks would be allowed to have subsidiaries, under the same terms as the National Bank Act, and up to one-third of national bank directors could be foreign nationals. These subsidiaries would be known as "interna-

tional banks." Edge Act subsidiaries would also be permitted.

#### **Nonbanking subsidiaries**

Nonbanking subsidiaries controlled by foreign banks would be subject to the same rules that are applied to domestic bank holding companies under the BHC Act. This clause is the same as in the Foreign Bank Act, except that non-conforming affiliates would have to be phased out within five years.

#### **Federal Reserve membership**

Federal branches and banking subsidiaries of foreign banks would be subject to the same reserve requirements that are applied to similar domestic banks by the Federal Reserve System. Federal Reserve services and credit would be available to these institutions. State-licensed branches and agencies would be subject to System reserve requirements but would not have access to System services.

#### **Summary**

The Financial Reform Act now being considered by the House is much closer to the Foreign Bank Act than to the FINE study in its foreign banking clauses. However, like the FINE study, it excludes grandfather rights for existing interstate banking offices. This amounts to a strict interpretation of the principle of equal treatment for all financial institutions. In the FINE Study, the impact of this exclusion was largely offset by a liberalization of interstate branching rights for all banks. In contrast, the Financial Reform Act makes no change in branching laws, so that its lack of a grandfather clause would have a more substantial impact on foreign banks. The Financial Reform Act, like the Foreign Bank Act but not the FINE Study, includes such provisions as foreign directors for national banks, federal licensing, and FDIC coverage of branch deposits.

### **C. International Banking Act of 1976**

The third bill now before Congress, the International Banking Act of 1976, resembles the other pieces of legislation in its basic ap-

proach—giving foreign banks the same rights as domestic banks while bringing their operations under Federal control.

## **Grandfather rights**

Multi-state banking operations would be grandfathered, except that state-licensed branches and agencies outside the principal state of operations would have to convert to Federal branch status.

## **Federal licensing for entry**

Federal licenses would be required, and foreign individuals' share purchases involving control of a domestic bank would require Federal approval.

## **Treatment of branches and agencies**

Federal licenses for branches would be available except where state law prohibits such branches. Interstate expansion by branches or agencies would be allowed with state permission. As a substitute for FDIC insurance, an equivalent surety deposit would be required. Multi-state branches would all have to be Federal branches.

## **Nonbanking subsidiaries**

Nonbanking activities of foreign banks which control subsidiary banks, branches or agencies would be limited to those allowed under the BHC Act. Securities affiliates could deal in securities to the extent allowed national banks.

## **Federal Reserve membership**

Federal Reserve membership would be required for all banking subsidiaries. Branches and state-chartered investment companies controlled by foreign banks would be subject to System reserve requirements.

## **Summary**

The International Banking Act is generally similar to the Foreign Bank Act. An earlier draft circulated in 1975 would have prohibited foreign branches from accepting domestic deposits; this provision has been removed. This bill gives the states more latitude than they have under the Foreign Bank Act to control multi-state branch operations. Individual states could forbid the entry of foreign branches, but those that wish to build up a local international banking market could continue to do so. Multi-

state branching would be allowed if permission is obtained from banking authorities in both the home state and the state which the foreign bank wishes to enter. Such rights need not be granted to domestic banks, as the Foreign Bank Act requires. All such multi-state branches would have to operate with Federal licenses. Multi-state acquisitions of banking subsidiaries would continue to be prohibited under terms of the BHC Act.

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The proposals described in this article have the common goal of establishing effective Federal control over foreign banks operating inside the United States. They also adopt the principle of nondiscrimination or equality of national treatment. Nonetheless, important differences remain despite common goals and principles.

On the issue of federal control, all adopt with little variation the same general approach: Federal licensing of foreign banks entering or expanding their banking activities inside the United States. Consultation with the Treasury Department and State Department would be required by the appropriate licensing agency to allow for consideration of foreign-policy goals. Nonbank subsidiaries and affiliates would all be brought under the Bank Holding Company Act. Federal Reserve System reserve requirements would be imposed for purposes of monetary control.

The most significant difference concerns the application of the principle of equal treatment to nonconforming multi-state banking offices. The strict view, as embodied in the Financial Reform Act, would phase out foreign banks' multi-state banking offices where domestic banks do not have equivalent powers. The alternative, followed in the other bills, would grandfather existing banking operations but prevent new multi-state offices.

The Federal Reserve's view is that no permanent competitive advantage would accrue from the retention of existing multi-state banking offices, and that the past legislative precedent for domestic bank holding companies would support a liberal grandfather clause in this case

as well. Moreover, liberal treatment would minimize the possibility of foreign retaliation against U.S. banks, and would be more consistent with U.S. efforts to strengthen the international banking system.

The Foreign Bank Act of 1975, the International Banking Act of 1976 and the Financial Reform Act of 1976 are all under consideration in this session of Congress. The first two are aimed at foreign banking within the framework of existing banking laws, while the latter treats foreign banking as part of a general reform of domestic financial institutions. Whichever approach is taken, the era of regulatory

dominance by state regulators is coming to an end. In the process, foreign banks will lose some privileges and gain others, but the trend will be to national treatment under the primary control of the Federal government.

#### FOOTNOTES

1. Statement by George W. Mitchell, Vice Chairman, Board of Governors of the Federal Reserve System, January 28, 1976, before the Subcommittee on Financial Institutions of the Committee on Banking, Housing and Urban Affairs, United States Senate.

2. Under the BHC Act, a corporation owning more than 25 percent of the shares of a bank was presumed to control that bank, and the corporation was required to register as a bank holding company. Below 25-percent and above 5-percent ownership, a formal finding by the Federal Reserve was required to establish that "control" existed.

### APPENDIX: GLOSSARY OF BANKING ORGANIZATIONS

*Domestic banking subsidiary*—A domestic bank with its own board of directors and capitalization. It is called a subsidiary because a controlling interest of its shares is owned by a foreign parent bank. The parent bank is regarded as a bank holding company and is regulated under the Bank Holding Company Act by the Federal Reserve System. The subsidiary bank is subject to the same regulatory rules as its domestic bank competitors and has access to FDIC insurance. Lending limits are determined by the subsidiary bank's own capital and surplus, not that of its parent. Federal Reserve membership is optional if the bank is organized under state law, and in practice most banking subsidiaries are nonmembers.

*Branch Office*—An office of a foreign bank licensed to do a banking business by a particular state, but with no separate corporate charter. A branch can make loans and accept domestic deposits. The deposits are subject to state reserve requirements but these can be met partially by interest-earning assets, so that the effective burden is less than that of Federal Reserve requirements. With some limitations, branches conduct a general banking business similar to that of a domestic bank. Unlike a domestically-chartered bank, the lending limit of a foreign branch is determined by the capital of the parent bank. Branch licenses are available in New York and Illinois. Some branches also operate in Oregon and Washington with deposit-accepting powers by virtue of grandfather rights.

*Agency office*—An office which, like a branch, has no separate corporate charter and is regarded as an office of the parent bank. An agency, unlike a branch, cannot accept domestic deposits but must

raise its funds through non-deposit sources, including funds of its parent or other commercial banks. An agency is not subject to lending limits and to reserve requirements. Under New York law, foreign banks can choose between agency and branch status. In California, because of a state requirement that domestic deposits have FDIC insurance, foreign bank offices are usually regarded as agencies (following New York terminology), although the state law describes them as branches. In Washington, foreign bank branches are effectively agencies, because only small amounts of domestic deposits are permitted.

*Representative office*—An office which conducts no direct banking business. Business is solicited on behalf of and appears on the books of the parent bank or its affiliates. Under California law, representatives are licensed by the state, but in most states they are not regulated because they are not engaged directly in any local banking activity. Representative offices are the most common form of foreign banking presence in the United States.

*Edge Act Corporation*—A subsidiary of a member bank formed to engage in international banking, through foreign and domestic offices. The domestic offices may be located in states outside that of the parent bank. Edge Act operations in the United States are limited to international banking and acceptance of domestic deposits arising from international transactions. Lending limits are set by the capital of the subsidiary, not the parent bank. Edge Act corporations allow domestic banks to operate multi-state offices for international banking purposes, and they are similar to foreign agencies.