FOREIGN BANKING IN THE UNITED STATES:

Movement Toward Federal Regulation

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For at least a decade now, there has been much discussion about bringing foreign bank operations in this country under some form of Federal control. Recommendations that the scope of Federal regulatory authority be extended to cover foreign banks operating in the U. S. have come from several different quarters, both within and outside government. In response to this discussion, a number of bills directed toward foreign banking have been introduced in Congress, although none has been enacted to date. Today a new sense of urgency surrounds the issue, largely as a result of the dramatic growth in the foreign banking presence that has occurred during the past several years. Since January 1973, for example, the number of separately chartered and licensed foreign banking facilities has increased from 111 to 180, and the combined assets of these facilities have more than doubled to $57 billion. Consequently, Congress is now closer than ever to acting on the question, and it seems likely that a foreign banking bill will be enacted in 1976. Foreign banking legislation will probably follow one of two basic scenarios: the Federal Reserve framework, embodied in its proposed legislation known as the Foreign Bank Act of 1975,[1] or the House Banking Committee framework, outlined in the FINE (Financial Institutions and the Nation's Economy) study discussion principles.

The character of the eventual legislation is a matter of interest to all bankers, not just those who themselves engage in international operations or who have direct dealings with foreign banks. Foreign banking operations have grown to such an extent (over 6 percent of total bank assets in the U. S. are now under foreign control) that they now have an important effect on credit market conditions generally. This article reviews the background that has influenced the movement toward Federal regulation of foreign bank operations and outlines the major ideas contained in the two legislative proposals active today.

The Nature of Foreign Banking Operations The U. S. activities of foreign banks have been conducted through four basic organizational forms: representative offices, agencies, branches, and subsidiary banks. Representative offices, which have no real banking powers *per se*, constitute the most primitive form of activity. They serve as customer information centers and business generating facilities, much as do the so-called loan production offices opened in various parts of the country by large domestic banks. Of the states that allow foreign banking, only California requires licenses for representative offices. As a practical matter, the traveling representatives of foreign banks have unlimited access to customers across the nation, so the information and assistance function is virtually free of constraints.

Agencies engage in various types of lending and investment activity, are not empowered to receive deposits, and in all cases must be licensed. They are particularly active in financing trade and investment between the U. S. and their home nation and also participate heavily as lenders and borrowers in the interbank credit markets and Eurocurrency markets. As primary sources of funds, agencies rely on balances placed with them by affiliated institutions (e.g., parent banks in their home country) and short-term borrowings from other banks.

The U. S. branches of foreign banks conduct a general banking business including, in most cases, solicitation of demand and time deposits. They have an essentially wholesale orientation, and most of their loans are of a business and commercial nature. Their loans have traditionally been made to the U. S. subsidiaries of home-based corporate customers, but they are becoming more and more interested in penetrating the U. S. corporate banking market. Foreign trade financing and lending in the market for interbank funds remain important activities. A few branches have successfully entered the market for retail deposits, but corporate deposits, both domestic and foreign, and interbank borrowings represent their primary sources of funds.

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[1] The Federal Reserve's draft bill will have to be resubmitted again in 1976.

Foreign-owned subsidiaries, almost all of which are state-chartered, engage in a general banking business, as do branches. Unlike branches, however, their business is much more heavily oriented to the domestic market for loans and deposits, including retail deposits. Foreign subsidiary banks are required by the Bank Holding Company Act to carry FDIC insurance. They are eligible for membership in the Federal Reserve System and are on an equal competitive footing with domestic banks in the states where they operate. Although only about one-fifth as large as agencies and branches in terms of total footings, subsidiaries are nonetheless very important, especially in certain markets.[2] While the subsidiary form of organization provides the most complete set of banking powers to foreign entrants, it also has certain drawbacks. Perhaps the most significant drawback is the fact that subsidiary banks must be independently capitalized, making them an expensive investment relative to the branch alternative.

The Regulation and Development of Foreign Banking Operations The particular organizational form adopted by a foreign bank is determined to some extent by the intended function of its operation but more importantly by the laws of the individual states governing foreign banking activities. With only a few exceptions, foreign banking activities are regulated by the states.[3] Thus, foreign banks that desire to begin business here are faced with an array of different legal requirements and must adapt their organization to conform to the local laws under which they operate. Some of the laws that determine the structure of foreign banking in states where it is especially important will be reviewed in the discussion that follows.[4]

The first instance of direct entry in the U. S. by foreign banking interests dates back to the 19th century, when New York-based agencies of Canadian banks managed the money positions of their parent organizations. Dollar balances held with New York correspondent banks and call loans made to New York securities dealers and brokers were the primary types of secondary reserves maintained by the Canadian banks. When the volume of international capital and trade transactions increased after World War I, a more general interest in direct U. S. representation arose among banks of various nations, including Canada. Thus, in the early 1920's, a number of foreign branches were opened in several western states and in Illinois. Legislation prohibiting these operations was soon adopted across the nation, putting an end to the incipient expansion. The biggest blow to the expansion plans of foreign banks came in 1923, when a bill that would have permitted foreign branching was defeated in the New York legislature. Subsequently, the Great Depression and World War II reduced foreign bank interest in opening offices here.

Since World War II, the internationalization of business, supported by increased freedom in international capital movements, has provided a strong impetus to the development of foreign banking networks. This has been equally true for banks headquartered in other countries and for U. S. banks. Much of the liberalization in state laws to allow foreign bank operations has occurred out of recognition of this mutual interest. The leading U. S. banks, having encountered resistance to their strong foreign expansion programs in the 1950's, brought the need for reciprocal treatment to the attention of their state governments. Their efforts led to changes in state laws that have had far-reaching effects on the foreign banking presence in the U. S. The most notable changes in state regulations are those involving the financial centers. In 1961, for example, New York law was amended to permit branches of foreign banks to conduct a general banking business. And, most recently, a change in Illinois law effective in 1973 permits branches of foreign banks to operate in Chicago.

Ten states have enacted legislation that explicitly allows foreign banks to operate within their jurisdictions. In addition to the two mentioned above, this group includes Alaska, California, Georgia, Hawaii, Massachusetts, Oregon, Utah, and Washington. Sixteen states explicitly prohibit foreign banking operations of any kind, and laws of the remaining twenty-four are silent on the subject. There are no foreign banking facilities located in the

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[2] The importance of the subsidiary form of organization was recently highlighted when European-American Bank and Trust Company, owned by a consortium of six large European banks, acquired the failed Franklin National Bank and its extensive network of retail outlets.

[3] The FDIC examines state-chartered subsidiaries of foreign banks. Foreign-owned banks with a national charter would be regulated by the Comptroller of the Currency. The requirement that all national bank directors must be U. S. citizens, however, has effectively limited this form of organization to domestic banks only. The Board of Governors of the Federal Reserve System supervises, through Regulation Y, the banking-related activities of foreign-owned bank holding companies. It also has jurisdiction, implemented through Regulation K, over Edge Corporations, in which foreigners are allowed to hold a minority interest.

[4] New York laws applying to foreign bank operations and important differences between New York laws and the laws of other states are cataloged in Franklin R. Edwards, *Regulation of Foreign Banking in the United States: International Reciprocity and Federal-State Conflicts*, Columbia University Graduate School of Business Research Paper No. 64 (New York: Columbia University, Graduate School of Business, 1974).

Fifth Federal Reserve District, and most of the states have laws designed to discourage entry. Virginia law prohibits all types of foreign banking activity, while Maryland and North Carolina disallow foreign branching. The banking statutes of South Carolina are silent on the issue. West Virginia law establishes application procedures for foreign corporations to follow in requesting a banking license, but state officials are candidly ill-disposed toward approving such applications. Branches and agencies are prohibited in the District of Columbia.

What are the motives that have encouraged foreign banks to enter the U. S. and to accelerate their rate of entry in recent years? Originally, the U. S.-based facilities of foreign banks had a narrowly specified set of objectives. Their primary purpose was to provide continuous service to home-based customers who themselves had established U. S. operations. Their sense of purpose has broadened, however, and they have now become more active competitors for the loan and deposit business of U. S. corporations. The U. S. financial markets have been a traditional source of attraction for foreign banks, and they remain so today. In a few instances, furthermore, foreign banks have seen an opportunity to capture a share of the retail banking market.[5] Currently, the European nations and Japan are lagging the U. S. in recovery from world-wide recession; business alternatives in this country, therefore, seem especially attractive to foreign banks. Foreign bankers are bullish on their business prospects here and evidently intend to step up their efforts to play a fuller role in the financial aspects of recovery.[6] In fact, the investment opportunities provided by the U. S. economy probably account for an important part of the recent spate in foreign banking activity. This is illustrated by the fact that the combined operations of foreign banking interests have caused a net inflow of capital into the U. S. This sum has increased from $5.6 billion in 1972 to $7.6 billion in 1975.

The wide representation of foreign banks in the nation's financial centers has contributed to the continued preeminence of this country as the world's financial center. Foreign banks have made available a wider and fuller range of financial services and have done much to encourage foreign trade. At a time of widespread concern about capital shortages, they have channeled more investment funds into the country than they have transferred out. These are important contributions that must not be lost sight of in the debate over foreign banking regulation.

The Movement Toward Federal Regulation The essence of the debate over Federal regulation is whether or not regulation of foreign banking activities should be centralized at the national level. Two major arguments have been advanced in support of centralized regulation. The first argument contends that current institutional arrangements make it difficult for the central bank to achieve its monetary policy objectives, particularly with regard to credit market conditions. Foreign banks have an important effect on credit market flows and, so the argument runs, must be subject to national policy. Until now, foreign bank compliance with Federal policies designed to control these areas has been voluntary. Since June 1973, for example, foreign banks operating in the U. S. have been asked to maintain reserves against increases in their negotiable CD's and Eurodollar borrowings. This request was made by the Federal Reserve as part of its anti-inflation program. Although the record of compliance is admirable, it nonetheless remains true that the U. S. Government's formal power to regulate foreign banks is almost nil.

The second argument encouraging the movement toward Federal regulation of foreign banks centers around the idea that the foreign institutions operating here enjoy greater privileges than do domestic banks. Accordingly, some feel that foreign banks should have their activities restricted to the same extent as are those of U. S. banks. The major advantage held by foreign banks is their ability to operate branches and agencies in more than one state, a privilege they enjoy due to the acquiescence of the states themselves.[7]

Since about 1966, the debate over these issues has intensified. In July of that year the Joint Economic Committee published a research paper on foreign banking activities.[8] The study concluded that the

[5] These motives are more fully described in Fred H. Klopstock, "Foreign Banks in the United States: Scope and Growth of Operations," *Monthly Review*, Federal Reserve Bank of New York, Vol. 55, No. 6 (1973), 140-54.

[6] "Foreign Banks Like U. S. Market," *Banking*, Vol. 67, No. 11 (1975), 40-4.

[7] This position fails to recognize the issue of international reciprocity, for in most foreign countries no limits are placed on the branching privileges of U. S. banks. See Anthony Favill Tuke, "Proposed Limits on Foreign Banks in U. S. Criticized," *American Banker*, May 31, 1974, p. 7.

[8] U. S., Congress, Joint Economic Committee, *Foreign Banking in the United States*. Economic Policies and Practices Paper No. 9, by Jack Zwick (Washington, D. C., 1966).

public interest would be served if legislation providing for Federal supervision of foreign banking activities were passed. It also suggested that the option of Federal chartering should be made available to foreign banks.

Shortly after the JEC study was released, the first bill aimed at bringing foreign banking under Federal control was introduced in the Senate.[9] It designated the Comptroller of the Currency as the sole chartering and supervising authority for foreign banking activities and made foreign banks subject to roughly the same rules as national banks, with the exception that they would be able to operate across state lines. The Comptroller's powers included the ability to impose upon banks from a particular nation the same set of regulations applied to U. S. banks operating in the foreign country, should they be more restrictive than those here. In this way, it was thought, equal treatment for U. S. banks operating abroad could be guaranteed.

This bill languished but still achieved its sponsor's primary aim of arousing Congressional interest. Interest in foreign banking legislation was further spurred by the October 1966 collapse of Intra Bank, a world-wide financial institution headquartered in Lebanon. Intra Bank had a New York branch that, although holding only a small amount of U. S. deposits, caused quite a sensation when it closed. Further, several U. S. banks incurred losses as a result of the closing of Intra Bank offices in other countries.[10] A number of other bills were introduced in the House and Senate over the next several years, and their thrust seemed to change somewhat. The idea of unfair competition became increasingly prominent, supplementing the argument based on the need for greater control to implement economic policy.[11]

Over the past several years, the Federal Reserve has attached a high priority to dealing with the question of appropriate foreign banking legislation. It recognized the importance of having detailed information on the financial activities of U. S.-based foreign banks and instituted a data collection program. A body of monthly balance sheet information for foreign banking offices in the U. S. is now available from late 1972.[12] In addition, the Federal Reserve set up in February 1973 a System Steering Committee to review the regulatory aspects of international banking. As a result of this Committee's work, the Board sent to Congress on December 3, 1974, a draft bill known as the Foreign Bank Act of 1974. The intent of this proposed legislation was the establishment of a national policy toward foreign banks operating in the U. S. It was subsequently amended with a number of technical changes and resubmitted on March 4, 1975, under the title Foreign Bank Act of 1975. This bill has been introduced in the Senate.[13]

The basic principle underlying the Foreign Bank Act of 1975 is one of nondiscrimination between domestic and foreign banks. In other words, foreign banks would have the same privileges, and be subject to the same restrictions, as domestic banks. From this standpoint, the most important feature of the Act is the section extending the Bank Holding Company Act to cover branches and agencies of foreign banks, not just their subsidiaries, as is now the case.[14] The result would be to eliminate any further branch and agency expansion across state borders. A grandfathering provision in the Act, however, would allow foreign banks to retain interstate facilities operating prior to December 3, 1974, the date when the proposed legislation was first released.

Entry alternatives available to foreign banks would be increased under the Foreign Bank Act of 1975. Foreign ownership of national banks would be facilitated by giving to the Comptroller of the Currency authority to allow up to one-third of the directors of a national bank to be foreign citizens. Also, foreign banks and their state and Federally-chartered U. S. subsidiaries would be permitted to own controlling interests in Edge Corporations, an arrangement that is currently prohibited.

All foreign banking facilities, whether organized under state or Federal charter, would be required to obtain licenses from the Comptroller of the Currency. National control of all foreign banks, even those organized under state laws, would thereby be provided for. The requirement of FDIC insurance now applicable to foreign subsidiaries would be extended to branches and agencies. And Federal Reserve

[9] S. 3765, 89th Cong., 2nd Sess. (1966).

[10] H. Erich Heinemann, "Foreign Banking In U. S. Is At Issue," *The New York Times*, February 12, 1967, sec. 3, p. 1.

[11] See, for example, H.R. 11440, 93rd Cong., 1st Sess. (1973).

[12] "Data Series On Foreign Owned U. S. Banks," *Federal Reserve Bulletin*, Vol. 60, No. 10 (1974), 741-2.

[13] S. 958, 94th Cong., 1st Sess. (1975).

[14] Two organizational forms would remain exempt from the provisions of the Bank Holding Company Act: New York State Investment Companies, of which there are only a handful in operation: and foreign consortia in which none of the parent companies owns 25 percent or more of the bank's stock.

membership would be required of all foreign banking operations in the U. S. whose parent organizations had world-wide assets in excess of $500 million.

The House Banking Committee, several of whose members have been very active in drafting foreign banking legislation over the years, has also generated a position on the question. Its position is incorporated as part of the overall FINE study process, which is leading up to an omnibus bill on financial structure and regulation.[15] Hearings on this section of the FINE study have already begun, and it is probable that action on foreign banking regulation will precede action on the other parts of the study.

The emphasis of the House Banking Committee proposal is on the relative competitive aspects of foreign and domestic banking, rather than on national economic policy areas. The proposal achieves essentially the same result so far as national policy control is concerned but is significantly more restrictive with regard to definition of an appropriate structure and range of activity for foreign banks. Under the FINE framework, all foreign banking entities in the U. S. that accept domestic deposits would be required to function under the subsidiary form of organization. Grandfathering would not be permitted, thus implying large-scale closings of foreign branches and agencies and conversions to subsidiary banks. State chartering of foreign banking activities would be abolished, with the entire supervisory function transferred to a newly-created Federal agency, The Federal Depository Institutions Commission.[16] The underwriting and equity investment activities currently permitted foreign banking organizations under some state laws would also be forbidden.

Conclusion There is a widely-held belief that the time for closer Federal supervision of foreign banking activities in the U. S. has arrived. The sheer magnitude of the foreign banking presence, and its consequent influence on financial market conditions, argue for legislation designed to centralize supervision at the Federal level. According to one view, this would help in the attainment of national monetary policies aimed at the credit markets. Additionally, some see a need to equalize the competitive positions of foreign-owned and domestic banking organizations. These views are reflected in two legislative proposals active today. The Federal Reserve and House Banking Committee proposals are similar in several respects, but the latter is considerably more restrictive in its treatment of permissible foreign banking activities. Legislative action based on one or the other of these proposals, or on some combination of their different features, is likely this year.

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[15] U. S., Congress, House, Committee on Banking, Currency and Housing, *Financial Institutions and the Nation's Economy (FINE)—Discussion Principles*, 94th Cong., 1st Sess., Title VI (1975).

[16] The supervisory activities of the Comptroller of the Currency, the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, and the National Credit Union Administration would all be consolidated under the Federal Depository Institutions Commission. The new FDIC would then be responsible for the chartering and examination of *all* Federally-chartered depository institutions, foreign and domestic.