

# Remarks on Economic, Supervisory, and Regulatory Issues Facing Foreign Banks Operating in the United States

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*The following remarks were given by Mr. McDonough before the Comptroller of the Currency Conference on "Foreign Banks in the United States: Economic, Supervisory, and Regulatory Issues" in Washington, D.C., on July 13, 1995.*

I am delighted to be here today to address this important conference on economic, supervisory, and regulatory issues facing foreign banks operating in the United States. I also very much appreciate the efforts of my colleague Gene Ludwig and his staff at the Office of the Comptroller of the Currency in organizing these sessions. Foreign banks contribute importantly to the depth and breadth of financial markets throughout the United States, enhancing the sophistication and flexibility of our markets. It is a special pleasure for me to be here because so many of your institutions are located in the Second District and have close working relationships with us at the Federal Reserve Bank of New York.

What I would like to do in my remarks to you this morning is to stand back and take a look at the environment for foreign banks in the United States and comment on some recent developments. I will also touch on some of the challenges facing the banking industry.

I am very aware that the prospects for banks are

linked closely to the overall economic performance of the United States. As has been widely reported, the near-term outlook for the U.S. economy is uncertain. Particularly in this environment, it is essential that the Federal Reserve pursue a disciplined monetary policy, one aimed at fostering a sustained, noninflationary growth environment in which the economy continues to shift from a higher to a lower inflation climate. Only with price stability can productivity, real income, and living standards achieve their highest possible levels and thereby enable both households and businesses to function as efficiently as possible. The key, of course, is to instill a sense of confidence that inflation is trending lower in the long term. It is the path that in the long run creates the most hospitable environment for businesses to grow and households to thrive.

Fostering such an environment remains the number one job of the Federal Reserve and is a key element in maintaining the status of the United States as an attractive market for domestic and foreign banks alike. Another very important element contributing to an attractive climate for banks in the United States—and especially for foreign banks—is this country's longstanding policy of providing national treatment to foreign banks operating in the U.S. markets.

What does national treatment do? Most fundamentally, national treatment accords foreign banking institutions the same rights and privileges as domestic institutions in participating in our markets for financial services. In practice, national treatment seeks to create a level playing field for foreign and domestic banking insti-

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tutions by giving them substantially equal access to benefit from participating in our economy and by subjecting them to substantially similar regulations and supervisory oversight. The national treatment policy followed by the United States is premised on the belief that open and competitive markets strengthen all market participants and thereby provide both cost and quality benefits to the banking institutions themselves and their customers. Our nation feels strongly that this is the right way to achieve fairness in the financial marketplace for all competitors, and U.S. political leaders recently have raised the issue of reciprocity in the policy of national treatment by others.

The principle of national treatment in banking was reflected in bilateral treaties and later in major banking legislation enacted in the United States. It was, for example, embodied in the Foreign Bank Supervision Enhancement Act of 1991, which was enacted to align supervision and regulation of foreign banks in the United States with that applied to U.S. institutions. The strengthening of supervision and regulation of foreign banks in 1991 went hand in hand with comparable changes in legislation affecting U.S. institutions. These changes were reflected in the Federal Deposit Insurance Corporation Improvement Act of 1991, as well as in the earlier Finan-

cial Institutions Reform, Recovery and Enforcement Act of 1989.

Under the terms of the Foreign Bank Supervision Enhancement Act of 1991, before a foreign bank can establish a branch or agency in the United States, the Federal Reserve Board must determine that the foreign bank is subject to comprehensive consolidated supervision by its home country supervisor. While I recognize that it is not yet the norm worldwide, I am firmly convinced that comprehensive consolidated supervision is in the best interest of all banks if the integrity of our financial markets is to be preserved. Maverick institutions must be precluded from avoiding accountability to an appropriate supervisory authority. The approval by the Basle Committee on Banking Supervision in 1992 of a statement on minimum standards endorsing comprehensive consolidated supervision of banks worldwide provides an impetus for national regulators to move supervisory regimes in this direction.

A recent legislative effort to improve the climate for the banking industry in the United States is the Interstate Banking and Branching Efficiency Act of 1994. This Act substantially removes a number of barriers to full interstate branch banking for foreign as well as domestic banks. Interstate branching will enhance the ability of banks to diversify their balance sheets and thereby lessen credit risk stemming from lending concentrations.

Under the Act, bank holding companies, including foreign banks, will be able to acquire banks in another

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state beginning one year after passage of the Act, that is, by the end of September 1995. In addition, the Act allows branching by merger across state lines beginning June 1, 1997, provided that a state does not enact legislation prior

to this date to “opt out” of such branching arrangements. There are also provisions allowing states to “opt in,” that is, permit entry by merger or de novo branching before June 1997. I applaud the demise of the outmoded restrictions on banks’ ability to do business across state lines and believe it makes sense for all banks and their customers.

Another legislative initiative currently under discussion in the House of Representatives is the repeal of the Glass-Steagall Act. As proposed in the Financial Services Competitiveness Act of 1995, the repeal would, among other things, enable both foreign and domestic banks to expand their securities underwriting and dealing activities through separately capitalized securities affiliates within a “financial services holding company” structure. I not only support the goals of this legislation but also feel its passage is overdue.

Complementing these legislative initiatives are efforts by federal bank supervisors to improve the supervisory environment for foreign banks. These efforts are being directed to streamlining the supervisory process through the implementation of the “Enhanced Framework for Supervising the U.S. Operations of Foreign Banking Organizations,” more commonly referred to as the FBO program.

This program, which is now being put into effect, reflects a shift in emphasis in the supervision of foreign bank activities in the United States. Previously, the branches and agencies of foreign banks were reviewed more as stand-alone entities. Now, a more comprehensive approach emphasizes the role of these entities as integral components of the foreign banks as a whole. I am aware of concerns that this approach seems, to some observers, to extend U.S. bank supervision outside of our country. In reality, it does no such thing. Rather, it is an effort to place the U.S. operations of foreign banks in an appropriate context, using a systematic and consistent framework.

Consistent with this approach will be a series of initiatives, including a new examination rating system for U.S. branches and agencies of foreign banks, that several of you may already have seen. Overall, the program focuses more heavily than has been the case in the past on risk management and internal control systems with respect to both lending and capital market activities, similar to what

we’ve been doing increasingly in our examinations of U.S. banking organizations.

In addition to providing U.S. bank supervisors with a more logical approach to the supervision of foreign bank activities, the new program should yield considerable benefits to foreign banks. Most notably, foreign banks should, over time, see a significant reduction in the burden and duplication of supervisory efforts, as well as an improvement in examination efficiency and focus.

Another positive development aimed at enhancing the attractiveness of the United States to foreign banks is the Federal Reserve’s program, initiated in March 1993, to streamline the procedures foreign banks must follow when making application to establish a presence in the United States under the Foreign Bank Supervision Enhancement

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Act of 1991. Under these procedures, the processing of applications has been expedited and the burden on applicants reduced. Some of the key measures adopted, for example, facilitate the process of checking on the backgrounds of shareholders and key personnel, conducting concurrent reviews of applications by staff in Washington and at the Reserve Banks, and jointly identifying deficiencies in the application and promptly communicating these to the foreign bank. I’m well aware that there still is room for further improvement in reducing bottlenecks that have delayed applications. I can assure you that we are committed to continued progress and are working on achieving further efficiencies in an area that has been difficult for all of us.

Finally, I think it is worthwhile to note that the banking climate in the United States has benefited greatly from extensive communications between the supervisory

and legislative authorities. The Federal Reserve attaches great importance to working closely with other bank supervisors and legislators to craft policies and laws that we believe will foster competition and increase flexibility in the provision of financial services. At the same time, we are intent on preserving our unyielding commitment to the safety and soundness of the banking system. Continued

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cooperation in pursuit of these common goals should help ensure that the United States remains an attractive banking environment for foreign and domestic banks well into the twenty-first century.

While there is much cause for satisfaction with many of the measures already put in place, the future is not without considerable challenge. One of the most important challenges banks and supervisors face is to guard against a significant weakening in credit standards. In the aftermath of the 1990-91 stringency in credit, it was not surprising—and even desirable—to see some easing in credit standards. Of late, however, it appears that increased competition among lenders for middle-market and large corporate business has produced a narrowing of margins and additional relaxation in lending terms. Because experience has shown that easing of standards can be and often is overdone, it is incumbent on lenders and supervisors to ensure that future credit quality problems are avoided.

A second challenge banks and supervisors face is to continue their efforts to encourage the development of sound risk management practices in this period of rapid financial innovation. There can be no doubt that the better an individual institution's risk management system is, the more efficiently it can deploy its capital.

We at the Federal Reserve Bank of New York have

long encouraged innovation in financial instruments and financial markets. Innovation increases competition, improves market efficiency, and expands the variety of products that can better serve customer needs. But with innovation come increased responsibility and the need for each financial institution, regardless of size, to engage in prudent risk management practices to ensure that its activities remain consistent with its constantly evolving risk profile.

Based on our experience, we believe that a successful risk management system should satisfy—at the least—four basic principles:

- First, it should be subject to active oversight by the board of directors and senior management of the financial institution.
- Second, it should embody well-conceived risk identification measurement and reporting systems.
- Third, it should include comprehensive internal controls emphasizing the clear separation of duties.
- And, fourth, it should incorporate a well-defined structure of limits on risk taking.

A review of some recent, well-publicized problem cases clearly indicates that in each case there was a significant failure in the design or implementation of one or more of these basic principles.

I am pleased to note, however, that there seems to be a consensus building in support of these basic principles among a large group of internationally active banks, securities firms, end users, and their various supervisors. Last year, both the Basle Committee on Banking Supervision and the International Organization of Securities Commissions (IOSCO) issued papers addressing the need for sound practices regarding the risk management of derivatives activities. In March 1995, a private sector group representing the six largest securities firms in the United States issued a paper indicating their voluntary adherence to similar practices. In addition, the Group of Thirty has put forth two surveys and sets of recommendations on this issue. And, from the supervisory side, examiner guidance manuals on this subject have also been issued by the federal banking regulators. But support for these principles, how-

ever gratifying, does not mean that our jobs are over. Innovation is an ongoing process and management procedures, as well as supervisory practices, must continually adapt.

A third challenge for banks and supervisors has to do with what I would call internal culture issues. These issues involve the role of senior management and boards of directors in the risk management process. Most of the well-publicized problems of the recent past have also reflected shortcomings in internal management processes.

Experience to date makes it all too clear that the active involvement of a financial institution's board of directors and senior management is absolutely critical to their ability to articulate and promote the requisite risk management culture within their organizations. They must be knowledgeable about the financial products their institution is offering and the risks it is taking if they are to give definition to the organization's tolerance for risk and provide leadership in its implementation.

Innovative financial instruments often are extremely complex and can embody a variety of nontraditional risks. Therefore, no financial institution should be engaging in activities its senior management does not adequately understand and its board of directors cannot oversee. This need for understanding the products and their risk must extend to operating staff, auditors, and controllers.

Furthermore, senior management and boards of directors must foster an environment of open communication at all levels of the organization. Such a dialogue is the foundation of effective management supervision. A well-informed management that encourages this communication will be in a better position to assess the contents of daily internal monitoring reports and respond promptly and appropriately to prevent a problem from emerging.

Honesty is another aspect of this internal culture. The financial services business is traditionally one in which integrity is essential. The most effective managers are explicit about their commitment to fair business practice and arm's-length dealing in rules of conduct for employees, and encourage the prompt communication of problems to higher levels of management. This is more relevant today

than ever before. Competition is fierce. Markets can move quickly; huge volumes can be traded in minutes, if not seconds, and end users have a wide choice of alternative institutions with which to do business. In this environment, integrity is indispensable if institutions are to attract clients and retain their loyalty over the long run.

Finally, financial institutions must maintain open lines of communication with their supervisors. Even in the best-managed institutions, something can go awry. The cumulative experience of the industry is that the sooner a

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problem is addressed, the better the chances of limiting its financial and reputational impact. If a problem occurs, the supervisors must be kept informed—not in order to micro-manage the problem, but to be able to play a constructive role in its resolution. The questions supervisors ask will reflect their experience and their awareness of the potential success or pitfalls of different strategies.

In sum, the environment for the banking industry today is as vibrant as it has ever been. The range of opportunities for financial institutions to prosper and grow has never been greater, as technology continues to shrink the world, integrate markets, and open new avenues of potential profitability. In this environment, the real challenge confronting both banks and their supervisors is to balance the risks with the rewards. To do so requires commitment and vigilance on all our parts—supervisors and supervised—to an ongoing process of dialogue, accountability, and cooperation.