International Banking

By RICHARD A. DEBS
First Vice President and Chief Administrative Officer
Federal Reserve Bank of New York

An address before the tenth annual banking law institute in New York City on May 8, 1975

It's a great pleasure to be here with you today, and a privilege to have such a distinguished audience of experts in banking law. The roster of participants in this conference is indeed impressive, and the theme of your conference—"Defensive Banking"—is most timely. The subject of my talk today may seem a bit inconsonant with that theme, with your focus on domestic banking, but it is not at all unrelated. In today's world, no one can talk for long about the United States banking system without looking at international banking. For better or for worse—defensive or offensive—international banking is an integral part of the United States banking system. And, without belaboring the theme, I think it's fair to say that international banking has certainly been on the defensive during the last year or so, at least in the sense that it has had to react and adapt to massive, pervasive, and rapid changes in environment that have shaken the roots of the system and challenged its viability. I must hasten to add—and am happy to report—that so far the system has met the test of these challenges. And I can also add that international banking seems to have emerged from this troublesome period with a stronger and healthier foundation.

To support that conclusion I would like to summarize briefly the experience of international banking over the past year or so, to review what it has been through, where it is now, and where it may be going.

DEFINITION AND LEGAL FRAMEWORK

Before that, however, it would be useful to outline a working definition of what I mean by international banking from the point of view of United States banks. Very simply stated, on the one hand it refers to the operations of United States banks in foreign countries, with foreign customers, or in foreign currencies; on the other, it refers to the operations of foreign banks in the United States. And it must also refer to the Euro-dollar market, to ensure that all overseas banking transactions in United States dollars are included.

I'd also like to note very briefly the legal framework for this kind of working definition of international banking. I know that in this forum I should start with the law—putting first things first—and I also know that with such an audience I need not do more than recall to mind briefly the overall legal framework.

UNITED STATES BANKS ABROAD. First, with respect to the activities of United States banks operating abroad, the basic laws applicable are the Federal Reserve Act, including those provisions known as the Edge Act, and the Bank Holding Company Act, pursuant to which the Federal Reserve has primary regulatory authority over such activities. Among other things, such authority covers the establishment of foreign branches, investments in foreign subsidiaries and affiliates, the chartering of Edge Act corporations, and the supervision of the activities of such banking facilities. State laws also apply to the foreign activities of state-chartered United States banks but, except for a very few states like New York, state regulation and supervision of foreign activities have been minimal.

On the whole, I think it is fair to say that the Federal Reserve's regulatory philosophy with respect to international banking has been rather liberal, in the sense that it has permitted United States banks to engage in a much broader range of operations overseas than are authorized in the United States. In the area of international banking, the Federal Reserve has more or less limited its concern to the basic soundness of the United States banks that may be operating abroad and with the range of activities that such banks may undertake abroad. Within the limits set by its regulations, the Federal Reserve Board has reviewed on a case-by-case basis applications by United States banks to engage in additional financial activities abroad through subsidiaries and affiliates. But it has not chosen to impose a restrictive regulatory structure on international banking. I think that it is clear that, without this attitude over the years, the remarkable growth of United States banks' operations overseas could not have taken place.

I also recognize that, apart from this general philosophy, many banks and bank counsels feel that several specific provisions of the Federal Reserve's regulations unnecessarily restrict the ability of United States banks to compete abroad. The Federal Reserve itself has many questions and reservations about its regulations in this area. It is an area in which there has not been much change for many years, certainly not enough to keep up with the rapid changes in international banking over those years. Accordingly, the Federal Reserve, through its System Steering Committee on International Banking Regulation, is reviewing the entire range of the regulatory framework in this area.

FOREIGN BANKS IN THE UNITED STATES. In sharp contrast to the System's broad authority over the overseas activities of United States banks, its regulatory authority (as well as that of any other Federal regulator) over the activity of foreign banks in this country is minimal. Its formal jurisdiction is limited to the activities of United States subsidiaries of foreign bank holding companies. But these subsidiaries account for no more than a fraction of the total foreign bank operations in the United States. Although the use of such subsidiaries has been increasing, the great bulk of these operations is conducted by agencies and branches of foreign banks established and operating under state laws. Most of these agencies and branches operate in New York, with a large number also in California and several in Illinois. Thus, this segment of international banking—the part conducted by foreign banks in the United States—is subject primarily to state law and is not subject to Federal supervision and regulation.

As you know, the Federal Reserve Steering Committee has studied this question and has concluded that it would be desirable to provide for a system of Federal regulation and supervision of foreign banking operations in the United States. Accordingly, the Federal Reserve Board has submitted to the Congress legislation, entitled the Foreign Bank Act of 1975, that would provide foreign banks with the same opportunities to conduct activities in this country that are available to domestic banking institutions, and that would subject them to the same rules and regulations. The proposed legislation is based on the principle of "nondiscrimination", or "national treatment", in that it attempts to treat all banks operating within the United States—both foreign and domestic banks—on the same basis. I should also mention that the proposed legislation would provide a grandfather clause for existing operations.

It should also be noted, of course, that all United States banks abroad, as well as all foreign banks in the United States, are subject to the laws of other countries—the laws of the host countries and the laws of the home countries, respectively. In some cases, the banking laws of foreign countries can be quite restrictive, and in other cases they can be quite liberal—as you well know, I'm sure. And, of course, the difference in banking law philosophies has had a significant effect on the direction of the growth of international banking in the world.

EURO-DOLLAR MARKET. Finally, for the sake of logic, I should mention the legal framework of the Euro-dollar market, since I included the Euro-dollar market in my working definition of international banking from the point of view of the United States. However, I'm afraid that I can't do much more than just mention it. The Euro-dollar market itself is not easily definable, and its legal framework, if any, is even less so. The market grew rapidly without the assistance, or burdens, of an integrated or even coordinated set of laws. It is an international—or multinational, or transnational—phenomenon, but it is regulated only to the extent that the Euro-dollar activities of the institutions operating in that market—the Euro-banks—are subject to regulation and supervision by the national jurisdictions in which they operate. In practice, supervision by national banking authorities has been minimal, and there has been no overall legal framework regulating the Euro-dollar market *per se*.

GROWTH OF INTERNATIONAL BANKING

Turning now to a brief review of recent developments, we might take as a starting point the beginning of last year, since 1974 was in many respects a watershed in the history of international banking. Until then, international banking had been growing steadily and rapidly for many years. There had been a sharp rise in the number of major United States banks that developed global branch and affiliate networks, offering an integrated banking service of worldwide scope. This internationalization of United States banking was closely associated with the rise to prominence in the world economy of multinational corporations, which require broadly diversified financial facilities in a large number of countries. Another important factor in this development was the program of capital controls that was introduced in the United States in 1963, and which had put pressure on United States banks to establish banking facilities abroad in order to serve the borrowing needs of their customers operating overseas.

The growth in international banking over the years is dramatically reflected in almost any set of statistics relating to international banking for the period. For example, in 1965 only thirteen United States banks had foreign branches, with total assets of about $9.1 billion. At the end of 1974, 125 United States banks had branches abroad, and their total assets were in excess of $150 billion.[1] As another indication, in 1965 foreign earnings were a negligible portion of total earnings even for the largest banks. In 1974, foreign earnings for some of the larger New York City banks were about one half their net income after tax.

During the same period, there had been a steady, although not quite as dramatic, growth in the operations of foreign banks in the United States. For example, from 1965 to 1974, the number of foreign branches and agencies in New York City increased from 49 to 92, with total assets increasing from $4.8 billion to $29.5 billion. At the end of 1974, the total assets of agencies, branches, and subsidiaries of foreign banks in the United States added up to $56 billion.

Together with the expansion of international banking both here and abroad, there had been a parallel development in the growth of the Euro-dollar market. From rather modest beginnings in the early 1960's, the market burgeoned until it had reached rather massive proportions in the early 1970's. For example, in 1965 the net size of the market was about $9.5 billion and it reached a volume of approximately $150 billion in 1974, not including sizable Euro-currency liabilities denominated in currencies other than dollars.[2]

PROBLEMS OF 1974

Focusing again on the beginning of 1974, we all recall that the year began with the removal of capital controls by the United States. There was some uncertainty as to what all of the ramifications of that action would be, particularly with respect to the structure of international banking. (For example, it was expected that the removal of controls would result in the strengthening of New York City's role as a world financial center.) In any event, however, one point seemed clear: the action was a move toward a more open and efficient international banking system in the long run.

PETRO-DOLLAR SURPLUSES. However, other things happened in 1974 that began to cast grave doubts on the future of international banking. To begin with, the price of oil quadrupled and the world began to compile and wonder at the astronomical figures being projected as surpluses for the oil-producing countries. For example, in July 1974, the World Bank projected that OPEC (Organization of Petroleum Exporting Countries) would accumulate a cumulative surplus of $650 billion by 1980 and that this surplus would rise to $1.2 trillion by the end of 1985.[3]

And so the problem that came to be known as "recycling" was born. Because of the huge amounts of surplus funds that would be accumulating in the hands of the oil producers, the prospects for deeper deficits by many of the consuming countries, and the massive flows of funds that would be involved in the payment, receipt, lending, investment, and transfer of these "petro-dollars", there were serious doubts that the private international banking system could cope with the process of "recycling" these petro-dollars. The concern grew as larger and larger amounts of petro-dollars were accumulated in overnight Euro-dollar deposits. The position of the Euro-banks seemed to become more and more vulnerable as they used these overnight deposits to fund credits carrying much longer maturities, and in being exposed to the danger of sudden withdrawals of major portions of their deposit liabilities by a relatively limited number of depositors.

---

[1] Almost half of these assets was held by branches of United States banks in the United Kingdom. Another 20 percent was held by branches in the Bahamas and Cayman Islands. The Nassau and Cayman branches are principally "shell" offices which perform only limited services and conduct no local business; however, they act as a major vehicle for the acquisition of Euro-dollars by United States banks; also they enabled the banks to extend loans to foreigners financed with offshore funds without exceeding the quota limits established under the foreign credit restraint program.

[2] These figures attempt to exclude the large volume of interbank deposits in order to approximate the size of Euro-bank liabilities to others. See Charles A. Coombs and Scott E. Pardee, "Treasury and Federal Reserve Foreign Exchange Operations", *Monthly Review* (Federal Reserve Bank of New York, March 1975), pages 55-56, for a discussion of recent developments in the Euro-dollar market.

[3] See Robert McNamara's 1974 Annual Address to the World Bank, reprinted in the *Summary Proceedings of the 1974 Annual Meetings of the Board of Governors*, page 31. These estimates are in current dollars and assume an increase in prices over time. This 1980 estimate is equivalent to about $400 billion in constant 1974 dollars.

THE FRANKLIN CASE. These doubts were not eased by the emergence of another problem on the United States domestic banking scene—the Franklin National Bank case. Franklin was the twentieth largest bank in the United States, and it was also heavily engaged in the foreign exchange market. By May 1974, its situation had deteriorated badly, and it seemed clear that, unless a permanent solution could be found, the bank would soon be forced to close its doors. Such a closing would have caused serious harm to the bank's depositors and customers, would have shaken confidence in the entire United States financial system, and would have had major adverse repercussions for both the domestic and the international banking systems. In the circumstances, the Federal Reserve took up its responsibilities as lender of last resort and extended emergency credit to Franklin in an effort to permit the development of a permanent solution to the problem that would be in the best interests of all concerned. As you may recall, the loans extended by the Federal Reserve Bank of New York amounted to $1.7 billion by the time the solution was finally worked out in October of last year.

The Franklin case was particularly troublesome from the point of view of international banking because one of the major causes of Franklin's problems was its foreign exchange operations. Franklin, like many other banks, had expanded its international banking activities at a very rapid pace. In doing so, however, management control was not effectively maintained, and it was in this area that some of the more serious problems of the Franklin case came to light. As a result, there was deepened concern in the markets regarding the foreign exchange activities of all commercial banks, in addition to the general malaise caused by the tottering of one of the largest banks in the world.

HERSTATT AND OTHER CASES. This uneasiness was intensified by some substantial losses related to foreign exchange operations incurred by several banks in the spring and summer of last year. The most dramatic case, of course, was that of Bankhaus Herstatt, which was forced to close its doors in June. The very fact of a bank failure was, in itself, sufficient to create problems for the international banking community, but beyond that the circumstances in which Herstatt failed resulted in further problems for banks involved in foreign exchange. Confidence in the international payments mechanism was severely shaken. For a while, the mechanism hardly functioned at all, while participants in the international banking community retrenched and attempted to protect themselves from any possible exposure to credit risks. Since the international payments mechanism, by its nature, relies on confidence and credit, the result was that the mechanism ground down to a very slow and cumbersome pace.[4]

MARKET REACTIONS. The response of Euro-banks to these unhappy developments was to cut their credit lines rather ruthlessly for all but the very best names. Quality became the watchword for investors throughout the world, and rate structures in virtually all money and loan markets reflected this preference for quality. In the Euro-market, even banks with good names, but less well known than the prime banks, were forced to pay a premium over the rates offered to the bigger institutions. In order to obtain funds, banks in countries that in the view of the market had overborrowed, as well as fringe banks, had to pay rates substantially above the London interbank deposit rate. One consequence of this tiered rate pattern was that many banks at rollover dates for syndicated term loans were forced to refinance their commitments at rates close to or above the rates payable by the borrowers, which were based on the London interbank deposit rate for prime banks plus a small margin. As a result, a number of banks were no longer able to participate in syndicated loan operations. Fears were then widespread in the London financial community that some of the smaller banks participating in the Euro-currency market would be unable to secure sufficient funds to refinance their medium-term loans. Some of these banks, including branches and affiliates of regional banks in the United States, began last year to pull in their horns and to scale down their Euro-currency activities in London and elsewhere.[5]

All of these developments took place against the background of general disquiet and anxiety throughout the financial world. Worldwide inflation was rampant. Interest rates were at record high levels. Stock markets were plummeting. Confidence in the dollar remained precarious, and exchange markets continued to show wide rate fluctuations. No one had a good fix on the dimensions of the petro-dollar problem. Projected balance-of-payments deficits for some countries seemed to suggest that they were

[4] Perhaps the most vivid example was the practice by members of CHIPS (Clearing House Interbank Payments System, including about forty banks) during the latter part of June to meet each morning to state whether or not they intended to "recall" any payments of the preceding day before the settlement sheet was given to the Federal Reserve Bank of New York.

[5] For a detailed review of these developments, see Fred H. Klopstock, "Oil Payments and Financial Markets", *Record* (The Conference Board, Inc., May 1975).

on the brink of bankruptcy. The credit of major industrial countries was put into question. And questions were also raised about the soundness of banks and the banking system. All in all, 1974 was not a year of great promise for international banking.

RESPONSES TO THE PROBLEMS OF 1974

Yet, at the same time there were other developments, many of which were generated from these doubts and concerns, that assisted in bringing international banking through this period of uncertainty and that laid the groundwork for the emergence of an even healthier and stronger system.

COMMERCIAL BANK RESPONSES. In the first place, the banks themselves recognized their problems and took measures to deal with them. In a sense, the foreign exchange problem of the Franklin case dramatized to all banks the dangers of losing management control over foreign exchange operations. It brought home the need for internal controls and surveillance procedures, the need for management involvement, and the need for qualified staffs. In the past, there were too many cases in which foreign operations were launched by bank management as part of a fashionable trend, as a "growth industry" in which quick profits could easily be turned. Traders were too often left to their own devices, with management's interest limited to counting the earnings coming in. Those banks soon learned that this is an area of enormous risk that must be brought under more effective management control.

The Herstatt case, as well as other similar cases, also demonstrated the exposures involved in foreign exchange dealings, and underlined the fact that participants in the business that followed aggressive, speculative strategies could expose all their business partners to excessively high risks. Unfortunately, the Herstatt case also made the point that the rules of the game of the international payments mechanism were far from perfect and that innocent parties could be rather badly hurt by a malfunctioning of the mechanism. The lesson caused all parties concerned to undergo a searching reappraisal of those rules and to make changes in procedures to reduce the risks of exposure.

CENTRAL BANK RESPONSES. In addition to the steps taken by the commercial banks, there also has been much greater involvement by central banks, both individually and in cooperative efforts, in the problems of international banking and in measures to strengthen its soundness and integrity. One of the first moves in this direction was the action by the Federal Reserve to take over Franklin's foreign exchange position in order to avoid adverse repercussions in the international banking system, as well as to protect the domestic financial structure. In October 1974, as part of the package worked out by the authorities for the solution of the Franklin situation, the Federal Reserve Bank of New York, in an unprecedented step, took over Franklin's foreign exchange book with a view to liquidating it in an orderly fashion. The alternative—to permit the outstanding contracts to be dishonored—would certainly have led to serious disruptions in the markets.

In addition, the Federal Reserve and the other bank regulatory authorities in the United States, as well as their counterpart authorities in Europe, took measures to tighten their supervision of the foreign exchange operations of their commercial banks. Programs were undertaken to strengthen bank examination procedures and to provide for stricter surveillance and reporting requirements.[6]

The central banking fraternity also undertook to review the need for coordination among central banks in their supervision and examination of commercial banks involved in international banking, and they also reviewed their respective roles as lenders of last resort. The issues posed are complicated ones; they become more complicated as banks operate in foreign countries through subsidiaries, and even more complicated as they operate through affiliates or consortium banks in which their investments may be relatively limited. For example, which central bank should be (a) the supervisory authority or (b) the lender of last resort, with respect to (1) a foreign branch, (2) a wholly owned foreign subsidiary bank, or (3) a consortium bank with, say, five foreign minority shareholder banks as parents? And what are the responsibilities of the parent banks in any of these situations? As you know, the Bank of England has expressed a viewpoint on these questions in requesting "letters of support" from such parent banks.

In this connection, I should make the general point that all central banks have the responsibility for maintaining orderly exchange markets and do intervene in the markets from time to time to that end. Working together, the major central banks have developed more extensive procedures for consultation and coordination of exchange intervention

[6] In this country, the Federal Reserve has conducted a survey of selected banks' foreign exchange position limits and controls. The Federal Reserve is also monitoring United States banks' positions with the aid of Treasury foreign currency reporting forms recently instituted under the Par Value Modification Act.

than ever before. As you know, the Federal Reserve swap network has played a key role in these operations. In this area of conflicting philosophies over the functioning of exchange markets and the role of central banks, it has now been generally recognized that a floating system managed by open market intervention by cooperating central banks has a much greater chance of functioning well than a system in which order is imposed by extensive and detailed exchange controls.

"RECYCLING" PETRO-DOLLARS. Another development that helped to ease the concerns and worries of last year has been the ability of the private banking system to handle the petro-dollar flows. Despite the earlier dire predictions, the system has not only survived but has contributed in a significant way to coping with the problems of "recycling". The private banking system did not do it alone; it was aided in large part by official programs for the channeling of funds through multilateral institutions and arrangements —such as the International Monetary Fund (IMF) Oil Facility—and by the rather substantial direct lending and aid programs of the surplus countries. It was also aided by responsible and conservative investment policies followed by the central banks and governments of the surplus countries. Even with this assistance, however, a large measure of the burden of the recycling problem fell on the private international banking system; for example, it is estimated that in 1974 OPEC deposited over $20 billion in the Euro-currency market, and most of that was very short term.[7]

Another factor that contributed to a calming of concern about the future was the development of a better understanding of the dimensions of the petro-dollar surplus problem. It now appears that those dimensions are not as unmanageable as some had thought earlier. Total revenues of OPEC last year was over $100 billion, and the net investable surplus—the amount left over after expenditures for imports and after loans and grants to the less developed countries (LDCs)—was about $50 billion. But rather than increase over the years ahead, as originally predicted, the surplus will probably decrease gradually and shrink to much smaller proportions within a few years. Rather than the cumulative surplus of $1.2 trillion in 1985 and $650 billion by 1980—as originally predicted —the World Bank reportedly now estimates a peak in the cumulative surplus in current dollars of $460 billion by 1980. Other sources have estimated the 1980 surplus (in current dollars) to be in a range of $180 billion to $350 billion.[8]

The reasons for these changes in estimates are many, but one of them is simply a better understanding of the problem as it has evolved. Last year, there were very few experts indeed who were able to predict the level of imports reached by OPEC; nor were there many experts who were able to predict the level of loans and aid by the oil producers to LDCs. OPEC imports added up to more than $40 billion in 1974, and OPEC grants and loans to LDCs were about $7 billion.[9] Projections early in 1974 were substantially below these aggregates. This experience, of course, led to upward revisions in estimates of OPEC expenditures for future years. At the same time, the softening of demand for oil, reflecting the worldwide recession as well as the impact of higher oil prices, dampened the predicted rise in actual foreign exchange revenues by the oil-producing countries. This in turn caused a scaling-down in the forecasts of future revenues. Based on these revised forecasts, it now appears that the funds left over as "surplus"—the funds that are at the core of the "recycling" problem—are more manageable than previously predicted and should become more so in the years ahead.

In commenting on the dimensions of the recycling problem, I am referring primarily to the workings of a financial mechanism. I would not want to minimize the seriousness of the underlying problems. The potential pressures and strains arising from the oil-import-induced balance-of-payments deficits continue to involve risks to international financial stability. But experience to date indicates that, as a technical matter, the various channels used for coping with the recycling question have been dealing with that immediate problem.

[7] The Bank of England has estimated that oil exporters in 1974 placed Euro-currency deposits of $13.8 billion in the United Kingdom and $9.0 billion elsewhere. See the *Bank of England Quarterly Bulletin* (Vol. 15, No. 1, March 1975). The United States Treasury has estimated that OPEC placed $21 billion in Euro-currency deposits during 1974. See Treasury Secretary William E. Simon's statement before the Subcommittee on Financial Markets of the Senate Finance Committee (Washington, D.C., January 30, 1975), page 1.

[8] The World Bank estimate of $460 billion in current dollars is roughly equivalent to $250 billion in 1974 dollars. The United States Treasury has estimated the 1980 surplus between $200 billion and $250 billion in 1974 dollars. See Deputy Assistant Secretary of the Treasury, Thomas D. Willet, "The Oil Transfer Problem" (January 30, 1975).

[9] This includes bilateral and multilateral assistance. OPEC commitments—as opposed to disbursements—for developmental grants and loans made to LDCs in the last year were considerably larger, and are estimated to have been around $17 billion.

CONSOLIDATION AND RECOVERY

All of these developments I've referred to have contributed to a restoration of confidence that seems to be reflected in the overall tone of the Euro-dollar market. For example, differentials between the rate charged the different classes of banks—which were quite substantial last year reflecting the confidence crisis—are now only a fraction of those seen last summer. After some contraction in the summer and early fall, the market again resumed its growth, although at a much slower, and perhaps more reasonable, pace than in years past.

At the same time, there has been a retrenching, a consolidation, a sorting out, among the institutions involved in international banking, all of which should lay a solid basis for the future. After the experience of last year, many banks have withdrawn from or limited their participation in the field. Others have plans for gradual future expansion. All of them, however, are much more careful about the management of their international operations and want to avoid growth at a pace that could expose them to risks of weakened management control. As in domestic banking, there is a heightened emphasis on the quality of credit and on returns commensurate with risks. And, with the friendly interest of their banking supervisors, they are also aware of the desirability to proceed cautiously in the light of their need for adequate capital to support future growth.[10]

In any event, while the resumption of growth in international banking may be, and should be, gradual, it seems clear that a stronger foundation for the future has been laid. One of the growing edges of international banking is, as should be expected, in the Middle East, oriented to the petro-dollar. At the end of 1973, United States banks had interests in about thirty-four branches, subsidiaries, affiliates, and representative offices in the Middle East. Since then, they have opened, or have plans to open, about thirty additional facilities.

Future growth in international banking can also be expected from foreign banks operating in the United States. One of the incidental by-products of the Franklin case, of course, was the emergence of a foreign-owned consortium bank, European-American Bank & Trust Company, as a major banking institution in the United States. In addition, there is likely to be a continuing gradual growth of foreign banking offices in the United States. One of the more interesting areas of potential growth is the possibility of the development of banking interests in the United States on the part of the oil-exporting countries. There are several examples of such banking interests in Europe, and they may well find it convenient, much like the United States banks in the Middle East, to establish facilities within the United States.

ISSUES FOR STUDY

Having reviewed the experience of the last year and having concluded that, contrary to the expectations of some, international banking is still alive and well, I would like to take a brief look, not at the future (I wouldn't be so bold), but at the issues that may well influence the future. In doing so, I draw very heavily on the lessons of the recent past. And if I may, I would like to look at these issues from the point of view of a central banker.[11]

(1) To begin with, one of the immediate issues is the extent to which the international banking system is able to maintain adequate management control over foreign operations. This question relates not only to the commercial banks—domestic and foreign—involved in international banking but also to the regulatory authorities, both United States and foreign. The issue also encompasses all participants in international banking; it is not enough to say that most of the international banks observe stringent standards and have their operations in good order. As we have learned, weak links in the chain of the many partners involved in international transactions can cause problems for all.

(2) Another important issue relates to the regulatory framework for foreign banks operating in the United States. As I mentioned, the Federal Reserve has sponsored legislation that would provide for a new legal framework, under Federal law, based on the principle of nondiscrimination. The issue is now in the hands of the Congress, and its resolution will have significant implications for the future course of international banking.

[10] During the summer, the Federal Reserve Board expressed its general concern with the tendency of many United States banking organizations to pursue a policy of rapid expansion in domestic and foreign markets. The Board noted that such expansion can expose these organizations to substantial risks, and, therefore, such expansion should be supported by a strong capital base.

[11] Most of these issues are discussed in more detail in a speech by Governor Robert C. Holland of the Federal Reserve Board, entitled "Public Policy Issues in U.S. Banking Abroad", delivered at the fifty-third annual meeting of the Bankers Association for Foreign Trade on April 8, 1975.

(3) There is also the question of the regulatory and supervisory framework governing United States banks operating abroad. As I noted, the approach of the Federal Reserve, which is the primary United States regulatory authority in this area, has been developed over the years, within a statutory framework that itself evolved by the gradual accretion of statutory requirements over the years on an *ad hoc* basis. In view of the importance of international banking, as witnessed by its rapid growth in recent years and particularly by the events of the last year or so, it is timely to review the entire regulatory framework to see where changes are needed to keep up with changing times. As I noted, the Federal Reserve is undertaking such a comprehensive review.

(4) Another issue relates to the capital needs of United States banks engaged in international banking. As you in this audience well know, the issue of capital adequacy on the domestic scene is complicated enough, and has not yet been settled with any precision, but it's even more complicated with respect to international activities. In view of the risks that United States banks are exposed to in international banking, again as witnessed by the events of last year, it is important to focus specific attention on the question of capital adequacy in the light of the particular needs and requirements of international banking.

(5) Apart from the role of the United States regulatory and supervisory authorities, there is also the question of cooperation among the world's central banks with respect to the supervision of banks engaged in international banking; and the role of central banks as lenders of last resort for such banks. There is also the related question of the extent to which the Euro-dollar market, as a market, should or could be subject to greater regulation. In the light of recent developments, it seems clear that these are important issues for the future development of international banking. As I've indicated, they are under active study by a committee of central bankers.

(6) A final issue worth noting, and worth studying, is the extent to which international banking has implications for our domestic financial and economic conditions. International banking has grown so rapidly, and the Euro-dollar market has grown so large, that they cannot be dealt with in isolation. They have important ramifications for domestic policy and must be taken into account in the formulation of that policy.

In conclusion, let me emphasize that we in the Federal Reserve have no illusions that we have all the answers to the difficult issues raised by recent developments in international banking. We believe that we have learned many lessons from what has happened in the last year or two and, as I mentioned, are now undertaking a broad review of regulatory and supervisory policies with respect to the foreign operations of United States banks. We need the benefit of your experience and views, and would welcome a continuing dialogue with you in this challenging undertaking.