Foreign Banking in the United States: A Regulatory and Supervisory Perspective

The business of banking has changed substantially over the last two decades. A major aspect of this change has been the international expansion of banking operations. In the 1960s, U.S. banks moved abroad in large numbers. In the 1970s, foreign banks accelerated their expansion in this country, bringing home the effects of this change in banking.

The foreign banking presence in the United States has further stimulated competition among banks and has enhanced the international status of U.S. financial markets. But it also underscores the regulatory and supervisory issues which inevitably arise when banks move outside their home countries: What factors motivate banks to move beyond their local markets? When banks cross national boundaries, what changes in bank supervision are necessary to assure the safety and soundness of the banking system? How far does national supervisory responsibility and authority stretch? What types of regulations should apply to foreign banks in domestic markets? How do regulations affect and how are regulations affected by international banking?

International expansion of banking— motivating factors

The evolution of international banking since the early 1960s reflects changes in the economic and regulatory environments in which banks operate. By the same token, the changing nature of banking has influenced economic activity and the nature and scope of bank regulations. This article focuses on the regulatory influence on international banking, and the impact the international expansion of this business has had on regulations and supervisory practices.[1]

During the sixties, several factors combined to create incentives for U.S. banks to expand their overseas operations. First, the relative strength of the dollar stimulated American corporate investment abroad. Second, beginning in 1965, the voluntary credit restraint program imposed restrictions on lending to foreigners from domestic offices. Third, Regulation Q ceilings and reserve requirements on domestic deposits—not so onerous in low rate periods—exacted a heavy toll on domestic banking operations in the relatively high rate periods of 1966 and 1969-70.

Put another way, in the 1960s, regulation increased the cost of doing business out of domestic offices at a time when U.S. corporations and others were generating lucrative business abroad. By setting up branches in foreign countries, U.S. banks avoided the costs of these regulatory constraints. In 1960, eight U.S. banks had 102 overseas banking offices. Today 155 Federal Reserve member banks have over 700 offices abroad.

In many respects, the rapid growth of foreign banking in this country in the 1970s is a mirror image of the U.S. banking expansion abroad. The motivations and strategies stem from the same basic factors

[1] In this article, *regulation* is taken to be the framework of laws and rules in which banks operate. *Supervision* refers to the enforcement of such laws and rules, especially through the oversight and examination of banks.

—economics and regulations. In the 1970s, foreign corporations stepped up their investment activities in this country. Foreign banks, like their U.S. counterparts in earlier years, followed suit, setting up operations in the United States to sustain and expand the corporate relationships originally established in their home countries.

Further, the dominant role of the dollar in international finance in the 1960s and 1970s made a dollar-based operation advantageous for foreign banks doing an international business. With the emergence of New York as one of the major international financial centers of the world, foreign banks set up operations here to compete in domestic money markets as well as to provide global and around-the-clock services to their clientele.

Finally, the regulatory and political climate in the United States helped attract foreign banks here in the 1970s. Until the enactment of the International Banking Act of 1978 (IBA), branches and agencies of foreign banks were supervised and regulated only at the state level. They were not subject to Federal Reserve reserve requirements, deposit interest rate ceilings, or restrictions on interstate banking.[2]

Foreign banks in the United States

Foreign banks operate in the United States through three major types of offices: agencies, branches, and subsidiaries.[3] Branches and agencies are merely extensions of the parent bank, while subsidiaries are separately capitalized banking entities. The major difference between branches and agencies is that agencies are not allowed to accept deposits from citizens or residents of the United States.[4]

The structure of foreign banking operations in this country is summarized in Table 1. At the end of 1981, the number of branches (194) and agencies (195) were about equal. However, about two fifths of foreign bank assets were held at branches and only about one fourth at agencies. The 52 foreign bank subsidiaries accounted for about one third of foreign bank assets in this country.

The organizational form chosen by foreign banks has been greatly influenced by state and Federal laws. Prior to the IBA, licensing of branches and agencies was controlled at the state level. For example, California effectively prohibited entry by foreign branches. While California law explicitly permits the establishment of branches by foreign banks, it also requires that branches have Federal Deposit Insurance Corporation (FDIC) insurance. It was not until the passage of the IBA that the FDIC was authorized to insure branches of foreign banks.

New York State law permits foreign banks to establish branches within the state *provided* New York banks are allowed entry into the entering bank's home country. Until recently, Canadian law prohibited foreign banking operations in Canada. Consequently, Canadian banks had been limited to establishing subsidiaries and agencies in New York. Further, New York law does not allow foreign banks to operate both agencies *and* branches; the foreign bank must choose one form or the other.

The IBA authorized the Comptroller of the Currency to license Federal branches and agencies provided certain conditions are not violated. In particular, the Comptroller *cannot* issue a Federal license to a foreign bank to open an agency or branch in a state in which the bank already operates such an office under state law. Further, Federal licenses cannot be granted to establish offices in states which generally prohibit foreign branch and agency operations. The full scope of the Comptroller's authority, however, remains unclear. For example, under New York State law, foreign banks are allowed to establish branches. However, Australian banks are not allowed to establish state-licensed branches, because Australia does not allow foreign bank entry into its banking market. The Comptroller granted a Federal license to an Australian branch, because foreign branching, *per se*, is not prohibited in New York. This decision has been challenged and awaits a final ruling by the courts.

The organizational form chosen by a foreign bank can also depend on the type of business the bank expects to do. A foreign bank wishing to offer a full range of banking services in the United States would generally choose to establish or to acquire a subsidiary bank. Those seeking to conduct a wholesale lending business, in part funded in the United States, would generally need to open only branches. In states which do not allow foreign branching, some foreign banks have chosen to open both a subsidiary and an agency. The subsidiary provides a dollar deposit base while the agency, not subject to interstate branching

[2] Foreign-owned banks chartered in the United States, however, have always been subject to the same regulations as other domestic banks.

[3] Foreign banks have also established a small number of investment companies under New York State law and a large number of representative offices across the country. Investment companies are empowered to extend loans like a commercial bank and to accept credit balances but are not allowed to accept deposits. Representative offices are not allowed to conduct any banking business and serve only to disseminate information regarding parent organizations and to cultivate customer relationships. The IBA authorized foreign banks to establish Edge corporations as well. However, these institutions are restricted to doing international business and are not included in this analysis.

[4] Agencies are allowed to accept *credit balances* incidental to their customers' banking transactions. These funds are essentially clearing and compensating balances.

Table 1

Foreign Banking Offices in the United States

December 1981

Location of parent bank	Agencies	Branches	Sub-sidiaries	Total offices	Total assets (billions of dollars)
	Number of physical offices by ownership				
Japan	27	31	12	70	88.9
Canada	20	18	10	48	23.4
United Kingdom	12	19	7	38	46.2
France	7	14	1	22	16.1
Israel	6	13	3	22	4.2
Brazil	14	6	0	20	4.0
Germany	6	14	0	20	7.3
Spain	8	6	6	20	4.0
Korea	11	5	1	17	1.9
Hong Kong	8	6	1	15	12.4
Italy	5	9	1	15	10.9
Netherlands	4	7	1	12	4.8
Mexico	10	0	1	11	3.1
Switzerland	5	6	0	11	11.1
Other Asia*	23	19	2	44	1.7
Other Latin America	13	4	3	20	7.9
Australia and New Zealand	6	7	0	13	1.3
Other Europe	3	7	2	12	5.7
Middle East and Africa	7	3	1	11	0.7
Total	195	194	52	441	255.7

U.S. location	Agencies	Branches	Sub-sidiaries	Total offices
	Number of physical offices by state			
New York	61	113	24	198
California	96	4	20	120
Illinois	—	36	2	38
Florida	25	—	1	26
Washington	—	10	—	10
Georgia	9	—	—	9
Oregon	—	8	—	8
All other	4	23	5	32
Total numbers	195	194	52	441
Total assets (billions of dollars)	65.5	107.7	82.5	255.7

* Excludes Middle East.

restrictions or lending limits, affords considerable lending flexibility.[5] Foreign banks seeking to establish an investment outlet for dollar balances accumulated abroad might choose to establish only agencies here.

Foreign banking operations in this country are highly concentrated in New York, San Francisco, Los Angeles, and Chicago (Table 1). Oregon and Washington have long had a number of foreign banks—especially Canadian and Japanese. In recent years, Miami and Atlanta have experienced rapid growth of foreign banking offices. In choosing among states allowing foreign banking, foreign bankers have been influenced primarily by their choice of target markets. Consequently, factors such as the concentration of large corporate headquarters and trade flows have been important in determining the location of foreign banking offices in this country.

Although over 175 foreign banks from 39 countries operate offices in this country, the foreign presence in U.S. markets is dominated by banks from major industrial countries. Japanese, British, and Canadian banks operate over one third (156 of the total 441) of these offices (Table 1). Further, the number of banking offices understates the position of these banks among foreign banks in the United States. At the end of 1981, Japanese banks held one third of foreign bank assets in this country and British and Canadian banks together held over one fourth of these assets.

Banking activities of foreign banks[6]

Most foreign banks in this country operate solely in the wholesale banking and money markets. Relatively few foreign banks actively seek retail business. In fact, a number of foreign banks discourage retail depositors by requiring relatively large minimum deposit balances. The retail banking markets—at least in large urban areas where foreign banks are located—are generally difficult for a foreign-named bank to penetrate. Moreover, establishing a retail business requires large investments in office space, computers, and personnel. Those investments typically show a profit only over a long time horizon. A good number of those foreign banks that have entered the retail market have done so through the acquisition of domestic banks with already established retail branch networks. Foreign agencies and branches are, therefore, by and large wholesale banking offices and should be analyzed separately from subsidiaries.

The target markets of foreign agencies and branches generally are determined by their parent organizations. More often than not, all U.S. agencies and branches of a given foreign bank pursue a common strategy, sometimes even guided by common management. Therefore, to analyze the business activities of a foreign bank in this country, one should look at a consolidated balance sheet of its branches and agencies, not at individual offices.[7]

The parent organization's strategy for its U.S. operations is influenced by a variety of factors. These include the parent organization's home-country banking activities and the size and scope of its worldwide banking operations. The dollar position of affiliated offices outside the United States, the areas of expertise of the bank's management staff, and home-country laws and regulations also can play a role.

The most common motivation for entering the United States is to expand existing types of business or business relationships. Most often foreign banks are seeking:

- to service the U.S. operations of corporations operating in the home country,
- to finance trade with the home country or with other countries in which the banks have offices,
- to set up a foreign exchange operation in New York,
- to operate in the U.S. money markets, and
- to generate U.S. investment interest in the home country.

Some foreign banks provide a very broad range of services, while others focus on only one or two of these types of activities.

The decision to acquire or to establish a subsidiary bank in this country generally reflects the parent bank's overall U.S. or worldwide strategy. The activities of a subsidiary bank are managed separately at arm's length from the parent bank's other U.S. operations. Nevertheless, the subsidiary contributes to the scope of banking services a foreign bank can offer to its customers and, more often than not, the major activities of the subsidiary complement or supplement the services provided by other U.S. offices of the same bank.

The economic and business factors affecting for-

[5] Before the enactment of the IBA, foreign branches also were free from interstate restrictions.

[6] This section is based on discussions with executives at the U.S. offices of Japanese, Canadian, Swiss, French, German, and British banks and on data from the Federal Financial Institutions Examination Council's Report of Condition.

[7] As argued below, there are several factors that can distort even such a limited consolidated balance sheet, making it unrepresentative of U.S. activities.

eign banking operations in the United States are common across banks. However, one factor—home-country laws, regulations, and practices—serves to distinguish the U.S. balance sheets of foreign banks from different countries. For example, Japanese banks are restricted in the number and types of foreign banking offices they may open.[8] Japanese banks do not have "shell" branches in the Caribbean as do many U.S. and other banks. Thus, Japanese agencies and branches in the United States seem to serve a somewhat broader international dollar lending role, and they have relatively more loans to non-U.S. residents than most other foreign banks. In contrast, Canadian banks book a relatively small amount of loans to nonresidents in the United States. This can be attributed, in part, to Canadian tax law which provides an incentive to book such loans at Bahamian and Cayman branches. German bank activity in the United States is influenced by home-country regulations which pertain to a bank's worldwide consolidated balance sheet. For example, German liquidity requirements—originally designed to protect the domestic depositor against loss—limit the degree to which asset and liability maturities can be mismatched. This, in effect, restricts the degree to which U.S. offices of German banks can extend long-term loans.

Many analysts have tried to assess foreign banking operations in the United States by looking at the balance sheets of different types of foreign banking offices. They have compared the composition and size of assets and liabilities across branches, agencies, and subsidiaries. Such an approach has several limitations. First, as discussed previously, the agencies and branches of a given foreign bank generally have the same objectives and therefore should not be analyzed separately. Second, and probably more important, the U.S. balance sheet is only one part of the whole. Foreign bank loans to U.S. residents are not always booked in this country. For example, LIBOR-priced loans are often booked at Caribbean branches where they are funded with Eurodollar liabilities. Finally, foreign bank dollar loans to third countries may be negotiated elsewhere (for example, at the parent bank where management responsibility for such loans may lie) but booked in the United States where they are funded.

Table 2 presents the consolidated balance sheet of all U.S. agencies and branches of foreign banks at the end of 1981. Table 3 presents the same information for foreign bank subsidiaries. For the reasons cited, these figures, at best, present only a partial picture of foreign bank activity in this country. However, several observations can be made. First, loans to domestic nonfinancial entities which are booked at agencies and branches are not fully funded by deposits from domestic nonfinancial entities. That is, foreign banks do not appear to be raising funds in this country to lend abroad. Quite the contrary, foreign agencies and branches rely heavily on affiliates and the interbank market for funding. This suggests that many foreign agencies and branches serve primarily as investment outlets for dollar balances acquired by overseas offices.

A second observation is that foreign agencies and branches hold a relatively small amount of government and corporate securities. A review of individual branch and agency data suggests that most of the $4 billion in securities is owned by a relatively few New York City branches and agencies which have special expertise in U.S. securities markets. The reason most often given for the small holdings of government securities is their yield which is low relative to the funding costs faced by these banks. Further, income earned on state and local government securities, while exempt from U.S. Federal taxes, is not exempt from home-country taxation.

Finally, a comparison of agency and branch balance sheets with those of subsidiaries underscores the differences in their target markets. Subsidiaries have greater retail operations and do more domestic business than do agencies and branches. This is reflected in the relatively large portion of deposits due to nonbanks. These deposits represent about 70 percent of total liabilities. Also, loans to foreigners, while only estimated, appear to be less than 5 percent of total assets. Loans to domestic nonbank entities account for about one half of total assets. In contrast, agencies and branches rely heavily on the interbank market for funding. Two thirds of their liabilities are to financial institutions. On the asset side, loans to foreigners represent about one fifth of total assets.

U.S. regulations and foreign bank activity

The regulatory and legal environment in which banks operate affects the types of business banks do and the locations in which they operate. As discussed earlier, the rapid expansion of international banking over the last two decades reflects this influence. But it has also brought about changes in banking laws and regulations. In the United States, the two most recent examples of this are the enactment of the IBA and the change in Federal regulations and state laws to encourage offshore banking in this country.

[8] The Japanese Ministry of Finance's criteria for granting permission to open new branches were recently eased in the broad-ranging revision of Japanese banking laws, effective April 1, 1982.

Table 2

Assets and Liabilities of U.S. Agencies and Branches of Foreign Banks

December 1981

Assets	Billions of dollars	Liabilities	Billions of dollars
Loans to nonfinancial entities	80.6	Deposits due to nonfinancial entities	34.8
U.S. addressees	*(44.2)*	U.S. addressees	*(26.6)*
Foreign addressees	*(36.4)*	Foreign addressees	*(8.2)*
Claims on unaffiliated financial institutions*	61.7	Liabilities to unaffiliated financial institutions‡	81.0
Claims on affiliates	19.3	Liabilities to affiliates	36.5
Other assets†	7.3	Other liabilities§	20.9
Securities	4.3		
Total assets	173.2	Total liabilities	173.2

Table 3

Assets and Liabilities of U.S. Banks Owned by Foreigners

December 1981

Assets	Billions of dollars	Liabilities	Billions of dollars
Loans to nonfinancial entities	47.6	Deposits due to nonfinancial entities	53.8
U.S. addressees	*(44.2)*¶		
Foreign addressees	*(3.4)*¶		
Claims on financial institutions*	21.9	Liabilities to financial institutions‡	14.5
Securities	9.1	Other liabilities§	8.1
Other assets†	4.5	Capital	6.2
Allowance for possible loan loss	−0.6		
Total assets	82.5	Total liabilities and capital	82.5

Figures may not sum to totals due to rounding.

* Includes cash due from depository institutions, Federal funds sold, funds loaned under repurchase agreement to banks, and loans to financial institutions.

† Includes lease-financing receivables, funds loaned under repurchase agreements to nonbanks, and "other assets" (which include income earned on loans but not collected and other claims on nonrelated parties).

‡ Includes deposits and credit balances due to banks, Federal funds purchased, funds borrowed from depository institutions under repurchase agreements, other liabilities to banks for borrowed money, certified and officer's checks, traveler's checks, and letters of credit sold for cash.

§ Includes liabilities to nonbanks for borrowed money, liabilities on acceptances outstanding, funds borrowed under repurchase agreement with nondepository institutions, and "other liabilities" to nonrelated parties (whch include expenses accrued and unpaid).

¶ For subsidiaries with no foreign offices or less than $100 million in assets, no breakdown between foreign and domestic loans is available. All loans reported by these banks were put in the U.S. addressees category.

The growth of foreign banks in this country in the 1970s highlighted the discrepancy between the regulation of these institutions and the regulation of domestic banks at the Federal level. The IBA was enacted to close this gap. This legislation set in motion a series of regulatory changes which embody the principle of *national treatment* of foreign banks operating in this country. Under national treatment, to the extent reasonably possible, foreign banks are subject to the same restrictions and have the same privileges as domestic banks. To this end, the IBA restricts the expansion of interstate deposit-taking by foreign banks, subjects foreign branches and agencies to Federal Reserve reserve requirements and interest rate regulations, requires deposit insurance for branches engaged in retail banking, extends the restrictions on nonbank activities of the Bank Holding Company Act to foreign banks operating branches and agencies in the United States, and allows agencies and branches access to the discount window and to payment services provided by Federal Reserve Banks.[9]

In providing greater equality of treatment, the IBA has also affected the business of banking for foreign bankers in this country. In this respect, perhaps the most important provision of the act was the imposition of Federal Reserve reserve requirements. As these requirements have been phased in, the reserve costs to foreign banks have increased.[10] As a result, foreign banks have found it necessary to monitor and to manage their reserve positions more closely than in the past.

Further, reserve requirements have affected the relative costs of various types of funds. For example, the 3 percent reserve requirement on jumbo certificates of deposit (CDs), effective in August of this year, increases by about ⅜ percentage point the overall or "all-in" cost of CDs offered at 12 percent. Foreign bank CDs are generally priced by adding a spread to the interest rate paid by large domestic money market banks on their CDs. Consequently, foreign banks cannot adjust their CD rates (as do money center banks) to offset the increase in reserve costs if they wish to remain competitive in issuing CDs.

Some foreign bankers claim that this has necessitated charging higher loan rates, while others assert that competition prohibits higher loan rates and that their net interest margins have suffered. In either case, the relative competitive position of foreign banks in funding and extending loans in the United States has changed. Inevitably, this will alter the future growth of their commercial lending business and may lead some banks to redirect resources to other banking activities.

In responding to the foreign bank expansion in this country, regulatory changes promulgated under the IBA generally were in the direction of greater regulatory coverage. However, the IBA also mandated a liberalization of rules governing Edge corporations to enable U.S. banks to compete more effectively with similar foreign-owned institutions. As a result, the Federal Reserve amended its regulations to allow Edge corporations to open branches nationwide and to expand their international banking services and deposit-taking ability. Keeping with the principle of national treatment, foreign banks were also permitted to own Edge corporations.

Another reduction of U.S. regulatory restrictions stemming from the expansion of international banking was the creation of international banking facilities (IBFs). Effective December 3, 1981, depository institutions operating in the United States—both foreign and domestic—were permitted to establish IBFs for the purpose of conducting international business within this country free from interest rate restrictions, reserve requirements, and FDIC insurance. Additionally, several states have enacted legislation which exempts IBF income from state and local taxes.[11]

The reaction to IBFs by foreign bankers seems to vary across nationalities. Japanese and Italian banks have shifted the most assets to their IBFs (Table 4). In large part, this probably reflects the fact that these banks do not operate "shell" branches in the Caribbean. Some bankers, such as the Swiss, report the appeal of U.S. country risk has led home-country customers to shift dollar deposits from third countries to IBFs. Other bankers are skeptical of the ultimate attractiveness of these facilities but have established IBFs to accommodate potential customer demand should it materialize—that is, to maintain their competitive position.

Supervisory issues

When banks expand beyond their home-country boundaries, the issue of supervisory responsibility cannot be ignored. The soundness of a foreign banking organization should be of concern to both the host

[9] For a detailed description of regulatory changes resulting from the IBA, see "The International Banking Act of 1978", a report by the Board of Governors of the Federal Reserve System to the Congress, September 17, 1980. The IBA granted certain grandfather rights to foreign banks with respect to interstate banking and nonbanking operations established in the United States prior to the enactment of the legislation.

[10] While some states imposed reserve requirements on foreign branch deposits, such reserves either could be held in interest-bearing form or could serve as compensating balances at correspondent banks.

[11] For a detailed description of regulatory and tax treatment of IBFs, see Sydney J. Key and Serge Bellanger, "International Banking Facilities: The Shape of Things to Come", *The World of Banking* (March-April 1982), pages 17-23.

Table 4

Assets and Liabilities of Foreign-Owned International Banking Facilities*

December 31, 1981; in billions of dollars

Assets and liabilities	Japan	Italy	United Kingdom	Switzerland	Germany	All others	Total
				Country of ownership			
Number	48	11	9	5	8	71	152
Assets:							
Loans to nonfinancial entities	12.7	1.9	2.1	0.4	0.5	3.7	21.3
Claims on unaffiliated financial institutions	6.0	2.7	2.3	1.7	0.4	2.8	16.0
Claims on affiliates	0.2	0.1	—	—	—	0.8	1.1
Securities	0.4	†	—	—	†	†	0.5
Other assets	0.3	0.1	0.1	0.1	†	0.1	0.7
Total assets/liabilities	**19.7**	**4.8**	**4.5**	**2.2**	**1.0**	**7.5**	**39.6**
Liabilities:							
Deposits due to nonfinancial entities	0.7	0.5	0.2	0.1	†	1.0	2.6
Liabilities to unaffiliated financial institutions	5.7	2.1	0.1	0.4	0.1	1.2	9.6
Liabilities to affiliates	6.2	0.5	1.0	1.7	0.2	2.9	12.5
Net due to establishing institution	6.9	1.1	3.0	†	0.6	2.1	13.8
Other liabilities	0.1	0.6	0.2	†	†	0.2	1.1

* These data are included in those presented in Tables 2 and 3. Figures may not sum to totals due to rounding.

† Less than $50 million.

country and the home country. Failure of such an organization could send ripple effects throughout the financial systems of both the host country and the home country. In fact, the high degree of cross-border interbank borrowing and lending leaves no banking market completely immune to the effects of a large bank failure.

The IBA authorized, for the first time, participation in the supervision of the U.S. operations of foreign banks by Federal banking authorities. This included the authorization of the Federal Reserve to act as the residual supervisory agency to ensure a national overview of interstate activities of foreign banks. In exercising this authority, the Federal Reserve draws on examinations conducted by the primary Federal and state bank regulatory authorities. In addition, the Federal Reserve receives annual financial information on the operations of the foreign parent banking organization.

However, effective supervision of international banks cannot be limited to unilateral efforts by domestic authorities. It requires a cooperative effort among national supervisory authorities. A major step forward in the area of supervisory cooperation was taken in 1975 with the formation at the Bank for International Settlements (BIS) of the Committee on Banking Regulations and Supervisory Practices.[12] This Committee was formed by the central bank governors from the Group of Ten major industrial countries[13] and Switzerland to improve the coordination of national surveillance of international banking activities. Committee meetings provide a forum for the discussion of the key supervisory and regulatory issues by senior supervisory officials from the major industrial countries. And, perhaps more importantly, they provide an avenue for developing personal working relationships between supervisors, which facilitate rapid and effective cooperation should banks experience difficulties.

Effective supervision of international banks rests on

[12] This Committee is often referred to as the "Cooke Committee" after Peter Cooke of the Bank of England, its current chairman. A more complete review of the committee's history and its contributions is presented in W. Peter Cooke, "The Development of Co-operation between Bank Supervisory Authorities in the Group of Ten Countries, Luxembourg and Switzerland", a paper given at the International Conference of Banking Supervisors (Washington, D.C., September 24-25, 1981).

[13] The Group of Ten consists of Belgium (and Luxembourg), Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States.

two premises. First, national authorities must be *willing* to cooperate in monitoring the activities of the overseas operations of their own banks and the local operations of foreign banks. Second, authorities must be *capable* of supervising their banks' international business.

One of the first tasks of the Committee in 1975 was to develop principles for international supervisory cooperation. In particular, guidelines were needed to ensure comprehensive and coordinated surveillance of all foreign banking offices. The general statement of the Committee's views—commonly referred to as the Concordat—was endorsed by the countries represented on the Committee in December 1975.

In dividing supervisory responsibility among national banking authorities, the Concordat distinguishes between the supervision of liquidity and solvency and between the supervision of foreign branches and legally separate banking subsidiaries incorporated in a foreign country. The supervision of liquidity of all foreign offices and the solvency of subsidiaries is regarded as the primary responsibility of the host-country authorities. The supervision of solvency of foreign branches is considered to be primarily in the hands of home-country authorities.

To be fully effective, the principles set forth in the Concordat need be endorsed by supervisors worldwide. Acceptance by supervisors outside the BIS member countries has spread, but no formal endorsements have been made. Further, the effectiveness of the Concordat rests on the capability of national authorities to supervise the international activities of their banks.

Fundamental to the effective implementation of the Concordat is the timely availability of information necessary to the supervisory process. In particular, worldwide consolidated financial information is needed to assess the overall soundness of a banking institution. Good progress has been made in this area by many countries, but such data are not yet available in others. The assignment of supervisory responsibility embodied in the Concordat also requires the exchange of banking information between supervisory authorities on a confidential basis. While there is agreement that such exchanges are necessary, banking secrecy laws or regulations in some countries still impede such flows of information.

While substantial progress has been made in the area of international supervisory cooperation, the increased importance of international operations of banks has raised new areas of concern to the bank supervisor. For one, the number of banks operating in the major financial centers of the world has grown to include a broad range of institutions in both size and nationality. The phenomenal growth of international money markets and payments activity has increased the interconnectedness of the world's banking system. This interconnectedness provides a ready conduit for transmitting local financial shocks throughout the system. This aspect of the market underscores the importance of ensuring that prudential market practices, internal bank control systems, and external audit and examination procedures are in place. It is largely through the proper functioning of such safeguards that the effects of the failure of a bank or one of its customers can be contained.

Another type of concern is as much political as it is financial. The prospect that governments might exert leverage over financial institutions to achieve political objectives is not new. However, the enormous volume of cross-border and cross-currency transactions effected daily in the world banking system has magnified the riskiness of such strategies. The events in Iran, Poland, and Argentina exemplify the real exposure that such international activities bring about for banking institutions—a type of risk that is very difficult to measure and control.

Regulatory issues

On the regulatory side, banking across national boundaries raises questions regarding the equitable treatment of banks in different markets. As mentioned previously, the United States has adopted the principle of national treatment. An alternative approach—one based on the principle of *reciprocity*—would afford foreign banks in the United States the same treatment that U.S. banks are given in the foreign banks' home countries. Adoption of a policy centered on national treatment affords greater potential for realizing the benefits of enhanced competition in our banking markets. It also minimizes the risk, inherent in a policy of strict reciprocity, of retaliatory actions by foreign governments to place additional restrictions on U.S. overseas banking operations.

By the same token, however, national treatment offers little basis for further advancement of U.S. banking interests abroad. For this reason, an argument can be made for introducing aspects of reciprocity into the regulatory process. For example, consideration of reciprocal treatment as a factor in the balancing test in the applications process might serve as one type of catalyst to providing more equitable treatment for U.S. as well as other foreign banks in other countries. From a broader perspective, however, any substantial relaxation of remaining restrictions on entry by foreign banks into national banking markets is more likely to be achieved through negotiations at an international level.

National treatment, in the form of the IBA, has taken us a long way toward more equitable treatment of banks operating in the United States. Nevertheless, regulatory differences from country to country continue to sustain disparities in the competitive opportunities facing banks both here and abroad. The three key areas of difference are geographic restrictions, capital requirements, and product line restrictions.

The IBA placed foreign banks on a more equal footing with U.S. banks with respect to the limitations on interstate banking imposed by the McFadden Act and Douglas Amendment to the Bank Holding Company Act. Further, antitrust considerations continue to limit the degree to which large *intra*state acquisitions are permitted. In effect, domestic expansion of U.S. banks is restricted. However, large foreign banks not represented in the United States are still free to expand their international operations by acquiring large U.S. banks in attractive markets. Moreover, those foreign banks having only wholesale branches are largely free to make significant acquisitions in their home state. So it follows that, unless legislative restrictions are eased, competitive considerations will continue to favor foreign banks wishing to acquire large U.S. banks—especially large troubled banks. This issue is dealt with in a limited way by legislation now pending before the Congress.[14] What is perhaps more important, from a long-run competitive position, is the fact that most large international banks enjoy nationwide banking within their home country and, as such, have access to a nationwide core deposit base. Of course, neither U.S. nor foreign banks are free to branch across state lines in this country. However, this is more limiting to the growth potential of U.S. banks than their foreign competitors, since U.S. banks are not in a position to capitalize on the full market potential of their well-established retail operations.

Another dimension of home-country regulation which has an international impact is that of capital adequacy. There is general agreement that the erosion of the capital positions experienced in recent years by most major international banks should be reversed. However, there is no international consensus on the appropriate criteria for determining the adequacy of capital, or even what constitutes capital. This should not be surprising since U.S. bank supervisors are not in full agreement themselves on these issues. When different countries impose different degrees of stringency in assessing the capital adequacy of their banks, the impact on bank expansion plans can be significant. And banks with lower capital ratios can generally charge lower loan rates and obtain the same return as banks with higher capital requirements.

A third area in which domestic regulations affect international operations lies in restrictions on the types of activities in which banks can engage. For example, U.S. laws and regulations prohibit U.S. banks from engaging in commerce either at home or abroad. They also seek to maintain, at least within this country, a separation between investment and commercial banking. Most European countries do not require such separations. Rather they allow banks "universal banking" capabilities. For example, a German bank can provide banking services in the United States, engage in a full range of commercial and financial activities in its home country, and through an indirect U.S. nonbank subsidiary engage in commerce here. This makes these institutions very formidable competitors of more restricted U.S. banking corporations.

Home-country regulations have not only affected the evolution of international banking but regulatory changes themselves have been influenced to an increasing degree by the multinational nature of the banking business. Banking legislation and regulation formulated before the 1960s, for good reason, focused primarily on domestic concerns and objectives. The growing importance of foreign banks in domestic markets and of banking conducted outside national regulations has necessitated a review and reevaluation of existing legal and regulatory frameworks. In the United States, the IBA was needed to fill a regulatory void created by the expansion of foreign banking activities here. And the move to allow the establishment of IBFs reflects a desire by U.S. authorities to recapture some of the banking business conducted abroad to avoid the costs of home-country regulations. The influence of foreign banking is also reflected in the 1980 revision of Canada's Bank Act and the recent liberalization of Japanese banking laws.

The restructuring of the legal and regulatory frameworks is far from complete. Domestic regulations which adversely affect banks' international competitive position are sure to come under close scrutiny, as are restrictions which apply to banks in one location but not in others. It will become increasingly difficult to sustain differences in national policy with regard to capitalization and funding practices of banks with significant international business. It will also be difficult to maintain domestic barriers separating banking from other financial services, such as investment banking activities, when both U.S. and foreign banks engage in these activities in overseas markets. These pressures for regulatory change are broadly similar to those that have characterized our

[14] In particular, under S.1720, a bank holding company could, in limited and emergency circumstances, acquire a large, closed out-of-state bank.

dual (Federal/state and commercial bank/thrift institution) approach to banking regulation.

Summary

The rapid growth of international banking over the last two decades has been motivated and shaped by the interaction of economics and regulations. The development of extensive networks of foreign banks operating in domestic markets has served to initiate cooperation among national supervisors to develop comprehensive surveillance of international banking activities. Home-country legislation and regulation have been adapted to reflect the increasingly international nature of banking. Notwithstanding these changes, however, the continuing growth and evolution of the international banking system will remain a powerful force for further change in bank regulatory and supervisory practices.

Betsy Buttrill White