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INTRODUCTION

The decade of the 1960s witnessed a rapid development of overseas banking activities by American banks. Large U.S. banking institutions established overseas branch offices, acquired foreign subsidiary banks and finance companies, and participated more actively in global lending. By contrast the 1970s have brought a substantial inflow of foreign banks to the United States. Foreign banking institutions have established branch offices in several leading metropolitan centers across the United States, have established or acquired subsidiary commercial banks in a number of important states, and expanded their loan and investment banking services. In 1974 some 160 foreign banks held loan and investment assets in the United States aggregating over $40 billion.[1]

Why have foreign banks developed a heightened interest in operating from a U.S. base, and is this development likely to persist? How might the growing presence of foreign banks affect the role and functioning of credit markets in this country? Finally, does the accelerated influx of foreign banking institutions in this country necessitate a review and possible modernization of the manner in which banking is regulated in the United States?

This article seeks to find answers to the questions posed above. The problem of bank regulation is given special attention in view of the numerous regulatory proposals that have been made in Congress during the past three years.

GROWTH OF FOREIGN BANKING IN THE UNITED STATES

The "friendly invasion" of foreign banks into the United States has followed closely on the heels of growing involvement by American banks in international banking.[2] These two developments are interdependent, and have been supported by various factors in a subtle and indirect manner. These include the significant involvement of the United States in foreign trade, the importance of this country as a source of loanable funds, the special role of the dollar in international

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1. AMERICAN BANKER 188-89 (July 31, 1975); Address by George W. Mitchell, *New York As a World Financial Center*, Conference, June 10, 1974.

2. The term "friendly invasion" is borrowed from the title of an unpublished dissertation by R. CASSIDY, THE FRIENDLY INVASION—FOREIGN BANKS IN NEW YORK STATE (1968). For comparative data on the role of U.S. banks and banks of other countries in international banking see F. LEES, INTERNATIONAL BANKING & FINANCE 11-15 (1974).

finance, the size and efficiency of American banking institutions, and the highly developed securities markets in the United States.

The recent growth of foreign banking in the United States is part of a broad pattern which includes the internationalization of global business. The inflow of foreign banks is a concomitant aspect of the flow of foreign investment into the United States. In the period 1960-1974, foreign investment in this country expanded from $40 billion[3] to over $160 billion.[4] This investment took the form of securities investment in U.S. stocks and bonds, direct or business investment in manufacturing and distribution facilities, and short-term investment in liquid money market assets.[5]

All three forms of investment are intimately associated with the expanding role of foreign bank operations in the United States. Foreign business investments in U.S. manufacturing attract foreign banks interested in retaining corporate customers. For example, European banks have found it necessary to establish banking offices in the United States so as to service the financing requirements of American subsidiaries of home country firms, as well as to provide these firms with information and business contacts.[6]

Foreign investment in U.S. securities reflects the many advantages available to foreign investors in the efficient, low cost U.S. capital market. Here foreign banks provide non-U.S. investors with information on U.S. securities investments, manage investment portfolios on a multinational basis for non-U.S. customers, and operate U.S. securities affiliates which underwrite new securities issues and engage in many other securities market operations.[7] Short-term investment in the United States reflects the direct participation of foreign commercial banks in U.S. deposit and money market operations, and the advance of funds by parent foreign banks to their U.S. branches and agencies for loan and investment in the U.S. money market. In the relatively short period 1972-1974, foreign liquid claims in the United States increased from $82 billion to $112 billion.[8]

3. U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 855 (1963).

4. Author's estimate as extrapolated from other data.

5. The third category, short-term investment in liquid money market assets, accounted for the largest part of the growth in foreign investment in the United States. In 1974, foreign short-term investments in the United States represented $112 billion, or 70% of the total of $160 billion of foreign investment in the United States. 61 FED. RES. BULL. A63 (1975).

6. Klopstock, *Foreign Banks in the United States: Scope and Growth of Operations*, MONTHLY REVIEW of the Federal Reserve Bank of New York, 142-45 (June 1973).

7. Lees, *Foreign Investment in U.S. Banks*, 8 MERGERS AND ACQUISITIONS 4, 13-14 (1973).

8. 61 FED. RES. BULL. A63 (1975).

In addition to the need to service home country investments in the United States, foreign banks enjoy numerous other advantages from their expanded presence in the United States. These include opportunities for dollar sourcing, ability to achieve more rapid growth, and increased international portfolio diversification.

Despite persistent balance of payments deficits, the devaluations of 1971 and 1973, and renewed inflation in the United States, the dollar has been an attractive and sought-after currency by international bankers and businessmen. Therefore, many foreign banks have been prompted to establish U.S. banking offices to develop a base from which they can supply the dollar requirements of the bank. U.S. banking offices provide an excellent depository and clearing center for dollar operations of the parent bank. The New York office or affiliate of a foreign bank may be asked to extend overdrafts to other units of the parent institution. An important advantage of a dollar operating base is the ability to operate in the foreign exchange market after the head office in Europe has closed for the day. Access to the New York financial market permits the U.S. office of a foreign bank to invest dollar balances acquired either for its own account or for the account of the head office. Finally, a dollar based office can operate in either direction, as a source of liquidity when the parent bank is facing a credit squeeze at home, or as a lender of funds when the parent bank does not have more attractive alternative uses of funds.

Foreign banks operating in the United States have not confined their activities to wholesale banking. Many of these institutions have achieved significant deposit and loan growth via retail banking operations. A small number of U.S. based affiliates of foreign banks rank among the fifty largest banks in the United States. The attainment of additional growth through retail banking tends to complete the global competitive strategy adopted by large foreign banking institutions.

An important but often ignored motive for the overseas expansion of large banks is the desire to achieve international portfolio diversification.[9] Banks with offices located in several different countries may expect to achieve minimum risk in their loan portfolios (and deposit instability) to the extent that business conditions in the countries in which they operate are negatively correlated. Portfolio diversification is not efficient unless this negative correlation criterion is met.[10]

9. *See* Ragazzi, *Theories of the Determinants of Direct Foreign Investment*, International Monetary Fund STAFF PAPERS 476-80 (1973).

10. J. WESTON & B. SORGE, INTERNATIONAL MANAGERIAL FINANCE 358-66 (1972).

ORGANIZATIONAL AND LEGAL ASPECTS

Foreign banks employ a variety of organizational forms in their operations in the United States. These include the representative office, agency, branch, and corporate subsidiary. The representative office does not perform banking functions, but is able to facilitate banking activities. The most important activities of a representative office are to provide information about the parent bank, to function as an intermediary in providing information to American companies interested in offshore financing, and to serve as liaison concerning the activities of the parent bank.

The agency and branch forms are permitted in several states, with the approval of the state superintendent of banks.[11] A licensing requirement must be satisfied. The agency of a foreign bank appears to resemble a branch. However, agencies may not accept deposits. Agencies may accept credit balances, which are claims of customers that result from the clearing and settlement of foreign trade and other transactions. Branches are authorized to accept deposits, as well as conduct a general banking business.

Foreign-owned banking corporations generally operate in a manner similar to that of domestic banks. These subsidiaries may be eligible for Federal Reserve membership and may have deposit insurance provided by the Federal Deposit Insurance Corporation (FDIC). Several New York trust companies owned by foreign banks restrict their activities to corporate agency functions. However, the majority of banking subsidiaries in the United States conduct a general banking business.

Congress has remained silent on the matter of licensing and chartering foreign banks. At the present time there exists no federal statute written expressly to deal with the regulation or supervision of foreign banks operating in this country. Given the absence of federal banking legislation, foreign banks have turned to the various states to seek permission to carry on banking activities in the United States.

Only eight states permit the licensing and operation of foreign-owned banking offices in their jurisdictions. These states treat agencies, branches and subsidiaries of foreign banks as entities requiring distinct supervision.[12] In general, foreign banks may establish a representative office without the formality of obtaining a license.

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11. Zwick, *Foreign Banking in the United States*, in ECONOMIC POLICIES AND PRACTICES: PAPER 9, prepared for the Joint Economic Comm., 89th Cong., 2d Sess. 3-5 (1966).

12. At year end 1974, foreign banks were operating 72 agencies, 77 branches, and 62 banking subsidiaries in the United States. These banking offices were located in sixteen states, the District of Columbia and the U.S. Virgin Islands. AMERICAN BANKER 186 (July 31, 1975).

State chartered subsidiaries of foreign banks have been organized and supervised in a manner similar to domestic banks. Nonbank subsidiaries of foreign banks generally are treated according to the incorporation laws and business practice codes that apply. Three states (New York, California, and Massachusetts) appear to be the most permissive and allow any kind of foreign bank operation including agency, branch or banking subsidiary. California law requires that branches of foreign banks provide FDIC deposit insurance on domestic source deposits.[13] Present federal statutes do not provide for FDIC insurance on U.S. branches of foreign banks, and branch operations in California are not yet feasible.[14] Nevertheless, agencies in California are permitted to accept deposits from foreign sources. Due to the restriction on branch deposit operations, the state chartered subsidiary has been a popular means of representation for foreign banks in the United States.

New York amended its banking laws in 1960 to permit the establishment of branches by foreign banks. The agencies, branches, and subsidiary banking institutions in New York account for approximately three-fourths of the resources of foreign banks in the United States.

Several states prohibit foreign bank branches (Delaware and Texas), while others (Connecticut, Florida and Maryland) will not permit foreign bank representation in any form. In general, the remaining states have enacted no statutory provisions which refer to the establishment of foreign bank operations in their respective jurisdictions.

While foreign banks face a mixture of state laws and regulations, over 160 banking institutions from other countries have established direct representation in the United States. At midyear 1974, these foreign banks were operating over 140 representative offices, 62 agencies, 66 branches, and 30 banking subsidiaries in this country. The largest number of these banks and banking offices was located in New York. California ranked second only to New York in this respect. Illinois ranked third in importance. Other states hosting foreign bank agencies, branches, or bank subsidiaries included Colorado, Florida, Hawaii, Massachusetts, Oregon and Washington. In addition, several foreign banks operate securities affiliates and specialized finance companies in the United States.

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13. CALIFORNIA SUPERINTENDENT OF BANKS, REPORT ON FOREIGN BANKING MATTERS 23 (April 1974).

14. Similarly, federal law does not provide for FDIC insurance coverage on deposits in the overseas branches of American banks. *See* F. LEES, INTERNATIONAL BANKING & FINANCE 45 (1974).

ROLE PLAYED IN U.S. CREDIT MARKETS

The growing importance of foreign banks in the United States has injected new competition into the credit markets, has led to the more complete internationalization of our money market, and has posed serious questions and problems to bank regulatory agencies and lawmakers regarding the adequacy of the banking structure in the United States.

It is a widely accepted fact that foreign banks have become important participants in the U.S. credit markets. These institutions play an active role in bank loan syndicate placements where a medium-term corporate borrower may be serviced by a dozen or more banks, each taking a relatively small portion of the total credit. Bank participation in medium-term loan syndications parallels the arrangements that have developed in the Eurodollar market, and cross-competition is reflected in the closer alignment between Eurodollar lending rates (London Interbank Offer Rate—LIBO) and the U.S. prime rate. The importance of foreign bank participation in the U.S. loan markets is reflected by concern of Federal Reserve authorities over the extent to which inflows and outflows of funds facilitated by foreign banks operating in the United States neutralize monetary policy measures.[15]

The expansion of foreign banks in the United States has followed a pattern that threatens to upset the balance of power in the credit markets. Foreign banks have not conformed to two aspects of the American banking structure, namely the restrictions on interstate banking and the separation of investment banking from commercial banking.

Close to one-third of the foreign banks in the United States have been able to develop their representation on an interstate basis. This includes several large British, Canadian, and Japanese banks that simultaneously operate New York agencies and subsidiary banks, Chicago branches, and California agencies or subsidiary banks. The interstate operations of foreign banks have influenced the credit market structure in the United States in several ways. Interest rates in regional credit and banking markets have become more closely aligned. In response to this competitive thrust, large American banks have prepared themselves for interstate operations and sought legislative change that would permit them a wider geographic base of

15. G. Bell, in THE EURODOLLAR MARKET AND THE INTERNATIONAL FINANCIAL SYSTEM 103-104 (1973) notes that a tightening of monetary conditions in the United States followed by reduced lending to U.S. companies could be followed by these companies borrowing in the Eurodollar market. He further notes that arbitrage opportunities will exist for transfer of Eurodollar funds in New York within a matter of hours after the transaction has been consumated.

operations. Smaller American banks have reacted in a different manner and have supported state banking legislation that would restrict the expansion of foreign banks in their respective states. State legislatures have reacted in a variety of ways. New York will permit statewide branching in 1976, Pennsylvania is considering more liberal branching laws, and Texas has voted to strengthen an existing prohibition against foreign corporations operating banks.[16] We return to the question of interstate banking in a later section.

American banking structure has been shaped by the 1933 amendments to the federal banking laws. The Banking Act of June 16, 1933 makes it unlawful:

> For any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits subject to check or to payment upon presentation of a passbook, certificate of deposit, or other evidence of debt, or upon request of the depositor[17] . . . .

As a result, commercial banks in the United States restrict their underwriting activities to U.S. Treasury obligations and state and local government bonds, both categories being exempted from the prohibition cited above. The underwriting of corporate securities is entirely divorced from U.S. commercial banks.

The separation of commercial from investment banking in the United States contrasts sharply with the situation in other countries where banking institutions perform both functions. In Great Britain, well-established merchant banking firms accept deposits, carry on international banking activities, perform portfolio management functions, and underwrite venture capital projects. Similarly, in Germany and Switzerland the big banks conduct securities underwriting activities as an adjunct of their other banking operations. This permits these institutions to provide full services for their corporate customers needing long-term financing, and for their wealthy individual customers who require securities trading and portfolio management services.

Foreign banks with representation in the United States expect to provide the same full complement of services for their customers as they do at home. However, banking laws in the United States restrict foreign as well as domestic banks from engaging in securities trading and underwriting activities. As a result, several foreign banks have established non-bank securities affiliates in the United States

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16. This was voted in the Texas Constitutional Convention, held in 1974.
17. Federal Reserve Act *as amended through* Nov. 5, 1966, 12 U.S.C. §378 (1945).

which are not subject to the prohibitions against bank underwriting activities contained in the Glass-Steagall Act of 1933.[18] In this way foreign banks can service home country corporations that wish to sell long-term securities to finance business investments in the United States. Also, securities trading operations of these same securities affiliates permit the retention of valuable customer relationships where access to the American securities markets is important. Several foreign bank-owned securities affiliates are members of the regional stock exchanges, but are not presently permitted membership on the major stock exchanges in the United States.[19] Several securities affiliates of foreign banks have representation in major cities in more than one state.

PRESENT REGULATORY FRAMEWORK

The existing regulatory treatment of foreign banks provides for state and federal jurisdiction in the same manner as applies to domestic banking corporations. Regulation of foreign banking has developed largely as a reaction to problems and visible needs. In general, the United States has not applied special legislative or supervisory authority over foreign banks operating in this country and only a few states authorize establishment of offices by foreign banks. New York and California license agencies and branches of foreign banks, while Illinois and Massachusetts permit branches of foreign banks. In addition, foreign banks have established state chartered banking affiliates in several states and have acquired ownership interests in several domestic banks.

Until the present time, the federal government has remained silent on the question of foreign banking operations. Federal law designed to deal with domestic banks becomes applicable to foreign banks in several important areas. This includes the Bank Holding Company Act (BHC Act) as amended in 1970, which places approximately two dozen foreign banks in bank holding company status. The BHC Act has provided an explicit statutory framework for the expansion of foreign banking operations in the United States and has extended uniform treatment to domestic and foreign banks alike.

New York

New York has assumed a major part of the responsibility for chartering, licensing and supervising foreign banks. Therefore, the laws, administrative procedures and experience gained there consti-

18. Several German and Swiss banks have confined their U.S. representation to the New York branch plus securities affiliate, thereby avoiding bank holding company status and Federal Reserve Board jurisdiction. *See* Lees, *Foreign Investment in U.S. Banks*, 8 MERGERS AND ACQUISITIONS 4, 7-9 (1973).

19. Lorie, *Public Policy for American Capital Markets*, in REPORT PREPARED FOR U.S. DEPARTMENT OF THE TREASURY 18 (Feb. 7, 1974).

tute the most significant body of regulatory control that presently applies to foreign banks in the United States. New York embraces over three-fourths of the foreign bank resources located in the United States and its banking laws have attended to this responsibility with scarcely any need for special statutes applicable to foreign banking institutions.[20]

In New York, chartering procedures and requirements for a foreign controlled bank, trust company or investment company are similar to those required for all domestic commercial banks. The Superintendent of Banks issues licenses for agencies and branches with approval of the Banking Board. State law requires that a foreign banking corporation that operates a branch office in New York must deposit specified assets with the Superintendent. A foreign bank may be licensed to maintain a branch in New York only if the laws of its country grant reciprocal privileges to New York chartered banks.

New York banking law establishes minimum requirements of capital stock in the formation of banks and trust companies, but the scope of operations of the proposed bank is also considered in establishing such minimum levels. A foreign bank wishing to obtain a branch or agency license must have assets of at least $1 million, but again these statutory minima are far exceeded in the application of supervisory authority. New York branches of foreign banks must maintain specified types of assets equal to at least 108 percent of liabilities payable at or through the New York branch.

In New York, all banks, trust companies and branches of foreign banks are subject to the same size restrictions on individual loans. A bank may lend unlimited amounts to the U.S. government, New York state, or other governmental entities. Loans secured by cash collateral or government securities are also exempt from lending restrictions. Loans to states other than New York or foreign nations are limited to 25 percent of the bank's capital and surplus. Similar limits apply to loans connected with the creation of banker's acceptances. Unsecured loans and loans to other categories of borrowers are limited to ten percent of the bank's capital and surplus. A separate limitation applies to loans on letters of credit (ten percent of capital and surplus if non-documentary and 25 percent if secured by documents).

New York banking law prohibits the acceptance of deposits by any business entities except banks, trust companies and New York branches of foreign banks. Agencies and investment companies of foreign banks are not permitted to accept deposits. They may, however, maintain credit balances.

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20. An exception to this would be the legislation passed in 1969 permitting foreign banks to establish branch offices in New York. N.Y. BANK LAW § 201-a (McKinney 1971).

The Banking Department in New York enjoys a number of supervisory powers over banking institutions, including the power to conduct examinations and issue examination reports, authority to issue supervisory letters based on examinations, moral suasion, the power to require reports of conditions and the authority to review director's examinations. The examination report assures compliance with legislative policy and reflects management effectiveness. The typical examination report covers the examiner's comments relating to the condition of the banking institution, statement of assets and liabilities as found by the examiner, summary of examination highlights, information concerning the quality and diversification of the investment portfolio, a listing of assets criticized by the examiner, a review of the foreign exchange position and the examiner's comments on operating procedures and internal controls.

This writer is of the opinion that the New York State Banking Department is in a position to administer the banking laws and supervise foreign banks in a reasonably effective manner. While a rapid expansion has taken place in foreign banking operations in New York, there is no evidence of deterioration in quality standards.

Other States

California ranks second in importance in terms of the extent of foreign banking operations in the United States. California has adopted a liberal policy toward foreign banking activities and permits the establishment of state chartered subsidiaries, agencies and branches. California banking law has required that operation of a branch by a foreign bank be permitted only on condition that FDIC insurance coverage apply to deposits in that branch. California law permits an exception for foreign source deposits not protected by FDIC insurance. Federal law does not provide for FDIC insurance on deposits in American branches of foreign banks and this has precluded branch operations in California. However, California does permit branches to accept foreign source deposits without FDIC insurance.

Illinois ranks as the third most important state for foreign banks. Prior to 1973 foreign banks were able to establish state chartered subsidiaries and representative offices in Illinois. In that year the Foreign Office Banking Act was passed by the Illinois legislature, making it possible for foreign banks to establish a single branch office in the Chicago Loop Area. This Act brought forth considerable controversy inasmuch as Illinois is a unit banking state (no branching permitted).

Florida provides a contrast to California and Illinois, in that it has not adopted a liberal approach toward foreign bank operations. Florida is a unit banking state which provides significant opportunities for holding company expansion within the state. Only one bank, owned by a Canadian trust company, is controlled and operated by foreign shareholders. This acquisition took place in 1972 and was preceded by an amendment to the Florida banking laws which prohibited the acquisition of Florida trust companies by foreign holding companies and banks. However, this new statute did not take effect until shortly after the acquisition.

Federal

Domestic and foreign banks are subject to a uniform set of federal laws and supervisory regulations. The Congress has not enacted any special laws that pertain to foreign banking activities in the United States.

Three federal agencies enjoy supervisory powers over foreign banks. The Federal Reserve Board has jurisdiction over BHCs which include foreign banks that own and operate banking subsidiaries in the United States. In addition, the Federal Reserve enforces the provisions of the Glass-Steagall Act in cases of banks subject to its jurisdiction. The FDIC has supervisory jurisdiction over insured banks and all state chartered banking institutions owned by foreign banks have FDIC protection. This includes FDIC authority to conduct examinations. Finally, the Comptroller of the Currency enjoys regular supervisory authority over national banks including the power to examine and report on their condition and status.

TOWARD FEDERAL REGULATION

The growth and expansion of foreign banking have generated problems as well as benefits for the United States. These problems relate to 1) the need to strengthen monetary policy in light of the increased scope for inflows and outflows of credit funds, 2) the fear of developing inequities in regulatory treatment between domestic and foreign banks, and 3) the possible need for special regulatory treatment of foreign banking institutions in the United States. In the discussion which follows we examine these problem areas, view recent regulatory proposals in light of the problems faced, and point to basic issues that require resolution.

Governor Mitchell of the Federal Reserve Board has pointed out that international credit flows through foreign owned banking institutions are not subject to Federal Reserve jurisdiction.[21] In June 1973 the Federal Reserve Board requested foreign banks operating in the

21. Address by George W. Mitchell, *Bankers Association for Foreign Trade*, Annual Convention, Coronado, California, April 8, 1974. This is because non-member banks (state chartered subsidiaries of foreign banks) are not subject to Federal Reserve jurisdiction with respect to monetary policy controls and U.S. agencies and branches are not eligible for membership in the Federal Reserve System.

United States to conform voluntarily to marginal reserve requirements imposed on large certificates of deposit and net Eurodollar borrowings.[22] Large domestic banks are subject to such reserve requirements and the voluntary reserve requirement closed a monetary policy gap that had been of concern to the Federal Reserve. In addition, it tended to offset an advantage that foreign banks held in the area of reserve requirements on deposit liabilities. This advantage continues in part, since foreign bank branches and state chartered subsidiaries that are not members of the Federal Reserve enjoy lower cost reserve requirements. This is due to the fact that while most states have percentage reserve requirements that are close to those of the Federal Reserve, many states permit these reserves to be held in the form of interest-earning government securities. The Federal Reserve permits only cash assets to be counted in satisfying reserve requirements on deposit liabilities.[23]

It has been argued that foreign banks enjoy certain competitive advantages over domestic banks in this country. These advantages are derived from the ability of foreign banks to operate on an interstate basis, the investment banking operations of foreign banks in the United States, and their exemption from FDIC insurance requirements and insurance premium assessments.

From a practical standpoint foreign banks are not an important factor in the securities or investment banking industry in the United States. Several large Swiss and German banks simultaneously operate New York branches and securities affiliates. Where bank holding company jurisdiction applies, the Board of Governors has effectively sought to maintain the separation of investment from deposit banking. U.S. banks are not able to operate domestic securities affiliates in competition with foreign banks. However, they do operate such companies overseas via their Edge Act affiliates, which are permitted to own shares in such companies. It is also possible for U.S. banks to service the longer-term credit requirements of their domestic corporate customers by providing medium-term loans individually or in syndication with a group of commercial banks. Moreover, large com-

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22. 61 FED. RES. BULL. A7 (1975). These reserve requirements apply to member banks of the Federal Reserve System. Non-member banks enjoy a cost of funds advantage since they are not subject to such reserve requirements. Moreover, foreign banks with offices in the United States derive a second advantage since they may have access to lower cost funds in money markets outside the United States.

23. It should be noted that domestic non-member banks enjoy this same advantage and that their resources are four times as large as those of foreign banks in the United States. On December 31, 1973, total assets of insured non-member banks were \$170.8 billion. 61 FED. RES. BULL. A15 (1975). This compares with approximately \$40 billion in resources of foreign banks as cited by Governor George W. Mitchell, *supra* note 1.

mercial banks render a number of investment banking services in the areas of financing and facilitating corporate mergers, providing stock purchase plans for customers, and managing investment portfolios of individual customers and pension funds.

The interstate representation of foreign banks in the United States poses genuine problems for government policy makers. On the one side are the complaints of domestic bankers, some of whom are not permitted to establish branch offices in their own states. On the other side is the desire of regulatory agencies to permit competitive pressures to develop in banking markets so as to erode any excess profits that might exist in narrowly defined geographic market sectors. It is difficult to criticize the competitive advantages enjoyed by a handful of foreign banks when these same banking institutions are introducing into banking market sectors competition that results in lower loan rates and higher deposit rates for depositors.[24]

Foreign banks operating state chartered bank affiliates have obtained federal deposit insurance protection for depositors. As a matter of practicality all but several hundred of the smallest banks in the United States have obtained deposit insurance coverage. Branches of foreign banks are not eligible for deposit insurance coverage, although this matter was given serious consideration after the demise of the Intra Bank in 1966. In that case the New York branch of the Lebanese bank was forced to close its doors when the parent institution went into bankruptcy.[25]

While it is alleged that branches of foreign banks in the United States enjoy a competitive advantage in not being required to obtain FDIC insurance protection, the cost burden on insured domestic banks is not significant. Moreover, a significant part of deposits housed in these branches is held by non-resident business firms conducting trading and manufacturing activities in the United States. Therefore, there may be no competitive factor involved in bidding for such deposits. In this connection, these foreign branches represent an extension of the parent bank and it seems questionable whether deposit insurance is necessary or even desirable for banking institutions that are appendages of larger parent organizations operating from a foreign currency base.

REGULATORY PROPOSALS

In 1973, legislative proposals were filed in the U.S. Congress that would affect foreign bank operations in the United States. In 1974,

24. CALIFORNIA SUPERINTENDENT OF BANKS, REPORT ON FOREIGN BANKING MATTERS 37-39 (April 1974).

25. For a complete account, *see* Taylor, *The Day They Shorted the Intra Bank*, 150 BANKERS MAGAZINE 9 (1965) and F. LEES, INTERNATIONAL BANKING & FINANCE 185-86 (1974).

the Board of Governors of the Federal Reserve System made public its own legislative proposal regarding regulation of foreign banks operating in the United States. Our discussion of these proposals focuses on the reasons for the proposed legislation and the issues surrounding proposed federal jurisdiction.

In 1973, the Patman bill, also known as the Foreign Bank Control Act, was filed in Congress.[26] Several considerations appear to have served as motivation for the Patman bill, including the advantages allegedly possessed by foreign banks over domestic banking institutions, the desire to strengthen monetary policy, and the desire to preserve competition in banking markets. The Patman bill provides for federal chartering of foreign owned banks to conduct an international banking business and state chartering of foreign owned banks to conduct a domestic banking business. There would be no alternative means available for the licensing of foreign banking operations except that described above.

Under the Patman proposal all foreign bank activities in the United States would be conducted through subsidiaries. A foreign bank would be limited to one domestic banking subsidiary whose operations would be confined to a single state. Foreign banks would be excluded from states which have laws that prohibit foreign banking. Individual foreign banks would be limited to five federally chartered international banking subsidiaries. These international banking subsidiaries would operate in more than one state as Edge Act affiliates do in representing domestic parent banks.

The Patman bill prohibits establishment of overseas branches and subsidiaries by foreign banks headquartered in the United States. Foreign owned banks would be required to adhere to reserve requirements of the Federal Reserve. However, foreign bank subsidiaries would not be eligible for membership in the Federal Reserve System.

The Patman bill has been considered somewhat restrictive in its treatment of foreign banks, and possibly harsh enough to generate a negative reaction outside the United States. The restrictive attitude toward foreign bank operations and failure to treat foreign banks on a par with domestic banks represent significant weaknesses in the proposal.

Discriminatory treatment in the Patman bill precludes foreign banks from obtaining national charters to conduct domestic operations in the United States, thus limiting foreign banks to only one domestic banking subsidiary, prohibiting mergers or consolidations of

26. H.R. 11440, 93d Cong., 1st Sess. (1973).

foreign bank subsidiaries with domestic banks, barring foreign bank subsidiaries from Federal Reserve membership, limiting foreign banks to five international banking subsidiaries (whereas there is no statutory limit on the number of Edge affiliates a member bank of the Federal Reserve may operate), and prohibiting international banking subsidiaries from establishing foreign branches or foreign equity investments.

The Federal Reserve proposal was submitted to Congress in 1973[27] and resubmitted early in 1975.[28] Included among the considerations mentioned by the Federal Reserve in transmitting this legislative proposal were the following: differences in state regulatory treatment of foreign banks (ranging from complete exclusion to liberal treatment), interstate banking by foreign banks, lack of restraint on non-banking activities, the fact that few foreign banks are members of the Federal Reserve System which excludes a growing sector of money and credit from monetary policy, and the fact that the Federal government can play only a limited role in foreign bank operations even though this may have important implications for U.S. foreign relations.[29]

According to Arthur Burns, Chairman of the Board of Governors of the Federal Reserve System, the Board's proposal would provide for a federal role in the licensing and chartering of foreign banking operations. Moreover, it would standardize the status of foreign banks on the basis of non-discriminatory national treatment aimed at providing foreign banks with the same opportunity to conduct banking operations in this country as is afforded domestic banks. The Comptroller of the Currency would issue licenses for all foreign banking facilities in the United States and would supervise foreign-owned national banks and federally insured branches of foreign banks. The Federal Reserve would exercise supervisory authority under the Federal Reserve Act and the Bank Holding Company Act. The FDIC would be required to submit proposals to extend deposit insurance to branches and agencies of foreign banks.

Under the Board proposal the BHC Act would be redefined to include branches and agencies of foreign banks, bringing virtually all foreign bank operations in the United States under the BHC Act. Equality of treatment would be provided by permitting foreign banks to seek U.S. representation via federal or state regulatory channels, thus making available the dual channels that domestic banks possess. Foreign ownership of national banks would be facilitated by

27. H.R. 11597, 93d Cong., 1st Sess. (1973).
28. H.R. 5617, 94th Cong., 1st Sess. (1975).
29. Federal Reserve Board Press Release (Dec. 3, 1974).

permitting up to one-third of the directors of a national bank to be foreigners.[30] In addition, the Comptroller would be empowered to license branches of foreign banks to conduct a banking business in any state on the same basis as a national bank. This would provide foreign banking institutions with a means of entering any of the state banking markets in the United States.

The section of the Federal Reserve Act pertaining to Edge Act corporations would be amended[31] to allow foreign banks to establish and own Edge Act subsidiaries. Under present law a majority of the shares of an Edge corporation must be owned or controlled by citizens of the United States and all of the directors of an Edge corporation must be citizens of the United States. The Federal Reserve proposal would give the Board of Governors authority to waive these provisions regarding share ownership and eligibility for directorship.

All branches, agencies and subsidiaries of parent foreign banks that possess worldwide assets exceeding $500 million would be required to become members of the Federal Reserve System. This would extend Federal Reserve requirements and other regulations to these banking units with respect to their operations in the United States. In return, these institutions would gain access to the discount and lending facilities of the Federal Reserve.

Subsidiary banks of foreign banking institutions are presently required by the BHC Act to carry FDIC insurance. The proposed legislation would extend this requirement to branches and agencies of foreign banks, assuring that depositors in virtually all banking institutions in the United States are covered by this insurance.

The Federal Reserve proposal would provide for a national policy toward foreign banks, in that a federal banking license would be required for all banking facilities of foreign banks, whether organized under state or federal law. This would include consultation with the Secretary of State, insuring that the broadest aspects of economic relations with the home government are related to the application for establishing U.S. operations.

The Federal Reserve proposal would limit future multi-state securities company and other non-banking company operations to the same extent as domestic banks. However, permanent grandfather status would be extended to existing non-conforming activities. Non-conforming banking facilities established after the grandfathering date would have to be divested within two years and non-conforming non-banking facilities would have to be divested within ten years.

30. At present all of the directors of a national bank must be U.S. citizens. 12 U.S.C. § 72 (1945).

31. 12 U.S.C. § § 611-631 (1957).

The Federal Reserve bill is regarded as moderate in approach and, when compared with the Patman bill, appears to be the more acceptable legislative approach. Foreign banks are placed on a competitive par with American banks and are permitted to operate in a relatively flexible manner. Existing activities are given grandfather protection in cases where they do not conform to statutory provisions.

The Federal Reserve bill appeared on the scene approximately eight months after the Patman bill was filed in Congress. The Patman bill was severely criticized by many U.S. bankers who feared that foreign governments might become less liberal in their treatment of U.S. banks. Moreover, this bill was criticized by foreign bankers who feared that their existing activities in the United States were threatened. The Patman bill was filed only a few months after the New York Superintendent of Banks had denied the request of Barclays Bank, Ltd. to acquire the Long Island Trust Company, Garden City, New York. This decision was interpreted by European bankers as a denial of reciprocity since American banking and business interests had grown to absorb a large share of the market in the United Kingdom, Germany and other countries in Europe.

The Federal Reserve bill had the effect of shifting the trend of discussion concerning regulation of foreign banking back to a middle ground and its timing was important in the general context of efforts by the government to make this country a more attractive focal point for foreign investment inflows. Very early in 1974, the U.S. government and various government agencies had removed all of the controls on private U.S. capital outflows, in part to make the U.S. financial markets better able to serve as a financial *entrepot* through which petro-dollar accumulations of the oil exporting nations could be recycled. The Federal Reserve recognized the important role that foreign banking institutions could play in directing petro-dollar investments through the U.S. financial markets. Moreover, the early 1970s had witnessed a heightened interest on the part of foreign business investors in establishing U.S. manufacturing and distributing facilities. In part, these investments have depended on the availability of foreign banking facilities in the United States.

THE CASE FOR OR AGAINST FEDERAL REGULATION

The case for or against federal regulation of foreign banks is a complex of interdependent issues and alternatives. Of necessity, there are trade-offs and a middle ground of views will be woven into any final legislative action that may be reached. Our purpose here is to review the reasons espoused for proposed legislation. These reasons fall into the following major categories: (1) to control capital flows; (2) to strengthen monetary policy; (3) to assure reciprocity; (4) to place domestic banks on par with foreign banks in the United States.

1. *Control Capital Flows*

Foreign banks in the United States can effect inward and outward capital flows that influence liquidity in the United States. As direct operating arms of their parent institutions, foreign banking offices in the United States include in their major activities lending to non-residents and accepting deposits from offshore areas. In addition, these U.S. located offices participate in foreign exchange transactions and manage money market investments of parent institutions. Inevitably these activities give rise to capital inflows and outflows. Large American banks similarly initiate substantial capital flows of this type. Other countries are far more exposed to international flows of liquid funds than the United States and remain able to apply appropriate restraint measures against capital flow influences on domestic liquidity.

2. *Strengthen Monetary Policy*

Foreign bank agencies and branches in the United States can operate without being subject to the same degree of reserve requirement restraint as domestic banks. International monetary flows through foreign banking institutions are not subject to Federal Reserve jurisdiction. However, foreign banks have complied with the Federal Reserve Board request that they adhere to voluntary controls on borrowed funds.[32] Application of reserve requirements by the Federal Reserve Board can be defended if foreign bank operations are sufficiently large to present a significant gap in coverage. It is possible that there may be a greater need to extend uniform reserve requirements to all domestic banks (including non-member banks) than to foreign banks operating in the United States. At year end 1974, assets of non-member banks were four times the amount of assets held by foreign banks in the United States.

3. *Assure Reciprocity*

It is held that reciprocity for U.S. banks operating overseas can be better obtained by federal, rather than state, regulation of foreign banks. The definition of reciprocity is an unsettled issue. Foreign banks hold that an interpretation based on permitting foreign banks to conduct business according to the rules that apply to domestic banks is overly restrictive. This is because bank regulation in the United States is more control-oriented than in other countries. American banks operating overseas enjoy greater flexibility than at home and obtain more advantages than foreign banks that have branches or subsidiaries in the United States. The reciprocity argument for regulation of foreign banking in this country rests on the tenuous position that denial of reciprocal treatment has been damaging to the

32. This applies principally to borrowing of funds from outside the United States.

overseas activities of U.S. banks. More important, it rests on the assumption that foreign governments that have practiced a closed-door policy could be induced to open the door to U.S. banking institutions. If anything, countries in this category (Canada, Australia) appear to be adopting even harder policies in this respect.

4. *Place Domestic Banks on Par With Foreign Banks in the United States*

It has been said that foreign banks operating in the United States enjoy certain advantages over domestic banks. Advantages include lower cost of operation, ability to engage in investment banking activities, and freedom to operate across state lines. The cost advantages relate to FDIC insurance assessments where branches of foreign banks are involved and lower effective costs of reserve requirements where branches and non-member state chartered subsidiaries are involved. New York branches of foreign banks must conform to the same percentage reserve requirements and loan limitations as state chartered banks. A 1969 amendment to the New York banking law requires that branches and agencies of foreign banks in New York maintain New York assets equivalent to 108 percent of liabilities. State chartered affiliates of foreign banks now have FDIC insurance and only branches of foreign banks enjoy a cost advantage in this area. An important cost advantage could occur in cases where state reserve requirements are lower than those of the Federal Reserve. This is not a significant factor in states such as New York and California where the major part of foreign banking resources is located.

Foreign banks are not important factors in the securities or investment banking areas in the United States. Quoting the Board,

> The securities affiliates of foreign banks are few in number and small in size with little competitive impact within the securities or banking industries. For the most part, these securities affiliates engage in brokerage activities for the foreign customers of the foreign bank and in corporate financial services such as advice on mergers and acquisitions.[33]

It is doubtful that the minor exceptions of foreign bank activity in investment banking are significant enough to justify special federal jurisdiction.

Interstate operations of foreign banks in the United States probably represent one of the most sensitive issues concerning unfair advantages. American banks are able to respond competitively via their Edge Act affiliates, which permit multi-state representation to conduct international banking activities. A number of large U.S. banks now operate Edge affiliates in several major cities across the nation. Some interstate representation by foreign banks involves a mix of

33. Federal Reserve Board Press Release 11 (Dec. 3, 1974).

retail-wholesale banking not fully associated with international finance. In these cases a competitive advantage accrues to the foreign bank. Whether this competitive advantage is significant or not is an open question.

Recent proposals by the New York Superintendent of Banks for reciprocal interstate banking privileges (with California and other states) offer a flexible solution. Moreover, this approach would involve minimum interference with state prerogatives over bank legislation. Federal regulators and Congressmen might look in this direction since it represents a liberalizing rather than a restrictive approach.[34] Regulatory approaches that place emphasis on liberalizing the treatment of domestic banks rather than reducing foreign bank activities to a low common denominator of American practice should be given priority.

CONCLUSION

Two contrasting legislative proposals have been under consideration for the past one-and-one-half years which would extend federal jurisdiction over the licensing and chartering of foreign banks. The Patman bill can be regarded as the more burdensome since it would restrict foreign banks to one domestic banking subsidiary and to five international banking subsidiaries in the United States. Federal Reserve membership would be required of foreign banks, but there would be no access to the Federal Reserve discount window. Foreign banks would be placed at a competitive disadvantage vis-a-vis domestic banks in several ways, including the limited number of bank subsidiaries they could control in the United States, exclusion from states that do not permit foreign banking, a prohibition against using national chartered banks for domestic operations in the United States, and a prohibition against foreign owned banks establishing overseas branches or making equity investments.

The more liberal Federal Reserve proposal would add a second avenue by which foreign banks could gain access to the United States, but leave intact the existing procedures by which the states charter and license foreign banks. All foreign banks with U.S. representation would become subject to the BHC Act. Moreover, greater flexibility would be provided for foreign ownership of national banks and for establishment of Edge Act affiliates by foreign owned banks.

The legislative proposals described above would significantly affect delicately balanced relationships between state and federal regulatory agencies, between large and small banks, between federal reserve and other federal regulatory authorities, and between foreign

34. Lees, *Which Route for Foreign Bank Regulation?*, 157 BANKERS MAGAZINE 53, 55-56 (1974).

and domestic banks in the United States. More important, they could affect the status of U.S. banks with heavy overseas investments in branches, subsidiaries and correspondent bank networks. At year end 1974, the U.S. overseas branch banking system held total reserves of $150 billion, three times the resources held by foreign banks in the United States.

The brief made in support of proposed legislation must be analyzed critically in order to determine how urgent the question of federal regulation really is. It can be argued quite easily that any strengthening achieved in monetary policy through the proposed legislation might represent only a marginal improvement. Similarly, the reciprocity argument does not appear to offer a sound basis for enactment of either of the two legislative proposals. Reciprocity is a difficult concept to pin down, and has a different meaning for U.S. and foreign bankers and regulators. Finally, the advantages that foreign banks are considered to enjoy in comparison with domestic banks are not significant. One could argue that these advantages may be of importance to the foreign banks, but not to the U.S. banks against which they compete. For example, there is no doubt in this writer's mind that the ability of foreign banks to offer securities services (underwriting and securities trading) to their regular customers on a global basis is a critical factor in their being able to retain such customers. However, the securities affiliates of foreign banks in New York do not as yet represent a real competitive threat to major U.S. banks.

If there is not a critical need for extending federal regulatory authority over foreign banks, what avenue of approach (if any) should be explored? The answer seems clear. Federal regulatory authorities should examine the possibilities of liberalizing the regulation of domestic banking institutions. Liberalizing the regulatory treatment of domestic banks would make it possible for them to respond competitively to the expansion of foreign banks in a more flexible manner, and in a way that could generate better services and improved efficiency for the user of banking services. Congress now possesses a unique opportunity. Foreign competitive pressures are generating changes that suggest the need for adaptation by domestic banking institutions. Congress can move in either of two directions or do nothing. The two directions that can be followed are (1) to restrict foreign banks more severely, and (2) to liberalize the regulation of domestic banks. Provided that an atmosphere of excessive competition is not engendered, Congress should choose the second of these options.