

## INFLUENCE OF INTERNATIONAL BANKING ON BANK REGULATION IN THE UNITED STATES

Robert Carswell

MR. MUNDHEIM: These questions on supervision could be pursued at length, but it is time to turn to the question of the influence of international banking on bank regulation in the U.S. and ask Bob Carswell, a former Deputy Secretary of the Treasury and presently Visiting Distinguished Practitioner at the University of Pennsylvania Law School, to address those questions.

MR. CARSWELL: Previous speakers have described in some detail the extraordinary net of laws and regulations that the Congress and our small army of federal and state bank regulators have woven in the last few years as a response to the equally extraordinary growth in the international financial and banking markets. Most of the substance of this regulation derives from a decision to retard the internationalization of these markets by requiring new entrants to play in the U.S. by our domestic rules rather than addressing possible changes in those rules to give domestic banks more freedom to compete against foreign entrants. Since our domestic rules are complex, the technically competent response produced is, not surprisingly, even more complex.

I would like to discuss briefly the context in which this latest round of regulation has proceeded, some of the forces that are operating, and how these forces are affecting several areas of regulation.

### 1. HISTORICAL PERSPECTIVE

Fifty years ago we had a banking crisis in this country that had profound effects on hundreds of thousands of people and businesses and on our whole economy. Several broad statutes were passed, abuses were corrected and a comprehensive framework of regulations was instituted that had the long-term effect of reducing the areas in which banks could compete and of curtailing initiative in the banking business.

The crisis passed, but in the decades after World War II it became clear that a price being paid for sound banks was that a large share of the growth in our domestic financial markets was going to less regulated financial institutions. A generation ago, there were no significant non-bank commercial lenders, banks had most of a much smaller personal finance and consumer credit market, through their trust departments they dominated a much smaller market for investment advice, the Small Business Investment Corporation and other government credit programs were a small fraction of their present size, and there were no money market funds or brokerage houses offering the equivalent of checking accounts. On the other hand, our larger banks expanded dramatically in unregulated overseas markets, and a large volume of international banking business simply moved out of the U.S.

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A series of panels and commissions appointed by administrations over a twenty-year period all recommended substantial legislative changes to simplify the system, increase competition, and dispense with unnecessary regulation. The Congress failed to act, apparently viewing the area as a dispute among business rivals with little public interest involved in the outcome. It was not until last year when a large number of small consumers complained that the banks only paid them five and one-half percent interest while everybody else was getting fifteen percent or more that the Congress finally responded to some of the neglected agenda. That response, in the form of the Depository Institutions Deregulation and Monetary Control Act of 1980, has begun to redress the balance and restore competition in some areas. But the pace of change will also depend on more general economic developments and, in no small measure, on likely continued internationalization of the financial markets.

## 2. DEVELOPING POLICY AREAS

This interaction between events and the trend toward deregulation is evident in a number of areas of bank regulation, of which I will touch on three: (1) monetary policy and interest rate control, (2) standards by which to judge foreign acquisitions or control, and (3) equality of competition between domestic and foreign banks.

### A. Monetary Policy

Whatever one's views of monetary policy, it seems abundantly clear that control of the money supply will be a crucial element in the domestic policy of most, perhaps all, developed countries. It is equally clear that authorities in virtually all those countries are experiencing a variety of technical and operational problems. In the U.K. critics argue whether the cause of the government's problems is the Bank of England's inability or its unwillingness to restrain monetary growth. The Board of Governors of the Federal Reserve System has faced similar criticism as a consequence of erratic short-term swings in interest rates and the money supply. The necessity of taking action with respect to interest rates to accommodate balance of payments or exchange rate problems, presents similar difficulties. It may be useful to illustrate with a few recent policy dilemmas.

#### (i) Reserve requirements

In October 1978, the dollar was dropping in a disorderly fashion on the exchange markets and raising concerns that panic conditions might be precipitated in the markets. A joint Treasury-Federal Reserve response was hastily fashioned, relying principally on a large increase in the war chest for intervention, a one percent increase in the discount rate and a two percent supplementary reserve requirement on time deposits of \$100,000 or more. The Federal Reserve commented at the time:

The reserve requirement action will help to moderate the recent relatively rapid expansion of bank credit. It will also increase the incentive for member banks to borrow funds from abroad and thereby strengthen the dollar by improving the demand in Euro-markets for dollar denominated assets.

Whether the action on reserves taken would have the advertised impact was debated by some; others complained that it would have

inequitable competitive effects. Whatever the precise results, it was evident that the use of reserve requirements in this type of situation was less than a panacea because of the very large size and volatility of the Eurodollar market. Partially in response to suggestions from the Congress, the Federal Reserve (with Treasury participation in the effort) initiated discussions with Governors of the central banks of the Group-10 countries and Switzerland concerning the possible imposition of reserve requirements on Euro-currency deposits. The U.S. tabled a discussion paper; two committees were appointed; but there was little enthusiasm for the idea in Europe in 1978 and 1979, and nothing tangible has come of it as yet.

(ii) Eurodollar market

No one argues that the Eurodollar market does not complicate the Federal Reserve's ability to conduct monetary policy in the U.S. --whether with the objective of controlling the money supply or influencing exchange rates. Large U.S. borrowers have learned to use the Eurodollar market, and their access to foreign banks is clear enough. Thus, efforts by the Federal Reserve to restrict credit domestically will be effective only to the extent the Eurodollar market rates and movements parallel those of our domestic markets. Governor Wallich has pointed out that frequently they do. But he concluded in testimony in July 1979, that the thrust of his discussion was to recognize that "the existence [of the Euro-currency market] makes the execution of monetary policy more difficult."

(iii) Inflation curbs

In March 1980, the U.S. announced a series of monetary and credit actions as part of a general government program to help curb inflationary pressures. They included a Special Credit Restraint Program that specifically included credit extended to U.S. residents by the U.S. agencies and branches of foreign banks. The Federal Reserve also stated: "The parents and affiliates of those foreign banks are urged to cooperate in similarly restricting their lending to U.S. companies." Foreign banks generally were asked to respect the substance and spirit of the Credit Restraint guidelines in their loans to U.S. borrowers or loans designed to support U.S. activity. A panel of large U.S. corporations was asked to report monthly on their borrowings abroad. There is no public assessment of the results of this effort to control the extension of credit by foreigners to U.S. persons.

It is also worth noting that the Federal Reserve currently imposes a three percent reserve requirement on certain Euro-currency activity pursuant to authority granted in March by the Depository Institutions Deregulation and Monetary Control Act of 1980. They are

- net borrowings from related foreign offices;
- gross borrowings from unrelated foreign depository institutions;
- loans to U.S. residents made by overseas branches of domestic depository institutions; and
- sales of assets by depository institutions in the U.S. to their overseas offices.

It is clear enough that these requirements alone will not control the potential influence of the Euro-currency market on our domestic money supply.

*(iv) Future trends*

These illustrations represent, in gross, a groping by the Federal Reserve to cope with the real or potential influence of the Euro-currency market on its ability to carry out domestic regulatory responsibilities. These efforts will almost certainly continue. The dollar will have problems again, and it would take unbridled optimism to believe that the course of monetary policy will run smooth. More likely, the influence of the international markets will increasingly impinge on domestic policy and lead to responses both in the U.S. and in other countries. These responses could come through international agreements or cooperation, or they could come through exchange or other types of controls or reserve requirements with varying degrees of effectiveness.

**B. Standards for Judging Foreign Bank Acquisitions**

A second area where regulatory policy will be significantly influenced, perhaps shaped, by market and economic developments is the standard by which regulators will judge acquisitions, or control, of U.S. financial institutions by foreigners. With the Euro-currency market continuing to expand at a rate at least twice that of the U.S. market and with foreign banks increasing their share of that market, foreign banks should have no particular problem about resources with which to expand.

*(i) 1980 moratorium on acquisitions*

The moratorium imposed by the Depository Institutions Deregulation and Monetary Control Act of 1980, followed by the call for an additional moratorium by the General Accounting Office in August, indicates sensitivity in various quarters about the standards now being applied. The result--whatever it may be--of Midland Bank's proposal to acquire Crocker National may well trigger either a Congressional reaction or early preemptive foreign acquisitions. Perhaps the most critical but unpredictable influence on foreign acquisitions will be the general health of our banking system.

Most of the completed foreign acquisitions have involved banks that were on the verge of failure, or at least in need of infusion of capital. As previous speakers have pointed out, under present law the only available saviors of larger troubled banks may well be foreign institutions. If general economic conditions lead to an increase in the number of sizable banks in trouble, there will be pressures for a continuing permissive attitude toward foreign acquisitions. On the other hand, there will also be pressures from some domestic banks for modifications in the McFadden Act or the Douglas amendment to the Bank Holding Company Act to permit domestic banks to make the same acquisitions as foreign institutions.

*(ii) Extraordinary Assistance Bill*

In March of 1980, the bank regulators agreed on the text of an Extraordinary Assistance Bill of 1980, which was introduced as H.R. 7080 and S. 2575 in the last session of Congress. That bill included a provision that would have permitted across-state-line acquisitions by domestic banks in troubled bank situations if the appropriate regulator could make necessary findings. The effect of that bill would be significantly to reduce the foreign bank advantages in these situations. If the economic storm clouds thicken, that bill (or some derivative of it that liberalizes the McFadden Act or modifies the Douglas amendment) will doubtless be introduced. The severity of the problems encountered will have as much to do

with the outcome as the conflicting public policies involved.

The overall public policy issue remains the question of what standard is the appropriate one for judging foreign acquisitions. Because of the limited presence here of many foreign banks and the present state of the law, the applicable standards can properly be characterized as permissive. But it would be hard to find a Congressman who would feel comfortable about permitting the takeover of one or two of the five largest banks in the U.S.

(iii) Possible tests

What kind of test would articulate that unease but not amount to mere market protection? Neal Petersen has mentioned two candidates that have been under discussion: first, an objective test--probably prohibiting acquisitions involving more than some relatively high percentage of assets in some relevant market. That test would have the virtue of being predictable of result, but the impact in various sections of the country, depending on the percentages and markets chosen, would be widely disparate. Second would be a subjective test, such as prohibiting the acquisition value unless the regulator can find that public benefit could be formulated. Predicting what that kind of test really means would be hazardous. Depending on how it was applied, it would no doubt lead to charges of discriminatory action and perhaps lead to retaliation abroad.

I doubt that it is particularly profitable to try to answer this question in the abstract. A few more clear fact situations would clarify a lot of minds. Since it will likely take a year for the regulators to act on any major proposed acquisition, the Congress will have ample time to react before its consummation. That fairly obvious procedural framework will, I hope, lead foreign banks to proceed circumspectly.

### C. Equality of Competition Between U.S. and Foreign Banks

The third area where pending events will continue to impact bank regulation is that of the so-called level playing field or equality of competition between U.S. and foreign banks.

My personal conclusion about this area (with the exception of the advantages foreign institutions have as to acquisitions) is that the substantive inequalities do not now bulk very large. They achieve prominence largely because various aspects of inequality are thought to be excellent reasons to present to Congress or the regulators to justify expanded (and usually highly desirable) powers for domestic banks.

(i) Geographical limitations

Revisions of the McFadden Act and the Douglas amendment have been overdue for a decade or more. The tardily released Report to the President, *Geographic Restrictions on Commercial Banking in the United States*, contains moderate recommendations for change in this area. It notes that, as previous speakers have pointed out, foreign banks have limited advantages in operating across state lines, but it does not rely heavily on this anomaly. As Steven J. Weiss has pointed out in his paper, *The Competitive Balance Between Domestic and Foreign Banks in the U.S.*, the substantive impact of this privilege does not appear to be important.

The geographic advantages are of two varieties. First, grandfathering of the branches and other non-home state operations a foreign bank had prior to July 27, 1978; and, second, the right to

establish non-home state branches or agencies with limited deposit-taking power if the establishment is not prohibited by state law. Forty of the fifty largest non-U.S. banking organizations have grandfathered deposit-taking facilities in at least one state and twenty-seven in two states or more. Those not grandfathered can establish new facilities with only marginal additional restrictions. The open question is whether domestic banks through Edge Act or loan production offices and the like can achieve approximate competitive status. Clearly they cannot with respect to receipt of retail deposits, but the foreign banks have not developed, and as a practical matter probably cannot develop, extensive retail deposits through their non-home state facilities. The other advertised advantages also appear very limited, with the result that although the technical inequality unquestionably exists, the likelihood of it commanding Congressional attention does not seem high.

(ii) *Non-banking activities*

Similarly, in the Glass-Steagall area foreign banks command competitive advantages. Under the IBA grandfather provisions, various foreign banks are authorized to continue to retain their interests in thirty-two U.S. firms that engage in various aspects of the securities business in the U.S. The regulators are still engaged in compiling data on the extent of the business conducted by these firms, but the list of U.S. securities affiliations of foreign banks in the Appendix to the Weiss paper is a very long way from a roster of *Who's Who* in the securities business.

The best guess seems to be that the present situation does not grant significant competitive advantages and is a long way from a challenge to the principles underlying Glass-Steagall--whatever they may be. The same general conclusion, namely that significant competitive advantages do not appear to be present, seems to flow from the fact that the IBA permits foreign banks to hold interests in types of non-banking entities that are off limits to U.S. banks. However, there is a potential in both these areas for unfair competition and undue concentration, and no doubt the area merits and will get regulatory surveillance so long as the inequalities are continued.

(iii) *Funding costs*

The area of funding costs is more difficult to assess and bankers occasionally point to possible inequalities there. Weiss finds little evidence to support the assertions, but it may well be that the effect of reserve requirements can be discriminatory, particularly when foreign banks have great potential flexibility as to where they book business. The ebb and flow of regulations would seem likely to change this area from time to time, particularly if the Federal Reserve response to its problems with the money supply is to increase the ambit of its regulations.

(iv) *Export trading*

There is one final area worth noting. And it is one where the Congress may be moving toward a liberalization of the powers of U.S. banks, not so much for the purpose of permitting them to compete on a more equal basis with foreign banks--although it would have that effect--but to enhance the export potential of the U.S. The Export Trading Company bill, which passed the Senate 77-0 last year under the guidance of Senator Stevenson, has been reintroduced by Senator Heinz as S. 144 and reported out unanimously last week by the Senate Banking Committee. The heart of the bill would permit U.S. banks to

invest up to five percent of capital and surplus in export trading companies without federal regulatory approval but would require approval of investments where control was acquired. The trading companies would have broader powers than are now available to banks to facilitate exports--powers modeled on, although more restricted than, highly successful export companies that exist in many foreign countries--particularly Japan.

The Board of Governors of the Federal Reserve System last year opposed the acquisition of control by a U.S. bank on the ground primarily that the activities are not sufficiently close to U.S. bank powers, and the bill did not emerge from committee in the House of Representatives. The new administration has announced its strong support of the bill, including antitrust exemptions contained therein. Chairman St. Germain of the House Banking Committee has not taken a public position, but there have been reports of discussions designed to work out a compromise.

Although it affects a somewhat peripheral area, this bill represents a current illustration of the difficulties our system has in adjusting its domestic regulatory paternalism even to the realities of the largely uncontrolled area of financing and facilitating exports and trading abroad. It will be instructive to watch whether the breezes of deregulation reach this area.

(v) *Future trends*

How these issues will be decided depends, in part, on the health of our banking industry. If we have a significant number of bank failures the administrators have already agreed on the form of a bill (introduced last year as H.R. 7080 and S. 2575) that has provisions to permit crossline acquisitions--that is, cross state line and cross other boundary line acquisitions by domestic banks in a way that would perhaps parallel what the foreign banks can do today. If this approach is followed, the pressure may let up here, because there will be competition from larger and stronger domestic banks to make acquisitions that presently cannot be made in troubled situations except by foreigners. This development would be healthy for everyone, but apparently it is not going to take place until we have real trouble in our system. Unfortunately this is not the right way to pass considered financial legislation.

The level playing field concept has largely developed into a debate between the various people on the playing field. Depending on what premise you start from, there is, or is not, substantive equality of competition; in most areas the point is arguable. I imagine that Alec may disagree with me, but I think there is more of an effort to influence the Congress to change the division of markets, rather than any desire to right competitive balances.

MR. MUNDHEIM: Alec, I will give you a chance to respond if you like, and then Peter has a comment.

MR. VAGLIANO: Not so much a response, but an observation. I think the question is really so much broader because the industry itself is in the process of a pretty dramatic change that will extend over the next fifteen years. This is brought about by a number of factors that are perceivable today: the narrowing of margins; the competition, as was mentioned earlier, from non-banking sources such as commercial paper and nationwide brokerage; the dramatic increase around the world of non-interest costs, both in terms of employee fringes and even the availability of employees in many places;

the entirely new technology, which has not yet been able to resolve other cost problems and has in fact added costs and put a great deal of stress on banks; and finally, the tremendous volatility of markets in an inflationary context where even the most prudent and conservative types of institutions like savings banks find themselves in great difficulty because of this dramatic change. I think, overall, you have so many factors working for rapid change that the risks are much greater, and these risks may end with some unfortunate developments. Then you are going to have to push more and more towards regulation, maybe--as Bob was just saying--in the unfortunate context where people do not have the chance to think through the problem and develop coherent long term policy. So I think there is going to be a lot of hit-and-miss going on.

MR. MUNDHEIM: Peter. . . .

MR. COOKE: Just a brief comment. Bob Carswell asked what had happened to the debate on the reserve requirements in the Euro-markets. He said it seemed to have disappeared. Well, it has disappeared, but with a flourish in the form of a communique that the central bank Governors issued in April 1980. It did not refer to reserve requirements as such, from which one can perhaps make certain deductions about the way the debate came out. But it did say that it recognized the need to have regard for the macro-economic environment in which the international banking system was doing its business and to enhance the existing capacity to monitor and keep an eye on that macro-economic environment, re-emphasizing the role of the Euro-currency Standing Committee which, like the Committee of Supervisors, meets in Basle on a fairly regular basis.

These are separate meetings: one group looks at the macro-economic environment in which international banks conduct their business, while the other, the supervisors' group, looks more at what I would call the micro-prudential elements of each individual bank's business and their inter-relationship. In between these two aspects is what I would describe as the macro-prudential dimension that is somewhere between macro-economic and micro-prudential. This calls for a certain amount of co-ordination between the work of the two groups.

As I see it, the macro-prudential encompasses all issues, like inflation or other macro forces that actually have a direct impact on the way in which an individual bank conducts its business. So the central bank Governors have not actually lost sight of the overall issues that were being addressed in the context of reserve requirements on the Euro-markets. That work is being continued on a regular basis.