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Proposals for Federal Control of Foreign Banks

Robert Johnston

Foreign banks have operated in the United States for over a hundred years, but they have begun to attract attention only recently, primarily as the result of the rapid expansion of their activities in the nation's major financial centers. In the past few years, foreign banks have become an important part of the national banking scene, and yet this growth has taken place under rules laid down by state law, not Federal law. The entry of foreign banks into specific markets has been determined primarily by the laws of the various states, so that foreign banks have been able to escape almost entirely from Federal banking control. Consequently, a series of Congressional proposals have been made to bring foreign-bank operations under effective Federal control.

Growth of Foreign Banks

Until the late 1960's, most foreign banks were located in New York City, being attracted there by the advantages of direct access to the New York money market and by the ability to offer New York facilities to their international customers. Apart from New York, California was the only state at that time with any significant number of foreign banks. Most of California's foreign banks specialized in serving international and business customers, but some differed from their New York counterparts by gradually building up a retail banking network.

The foreign-bank sector expanded rapidly in the early 1970's, in terms of both numbers and operating volume. The number of U.S. banking institutions owned by foreign banks rose from 85 to 104 between 1965 and 1972, and then accelerated to reach 181 by September 1975. This growth was fostered by their ability to establish an interstate banking network in a form denied to U.S. domestic banks. Because of legal organizations open to them under various state laws, foreign banks can establish banking offices across state lines (see appendix). In contrast, their domestic competitors are limited to their home states, except for international banking subsidiaries operating as Edge Act Corporations. Foreign banks can open branches or agencies in as many states as will license them. These branches and agencies are not separately incorporated but are legally offices of the foreign banks, so that the usual prohibitions against interstate branching or acquisitions do not apply, as they would to domestic banks.

Many foreign banks come under the Bank Holding Company Act (BHC Act), but this Federal statute affects only those controlling domestically-chartered banks. A foreign bank controlling a banking subsidiary — that is, a *commercial bank* with a state (or more rarely) national charter—must register as a bank holding company, and as such it is prohibited from making interstate acquisition of additional banks. But *branches* and *agencies* are not "banks" for purposes of this Act, which means that these holding companies can expand across state lines through new branches or agencies. Moreover, a foreign bank that limits its U.S. banking operations to branches or agencies is not subject to Federal banking laws, and it can also engage in nonbanking activities closed to U.S. banks and to those foreign banks which do come under the BHC Act.

Only ten states explicitly permit some kind of foreign banking, but this group of ten includes New York, California, and since 1973, Illinois. The ability to operate in the nation's three largest financial markets gives foreign banks a useful advantage over their domestic competitors. Currently, 44 foreign banking organizations have offices in at least two states, and 20 of them operate in three or more states. The growth of these interstate banking operations — a privilege denied domestic banks — helps explain the pressure behind the proposals for expanded Federal control.

Another reason for such pressure is the growing importance of foreign banks in the nation's credit markets, as shown in recent Congressional testimony by Federal Reserve Governor George Mitchell.[1] Between November 1972 and September 1975, "standard" banking assets of these institutions (after adjustments for clearing and transactions with the foreign parent bank or its affiliates) jumped from $18 billion to $41 billion. Their commercial and industrial loans doubled in this period from $11 billion to $23 billion, equalling one-fifth the business-loan volume of large domestic banks. Furthermore, three-quarters of their business loans were made to domestic (not foreign) borrowers. Yet despite these developments, total "standard" assets of foreign banks amounted only to about 5 percent of the total assets of all U.S. banks last year.

To a large degree, the foreign banks' rapid expansion in the U.S. reflects the worldwide growth of international banking. Foreign banks, in a sense, are following the U.S. banks' example by expanding overseas. For competitive reasons, foreign banks have had to follow their domestic customers to this country, since a major international bank must have at least one U.S. office if it expects to match the range of services offered by competing institutions. With the rapid development of international banking, foreign banks have become active in many national banking markets besides the U.S.—but in no other major country do national monetary and regulatory bodies have such little control over the foreign banks operating within their boundaries. Most such operations here are not subject to Federal Reserve System reserve requirements. Federal regulatory supervision is limited to subsidiary banks, and does not extend to the more important branches and agencies.

Further pressure for federal regulation arises from the recognition that the U.S. government is at a disadvantage in negotiating with foreign governments on behalf of U.S. banks, because effective control of foreign banking in the United States is in the hands of the individual states. A Federal presence in the control of such operations would increase the U.S. bargaining power when discussing banking issues with other governments.

Federal Legislative Proposals

Legislation to modify the present situation must consider domestic banking policy but also recognize possible international consequences. New regulations for foreign banks would affect the pattern of domestic competition, but changes which limit existing rights of foreign banks could result in new restrictions against U.S. banks operating abroad. Indeed, American banks and their customers would have more to lose in any such situation; the assets of U.S. banks abroad ($135 billion) are three times greater than foreign banks' assets here.

Legislation now being considered in Congress would eliminate discrimination by following a policy of uniform or national treatment. Foreign banks would have no more rights than U.S. domestic banks; both would operate under the same regulatory standards. A policy of non-discriminatory treatment, even where it has restrictive effects, is clearly easier to justify to foreign governments and less likely to result in retaliation.

The treatment of existing but nonconforming activities always presents a policy question, with several different legislative answers. Existing activities could be forced to conform fully to new regulations, but on the other hand, banking legislation commonly exempts or "grandfathers" existing operations, applying the new law only to operations begun after a specified date. A good example is the Bank Holding Company Act. Each interstate bank holding company existing when the Act became effective in 1956 was allowed to keep the banks it owned outside its principal state of operations, but future acquisitions were forbidden. In 1970, when the BHC Act was revised, grandfather rights were given to certain nonbanking subsidiaries. In the present context, grandfathering could be advocated because foreign banks originally established their operations legitimately under state statutes, and elimination of these existing rights might be regarded as a violation of our international treaty obligations.

Congress is now considering three separate bills that would establish Federal regulation of foreign banks. They all have the common aim of achieving equality of treatment between domestic banks and their foreign competitors while establishing more effective Federal control. The first is the Federal Reserve System's proposal, the Foreign Bank Act, originally introduced in December 1974 and reintroduced in March 1975. This bill deals only with foreign banking. The Financial Reform Act of 1976, while aimed generally at a general reform of financial institutions, contains a section dealing specifically with foreign banks. The third bill, the International Banking Act of 1976, in many respects resembles the Foreign Bank Act.

A. Foreign Bank Act of 1975

The Foreign Bank Act is based upon the principle of nondiscrimination: foreign banks in the United States should have the same powers as equivalent U.S. banks but no more than that. The bill came about as a result of Federal Reserve discussions with foreign banks, foreign governments, and U.S. banking organizations. Its provisions are detailed and in many sections very complex, but its goals are clear—to establish equal treatment consistent with established rights of foreign banks, and to achieve effective Federal control over this growing sector of the banking system.

Control of branches and agencies

The Foreign Bank Act deals with the question of interstate expansion by simply redefining all branches and agencies as "banks" for purposes of the Bank Holding Company Act. Foreign parent banks not presently covered would be regarded as bank holding companies. All interstate expansion by way of branches or agencies would be stopped. Since the BHC Act forbids interstate acquisition of "banks," foreign banks would be limited to their existing states of operation. But within those states, foreign banks could (with Federal Reserve permission) establish new branches or agencies and bank subsidiaries, on the same basis as domestic banks. Foreign banks entering the United States for the first time would be limited to a single state—in practice, probably either California or New York.

The BHC Act contains a clause allowing interstate acquisitions if state law gives specific permission and if the right is available to both domestic and foreign banking organizations. Only Maine to date has passed such legislation, although enabling bills have been introduced on occasion in both the California and New York legislatures. In brief, foreign banks would be unable to open branch offices across state lines until such time as domestic bank holding companies are allowed interstate acquisitions.

With all foreign banks brought under the BHC Act, their activities in nonbanking businesses also would come under Federal regulation. The BHC Act limits nonbanking activities to those approved by the Federal Reserve Board of Governors as being closely related to banking. Consequently, foreign banks would have to conform to the same set of rules which govern the nonbanking activities of domestic bank holding companies. For some foreign banks, particularly those involved in the securities business, this provision would cause problems, but for others it would confirm their right to engage in approved lines of domestic financial services.

Federal Reserve membership

Membership in the Federal Reserve System would be compulsory for all U.S. offices of foreign banks whose world-wide assets are above $500 million. This provision would bring almost all foreign banks under domestic monetary control.

Federal branches and national banks

At present, foreign banks have little choice except to operate under state license, whereas under the dual banking system, domestic banks have the choice of operating either under national or state regulations. To make dual banking an effective option, the Foreign Bank Act would permit up to one-third of each national bank's directors to be foreign nationals and would remove the present provision of the National Bank Act requiring U.S. citizenship for all directors. Secondly, the Act would establish a Federal equivalent to the state-licensed branch, and would permit conversion of state-licensed branches or agencies to Federal status. Each foreign branch would have all the privileges of a national bank, except that its its lending limits would be based upon the capital of its foreign parent. For these reasons, a Federal branch clearly would represent an important new option for foreign banks.

FDIC insurance

FDIC insurance, currently available to bank susidiaries of foreign banks, would be made available to branches and agencies as well. Actually, FDIC insurance does not appear to be necessary now for most branches, which are engaged mostly in wholesale-banking business, but under the principle of competitive equality, insurance coverage for branch deposits should be allowed. In California, this provision would permit agencies to assume the equivalent of branch status; at present, California law does not permit foreign agencies to accept deposits of domestic customers, because their deposit accounts cannot be insured by the FDIC.

Federal licensing

Federal authorities would establish effective control over the entry of new banks and the expansion of existing offices by requiring any foreign bank entering the United States to apply for a Federal license. Foreign banks already here would only have to register, but licenses would be required for all future acquisitions or mergers involving other banks, or for the opening of additional branches or agencies. The only exception would be *de novo* offices of bank subsidiaries, because such offices are not regarded as separate "banks." The Comptroller of the Currency would issue licenses, after applying the usual regulatory standards and consulting with the Federal Reserve, the Treasury and the Department of State. The Secretary of the Treasury could instruct the Comptroller not to issue a license, if it was "not in the best interests of the United States," whenever it appeared necessary to block entry for foreign-policy reasons.

Grandfather rights

The Foreign Bank Act follows the precedent of the BHC Act in allowing liberal grandfather rights. In doing so, it resolves most objections to the bill expressed by foreign governments, and thus minimizes the danger of retaliation. The Foreign Bank Act would grandfather all existing offices of foreign banks as of the date the bill was first introduced (December 3, 1974). Within its principal state of operations (measured by total assets), each foreign bank would be allowed to expand according to rights presently existing for domestic banks under state law. In other states, it could make no more new acquisitions, but could maintain any existing branching rights.

In the special case of investment-banking subsidiaries, only existing offices would be grandfathered and no further expansion would be permitted. This would conform with the provisions of the Glass-Steagall Act, which separates commercial from investment-banking operations—in contrast to the situation in Europe, where the two activities are commonly combined. Because of the limited number and size of the securities affiliates controlled by foreign banks, grandfathering of existing offices would appear to be the most acceptable solution. Current rights would be protected, but future expansion in violation of the intentions of the Glass-Steagall Act would be expressly prohibited.

Other provisions

The Foreign Bank Act allows foreign banks, for the first time, to establish Edge Act Corporations (see appendix). Edge Act subsidiaries could be established in other states as well as abroad, but U.S. offices would be limited to a purely international banking business. Because of the international specialization of many foreign banks, Edge Act subsidiaries would represent a reasonable alternative to the present agency form of organization as a mechanism for conducting business in other financial centers—and they would represent an alternative already open to U.S. banks.

In its original form, the Foreign Bank Act excluded from Federal regulation two forms of organizations used by foreign banks to operate in the United States—joint-venture banks operated by foreign banks, with none owning more than 25 percent of the outstanding shares,[2] and New York State-chartered investment companies which can conduct a banking business. The exception was made because of the very small number of these banking organizations, and because of the possible impact on domestic nonbank corporations of changing the BHC Act definitions of control. However, a number of foreign banks have recently applied for permission to form joint-venture banks or New York State investment companies, subsequent to the introduction of the Foreign Bank Act. In view of the potential for evasion of Federal control, the Federal Reserve has now proposed several limiting amendments. Future investment companies chartered in New York to engage in commercial banking would be subject to the same provisions applicable to branches and agencies. As for joint ventures, the definition of control would be changed to cover cases where shareholders, as in consortia banks, act in concert to control a domestic bank. This restriction would apply to domestic cases of joint control as well as to foreign banks.

Summary

The Foreign Bank Act would bring foreign banks in the United States under comprehensive Federal control. Federal supervisory and examination procedures would be applied to insure that appropriate banking practices are followed. Federal Reserve membership would be required to insure that an important sector of the banking industry is brought under national monetary control. Foreign banks would lose certain privileges, principally in multistate banking, but generally would exercise the same rights as domestic banks. Federal licensing procedures on entry and acquisitions would help strengthen the Federal governments' ability to obtain nondiscriminatory treatment for U.S. banks operating overseas.

B. Financial Reform Act of 1976

The Financial Reform Act of 1976 is the companion piece in the House to the Financial Institutions Act passed by the Senate in December 1975. This legislation reflects proposals contained in the recent Congressional study, Financial Institutions and the Nation's Economy (the FINE study), as well as the extensive hearings on that study. The FINE study was designed as a general reform of the nation's financial system — including activities of foreign banks — and the subsequent legislation represents a thoroughgoing, though more limited, revision of the system.

Chapter 4 of Title I of the Financial Reform

Act deals with foreign banks. Although based on Title VI of the FINE study, this chapter has been substantially revised as a result of proposals made by Federal Reserve representatives and others at Congressional hearings on this subject. Chapter 4 is designed to establish competitive equality between domestic and foreign banks, but the treatment of foreign banks is markedly different from that proposed in the Foreign Bank Act.

The following provisions of Chapter 4 would affect foreign banks' activities in this country:

Grandfather rights

There would be no permanent grandfather rights for nonconforming banking offices and for securities affiliates controlled by foreign banks.

Federal licensing for entry

The entry of foreign banks would be subject to Federal licensing requirements. Consultation with the Treasury Department and the Secretary of State would be required. This provision is similar to the corresponding one in the Foreign Bank Act, except that state-licensed branches and agencies would not be covered.

Treatment of branches and agencies

Federally-licensed branches would be permitted, except in states which prohibit such branches. Federal branches would maintain a surety deposit with the FDIC sufficient to give coverage such as that provided by FDIC insurance. Interstate expansion by either state or Federal branches would be prohibited.

National Bank Act

Foreign banks would be allowed to have subsidiaries, under the same terms as the National Bank Act, and up to one-third of national bank directors could be foreign nationals. These subsidiaries would be known as "international banks." Edge Act subsidiaries would also be permitted.

Nonbanking subsidiaries

Nonbanking subsidiaries controlled by foreign banks would be subject to the same rules that are applied to domestic bank holding companies under the BHC Act. This clause is the same as in the Foreign Bank Act, except that non-conforming affiliates would have to be phased out within five years.

Federal Reserve membership

Federal branches and banking subsidiaries of foreign banks would be subject to the same reserve requirements that are applied to similar domestic banks by the Federal Reserve System. Federal Reserve services and credit would be available to these institutions. State-licensed branches and agencies would be subject to System reserve requirements but would not have access to System services.

Summary

The Financial Reform Act now being considered by the House is much closer to the Foreign Bank Act than to the FINE study in its foreign banking clauses. However, like the FINE study, it excludes grandfather rights for existing interstate banking offices. This amounts to a strict interpretation of the principle of equal treatment for all financial institutions. In the FINE Study, the impact of this exclusion was largely offset by a liberalization of interstate branching rights for all banks. In contrast, the Financial Reform Act makes no change in branching laws, so that its lack of a grandfather clause would have a more substantial impact on foreign banks. The Financial Reform Act, like the Foreign Bank Act but not the FINE Study, includes such provisions as foreign directors for national banks, federal licensing, and FDIC coverage of branch deposits.

C. International Banking Act of 1976

The third bill now before Congress, the International Banking Act of 1976, resembles the other pieces of legislation in its basic approach—giving foreign banks the same rights as domestic banks while bringing their operations under Federal control.

Grandfather rights

Multi-state banking operations would be grandfathered, except that state-licensed branches and agencies outside the principal state of operations would have to convert to Federal branch status.

Federal licensing for entry

Federal licenses would be required, and foreign individuals' share purchases involving control of a domestic bank would require Federal approval.

Treatment of branches and agencies

Federal licenses for branches would be available except where state law prohibits such branches. Interstate expansion by branches or agencies would be allowed with state permission. As a substitute for FDIC insurance, an equivalent surety deposit would be required. Multi-state branches would all have to be Federal branches.

Nonbanking subsidiaries

Nonbanking activities of foreign banks which control subsidiary banks, branches or agencies would be limited to those allowed under the BHC Act. Securities affiliates could deal in securities to the extent allowed national banks.

Federal Reserve membership

Federal Reserve membership would be required for all banking subsidiaries. Branches and state-chartered investment companies controlled by foreign banks would be subject to System reserve requirements.

Summary

The International Banking Act is generally similar to the Foreign Bank Act. An earlier draft circulated in 1975 would have prohibited foreign branches from accepting domestic deposits; this provision has been removed. This bill gives the states more latitude than they have under the Foreign Bank Act to control multi-state branch operations. Individual states could forbid the entry of foreign branches, but those that wish to build up a local international banking market could continue to do so. Multi-state branching would be allowed if permission is obtained from banking authorities in both the home state and the state which the foreign bank wishes to enter. Such rights need not be granted to domestic banks, as the Foreign Bank Act requires. All such multi-state branches would have to operate with Federal licenses. Multi-state acquisitions of banking subsidiaries would continue to be prohibited under terms of the BHC Act.

* * *

The proposals described in this article have the common goal of establishing effective Federal control over foreign banks operating inside the United States. They also adopt the principle of nondiscrimination or equality of national treatment. Nonetheless, important differences remain despite common goals and principles.

On the issue of federal control, all adopt with little variation the same general approach: Federal licensing of foreign banks entering or expanding their banking activities inside the United States. Consultation with the Treasury Department and State Department would be required by the appropriate licensing agency to allow for consideration of foreign-policy goals. Nonbank subsidiaries and affiliates would all be brought under the Bank Holding Company Act. Federal Reserve System reserve requirements would be imposed for purposes of monetary control.

The most significant difference concerns the application of the principle of equal treatment to nonconforming multi-state banking offices. The strict view, as embodied in the Financial Reform Act, would phase out foreign banks' multi-state banking offices where domestic banks do not have equivalent powers. The alternative, followed in the other bills, would grandfather existing banking operations but prevent new multi-state offices.

The Federal Reserve's view is that no permanent competitive advantage would accrue from the retention of existing multi-state banking offices, and that the past legislative precedent for domestic bank holding companies would support a liberal grandfather clause in this case as well. Moreover, liberal treatment would minimize the possibility of foreign retaliation against U.S. banks, and would be more consistent with U.S. efforts to strengthen the international banking system.

The Foreign Bank Act of 1975, the International Banking Act of 1976 and the Financial Reform Act of 1976 are all under consideration in this session of Congress. The first two are aimed at foreign banking within the framework of existing banking laws, while the latter treats foreign banking as part of a general reform of domestic financial institutions. Whichever approach is taken, the era of regulatory dominance by state regulators is coming to an end. In the process, foreign banks will lose some privileges and gain others, but the trend will be to national treatment under the primary control of the Federal government.

FOOTNOTES

1. Statement by George W. Mitchell, Vice Chairman, Board of Governors of the Federal Reserve System, January 28, 1976, before the Subcommittee on Financial Institutions of the Committee on Banking, Housing and Urban Affairs, United States Senate.

2. Under the BHC Act, a corporation owning more than 25 percent of the shares of a bank was presumed to control that bank, and the corporation was required to register as a bank holding company. Below 25-percent and above 5-percent ownership, a formal finding by the Federal Reserve was required to establish that "control" existed.

APPENDIX: GLOSSARY OF BANKING ORGANIZATIONS

Domestic banking subsidiary—A domestic bank with its own board of directors and capitalization. It is called a subsidiary because a controlling interest of its shares is owned by a foreign parent bank. The parent bank is regarded as a bank holding company and is regulated under the Bank Holding Company Act by the Federal Reserve System. The subsidiary bank is subject to the same regulatory rules as its domestic bank competitors and has access to FDIC insurance. Lending limits are determined by the subsidiary bank's own capital and surplus, not that of its parent. Federal Reserve membership is optional if the bank is organized under state law, and in practice most banking subsidiaries are nonmembers.

Branch Office—An office of a foreign bank licensed to do a banking business by a particular state, but with no separate corporate charter. A branch can make loans and accept domestic deposits. The deposits are subject to state reserve requirements but these can be met partially by interest-earning assets, so that the effective burden is less than that of Federal Reserve requirements. With some limitations, branches conduct a general banking business similar to that of a domestic bank. Unlike a domestically-chartered bank, the lending limit of a foreign branch is determined by the capital of the parent bank. Branch licenses are available in New York and Illinois. Some branches also operate in Oregon and Washington with deposit-accepting powers by virtue of grandfather rights.

Agency office—An office which, like a branch, has no separate corporate charter and is regarded as an office of the parent bank. An agency, unlike a branch, cannot accept domestic deposits but must raise its funds through non-deposit sources, including funds of its parent or other commercial banks. An agency is not subject to lending limits and to reserve requirements. Under New York law, foreign banks can choose between agency and branch status. In California, because of a state requirement that domestic deposits have FDIC insurance, foreign bank offices are usually regarded as agencies (following New York terminology), although the state law describes them as branches. In Washington, foreign bank branches are effectively agencies, because only small amounts of domestic deposits are permitted.

Representative office—An office which conducts no direct banking business. Business is solicited on behalf of and appears on the books of the parent bank or its affiliates. Under California law, representatives are licensed by the state, but in most states they are not regulated because they are not engaged directly in any local banking activity. Representative offices are the most common form of foreign banking presence in the United States.

Edge Act Corporation—A subsidiary of a member bank formed to engage in international banking, through foreign and domestic offices. The domestic offices may be located in states outside that of the parent bank. Edge Act operations in the United States are limited to international banking and acceptance of domestic deposits arising from international transactions. Lending limits are set by the capital of the subsidiary, not the parent bank. Edge Act corporations allow domestic banks to operate multi-state offices for international banking purposes, and they are similar to foreign agencies.