# A SUMMARY OF THE INTERNATIONAL BANKING ACT OF 1978

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The International Banking Act of 1978 is a landmark piece of legislation which, for the first time, establishes a framework for Federal regulation of foreign banking activities in the U. S. [1] Discussion of such legislation dates back to at least 1966 when a study by the Joint Economic Committee showed that because they were not subject to Federal law, foreign banks experienced certain advantages and disadvantages vis-a-vis their domestic counterparts. [3] For example, foreign-owned banks had the unique opportunity to branch interstate, but were hampered in competing for "retail" deposits because they could not obtain FDIC insurance. Although a number of bills addressing these issues were introduced before Congress in the years following the JEC study, none was enacted until 1978.

During the 1970's, pressure for foreign banking legislation mounted as the number and size of foreign banking operations in the U. S. grew rapidly. [2] In 1973 there were about 60 foreign banks operating banking offices in the United States with combined assets of about $37 billion. By April 1978, there were 122 such offices with combined assets of approximately $90 billion. Moreover, the involvement of these institutions in U. S. credit markets had risen to the point where, by April 1978, they held over $26 billion in commercial and industrial loans. [5] This is equal to about 20 percent of business loans of the 300 large weekly reporting banks. Thus, foreign banks operating in the U. S. could no longer be viewed strictly as specialized institutions primarily engaged in financing foreign trade. Rather, they are significant participants in a wide range of markets for banking services in this country.

In discussions of the major thrust of foreign bank regulation, two divergent views emerged. One view argued for strong Federal regulation to be based upon the principle of "nondiscrimination" or national treatment. This policy sought to place foreign banks on an equal competitive footing with domestic banks, making both groups subject to the same rules and regulations. A different position argued for a policy of "reciprocity" which would allow a foreign bank in the U. S. to engage in as wide a range of activities and geographical areas as permitted by its home country to U. S. banks operating there. Since U. S. banks operating in many foreign countries face fewer regulatory constraints than in the U. S., it was suggested that only minor changes in existing legislation were warranted. While the question of international reciprocity in the regulation of foreign banks is addressed in the new legislation, the major emphasis of the Act is on national treatment of foreign banks. The reasons why this policy was favored should become clear below.

**Organizational Forms** Foreign banks in the United States operate under four major forms of organization: agencies, branches, investment companies, and commercial bank subsidiaries.

*Agencies* are primarily engaged in financing trade and investment between the United States and their home country. The major sources of funds for agencies are balances placed with them by parent or sister institutions and borrowings in the interbank and Federal funds markets. While agencies are prohibited from accepting conventional deposits, they can maintain "credit balances," which represent, among other things, undispursed amounts of loans made to their customers and receipts from international trade transactions. Thus, credit balances are sometimes analagous to the unused portion of a loan held by a customer on deposit with his commercial bank. But there are limits on the types of payments that can be made from such accounts. For example, payrolls and utility bills typically cannot be met from credit balances.

The *branch* form of organization allows foreign banks a broad scope of banking activities, including provision of a range of services approaching "full service" commercial banking. Unlike agencies, branches are able to solicit demand and time deposits. Traditionally, branches have focused their lending operations on the U. S. subsidiaries of home based corporate customers, although they have become increasingly involved in the U. S. corporate banking market. Although U. S. and foreign corporate deposits and interbank borrowings still represent the primary sources of funds for branches, the importance of retail deposits has been growing.

*Investment companies* engage in loan and investment activities and have many of the same banking powers as agencies. Like agencies, they cannot accept deposits but can maintain credit balances. One advantage of investment companies is that they are the only organizational form allowed to deal in securities.

Foreign banks may also establish commercial bank *subsidiaries* in the U. S. These subsidiaries are identical to banks owned by U. S. residents and are subject to identical regulatory restrictions. Through this form, foreign banking corporations can provide a full range of banking services in the United States. Prior to the 1978 legislation, subsidiaries were the only organizational form of foreign bank that fell under Federal regulatory authority, although in practice and for a variety of reasons Federal chartering was rarely favored. One reason was that Federal law required that all directors of a National bank be U. S. citizens, while some states allowed up to half of the directors of a state bank to be non-U. S. citizens.

It should be noted that foreign banks may simultaneously operate a variety of organizational forms. Though state laws prohibit foreign banks from operating both an agency and a branch in a single state, they may operate either of these forms with any or all of the other entities. For example, a foreign bank may simultaneously operate agencies, representative offices, investment companies, and state-chartered bank subsidiaries. Its choice in this connection is dependent upon the kind of banking business it wishes to conduct and the laws of the individual states in which it seeks to operate.

**The Multistate Banking Issue** As of April 1978, there were 63 foreign banks operating facilities in more than one state with 31 of these operating in three or more states. [4] This ability of foreign banks to operate on a multistate basis resulted from a number of factors. [6] First, Federal law did not prohibit multistate branching by foreign banks. Since foreign banks were not eligible for Federal Reserve membership, imposition of McFadden Act restrictions on multistate branching was not possible. Moreover, because branches and agencies of foreign banks were not defined as "bank subsidiaries" under the Bank Holding Company Act, they were not subject to the multistate banking prohibitions of that legislation. Finally, certain states enacted specific legislation permitting foreign bank entry regardless of whether the bank had facilities in other states. Thus, given the legal opportunity, foreign banks expanded their multistate operations in not only international banking and finance, but also in domestic commercial and industrial loans, money market operations, and in some cases, retail banking.

The effect on the competitive equality between foreign and domestic banks due to the ability of the former to conduct multistate operations was the most controversial topic addressed in the International Banking Act. To what degree, if any, did multistate branching give foreign banks a competitive advantage over their domestic counterparts? One view, supported by the Conference of State Bank Supervisors and the Institute of Foreign Banks, held that any advantage foreign banks appear to have is largely illusory because domestic banks have already established their own multistate presence through the operation of loan production offices, Edge Act corporations and nonbanking affiliates in other states. Also, since foreign banks are primarily engaged in international banking operations, their major competitors are not domestic banks but rather Edge Act corporations which, like foreign banks, are permitted to operate in more than one state. Finally, it was argued that restricting foreign banks to one state would give California and New York, which contain the nation's important centers for financing foreign trade, a virtual monopoly of these activities to the detriment of other states wishing to increase their role in international banking. Therefore, the argument ran, Federal restrictions on foreign bank branching was both unnecessary and undesirable.

The Federal Reserve and the Department of the Treasury believed otherwise. While admitting a multistate presence of domestic banks, they argued that the taking of deposits was the essence of banking, and it was in that activity that domestic banks were at a disadvantage. The multistate privilege, it was argued, gave to foreign banks a potentially broader and more diversified base from which to solicit deposits than was available to domestic institutions. Moreover, foreign banks operating on a multistate basis could provide a full line of services to large corporate customers with operations in various states and various foreign nations. The opportunity for a corporation to transact its entire banking business both at home and abroad with one bank was seen as an important reason that foreign banks were attracting such customers. [5]

To this argument was added the issue of the effect of multistate foreign bank operations on the structure of the U. S. domestic banking system. In his testimony before Congress, Chairman Miller of the Federal Reserve System warned of the dangers of allowing a third tier of privileged foreign chartered banks to develop over state and Federally chartered banks. [4] By permitting the world's largest foreign banks to establish full service facilities throughout the U. S. and at the same time continuing to prohibit multistate operation of domestic banks, a situation could arise where only a handful of the largest domestic banks would be competitive with these foreign institutions.

*The 1978 Settlement* The International Banking Act of 1978 attempts to settle the multistate banking issue by establishing rules that promote competitive equality between domestic and foreign banks while preserving the ability of states to attract foreign capital and develop international banking centers. Specifically, the Act allows foreign banks to establish branches or agencies in any state where permitted by state law, as was previously the case. However, the foreign institution is required to designate a particular state as its "home state" and its deposits from outside that state are limited to those foreign-source and international banking and finance related deposits permissible for Edge Act corporations. Thus, branches outside the home state are to accept only the type of credit balances allowable to agencies. Foreign banks are also prohibited from acquiring subsidiary banks outside the home state.

Finally, a "grandfather" clause in the Act exempts from these limitations all foreign bank operations existing on or before July 27, 1978. This feature of the Act has been criticized on grounds that it maintains domestic banks at a competitive disadvantage relative to grandfathered institutions and likewise places foreign banks entering the United States for the first time at a similar disadvantage. Failure to include such a clause, however, risked retaliation against U. S. banks operating abroad by foreign governments. Another justification for the grandfather clause was fairness. It was argued that businesses established under a particular set of rules should be allowed to continue under those rules.

The Act, it might be noted, contains a brief section that has the potential for altering the structure of U. S. banking. This section requires the President, in consultation with the bank regulatory agencies, to submit a report to Congress containing recommendations with respect to the applicability of the McFadden Act to the present financial, banking, and economic environment. The McFadden Act, passed in 1927, prohibits domestic banks from interstate branching. Modification or repeal of this legislation could lead to the establishment of multistate branch networks by domestic banks.

To summarize, by focusing on the key advantage to foreign banks, namely the ability to accept deposits on a multistate basis, the International Banking Act significantly improves the competitive equality between foreign and domestic financial institutions with respect to the taking of deposits. While foreign banks will still be able, with proper state approval, to make both domestic and international commercial loans throughout the country, this does not appear to give them a significant advantage vis-a-vis their domestic counterparts since U. S. banks also have ways of competing for domestic loan business. Thus, the 1978 legislation leaves intact the right of states to determine the extent of foreign bank activity within their own borders while at the same time ensuring that this does not give foreign banks a competitive edge.

**National Licensing and Chartering** As noted, until enactment of the International Banking Act all foreign bank branches and agencies operating in the U. S. did so under state authority. However, passage of the Act has given these institutions for the first time, the option of obtaining either a state or Federal license. Specifically, the Act allows foreign-owned banks to establish Federal branches or agencies in any state where it does not already have a state licensed branch or agency, provided that state law does not prohibit such institutions. In conjunction with this provision, foreign banks electing Federal branch or agency licenses gain access to Federal Reserve System services such as check collection and wire transfers.

Although foreign-owned bank subsidiaries have historically been allowed the dual charter option, only a handful have made this choice. The reason was that Federal law required all directors of National banks to be U. S. citizens. Therefore, to encourage Federal chartering of subsidiaries, the International Banking Act permits a minority of the directors of a National bank to be non-U. S. citizens, subject to approval by the Comptroller of the Currency.

To ensure that Federal branches and agencies of foreign banks do not have a competitive advantage over their state counterparts, several special provisions were included in the Act. These are: (1)

Federally licensed agencies of foreign banks, like state licensed agencies, cannot accept deposits but can maintain credit balances arising from their lending activities; (2) a foreign bank cannot maintain both Federally licensed branches and agencies in the same state, since states permit only one form of organization; and (3) Federal branches and agencies within states are made subject to the branching restrictions of the McFadden Act.

**Regulatory and Supervisory Authority** An important provision of the new legislation establishes a comprehensive framework for the regulation and supervision of foreign banking in the U. S. In the past, almost all of this authority has rested with the states, but passage of the Act has shifted major responsibility to the Federal level. Thus, the Federal Reserve Board, in consultation with the states, is given the power to set reserve requirements for all Federal and state licensed foreign bank branches and agencies whose parent organizations have over $1 billion in total worldwide assets. Almost all foreign banking organizations with U. S. offices meet this criterion. The power to set reserve requirements was deemed necessary for Federal Reserve control over inflows and outflows of funds, as well as over domestic deposits.

Regarding supervision, the Act provides authority for the Comptroller of the Currency, the FDIC, the Federal Reserve Board, and the states, to examine the foreign banking organizations within their respective regulatory jurisdictions. Specifically, Federally licensed branches and agencies will be examined by the Comptroller's office; state licensed branches insured by the FDIC will be examined by the FDIC and the states; and, all state licensed agencies and branches not insured by the FDIC will be examined by the states. In order to ensure full compliance with the Act, the Federal Reserve Board is provided with "residual examining authority" over all the banking operations of foreign banks. This authority permits the Federal Reserve to make independent examinations of any and all foreign bank operations in the U. S. It was granted to the Fed as a tool to be used in consolidating the examination of what in many cases are complex multistate operations. For example, a foreign bank may simultaneously operate a state licensed agency in one state and a Federal branch in another, each being supervised by a different regulator. Providing the Fed with this special examining authority allows a more comprehensive review of these operations than would otherwise be possible.

**Investment and Nonbanking Activities** The Glass-Steagall Act of 1933 made it illegal for a company to engage in both commercial and investment banking activities in the U. S. This prohibition was subsequently reinforced by the Bank Holding Company Act of 1956 and by rulings of the Board of Governors. These prohibitions, however, were not necessarily applicable to foreign banking organizations. By establishing a branch or an agency and simultaneously acquiring a controlling interest in a U. S. broker/dealer, foreign banks were able to engage in both commercial and investment banking. A similar situation existed regarding the separation of banking from nonbanking activities. While domestic banks are unable to acquire more than 5 percent of the voting shares of any company whose business is not closely related to banking, foreign banks were, in practice, allowed to make such acquisitions.

One argument used to justify the exclusion of foreign banks from the prohibitions of the Glass-Steagall Act and the Bank Holding Company Act was one of reciprocity. That is, if U. S. banks operating in a certain foreign nation are permitted to engage in investment and nonbanking activities there, then banks from that nation should be allowed to do the same in the U. S. The counter argument is that each country has the right to determine the banking structure within its borders. Moreover, discrimination within a given market is created when different sets of rules apply to banks from different nations.

The approach of the 1978 legislation to addressing the issue of nonbanking activities of foreign banks is similar to the one used to settle the multistate branching issue. In both instances the objective is to promote competitive equality between foreign and domestic financial institutions without sacrificing interests of national importance. Toward this end, the International Banking Act applies the nonbanking and anti-tying provisions of the Bank Holding Company Act to all foreign financial institutions. To prevent undue burden on a foreign financial institution as a result of these restrictions, existing nonbanking activities of such institutions are grandfathered from July 26, 1978. However, the Act gives the Federal Reserve the power to terminate the grandfathered status of any company after December 31, 1985, if this status has contributed to undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices. It is vital to note that foreign institutions' nonbanking activities conducted principally outside the U. S. are exempt from the restrictions of the Bank Holding Company Act.

**FDIC Insurance** Regarding the provision of FDIC insurance to foreign bank branches, two basic issues were involved. The first concerns competitive equality. Prior to enactment of the 1978 legislation, foreign bank branches were not eligible for FDIC insurance. This created both a competitive advantage and a competitive disadvantage. The advantage arose because foreign branches did not incur FDIC insurance premium assessments and thereby realized a cost savings not available to domestic banks. But because foreign banks were not insured they faced a disadvantage in competing for deposits, especially at the retail level. The second issue involved the lack of regulatory jurisdiction over the non-U. S. portions of foreign banks. The FDIC not only insures deposits, it also attempts to minimize bank failures via bank examinations and other means. But, since U. S. authorities have no jurisdiction over the non-U. S. operations of foreign banks, the FDIC is hampered in such efforts.

The International Banking Act addresses these issues by making FDIC insurance optional for all foreign banks that do not accept retail deposits (defined, for practical purposes, as deposits of less than $100,000). For those branches that accept retail deposits, FDIC insurance is made mandatory. In this way, small depositors are protected and competitive inequalities are reduced. To protect the FDIC from risks associated with insuring foreign banks that cannot be monitored, the Act requires that such banks deposit surety bonds or assets at the FDIC.

**Edge Act Revisions** Although the new legislation seeks mainly a revision of regulations that apply to foreign bank operations in the U. S., it also contains an important section revising the regulation of the specialized U. S. financial institutions known as Edge Act corporations. Edge corporations engage in international banking and financial operations and are restricted to activities that are closely related to their international and foreign business. The legislation that originally provided for the chartering of Edge corporations was enacted in 1919 in order to allow domestic banks to compete more effectively with foreign financial institutions in international banking markets. However, Edge corporations have been subject to restrictions that some consider to place them at a disadvantage relative to their foreign competitors. To redress these apparent disadvantages, the International Banking Act revises several provisions of the Edge Act. First, it removes the restriction limiting outstanding liabilities to ten times the capital and surplus of these institutions. This statutory limit on liabilities was included in the original Edge Act to prevent insolvency. However, because neither domestic nor foreign banks face such a limitation, and since Edge corporations are subject to examination and reports of condition in the same manner as member banks, the restriction was deemed discriminatory. The second major revision abolishes the mandatory 10 percent reserve requirement imposed on the liabilities of Edge institutions and replaces it with the same reserve requirements that apply to member banks.

Yet another revision in the Edge Act allows, for the first time, majority control of Edge corporations by foreign-owned banking institutions. Thus, Edge corporations may become another major organizational form for foreign bank operations in the U. S. in addition to the four mentioned earlier in the article. The original prohibition against foreign control resulted from Congressional concerns that U. S. companies lacked the sophistication to compete with the great banking and trading houses of Europe. Clearly, such fears no longer exist. Another provision of the Act requires the Federal Reserve Board to revise any other regulatory restrictions that discriminate against foreign-owned banking institutions or that disadvantage or limit Edge Act corporations in competing with foreign banking institutions.

**Summary and Conclusion** The International Banking Act of 1978 is the first comprehensive legislation that brings foreign-owned banking operations in the U. S. under Federal regulations comparable to those faced by domestic financial institutions. Its major objectives are to promote competitive equality between foreign and domestic banks, to improve Federal control over monetary policy and to provide a Federal presence in the regulation and supervision of foreign bank activities in the U. S. Under the Act, the deposits of foreign-owned bank branches operating outside of their home state are limited to the international finance related credit balances allowed agencies. Thus, while such branches may make loans, they are restricted in their ability to compete with local domestic banks for wholesale or retail deposits. In addition, the new legislation directs the Federal Reserve to revise regulations that encumber Edge Act corporations in competing with foreign-owned banking institutions.

The Act also allows foreign banks to obtain Federal licenses for branches and agencies and a Federally chartered National bank under liberalized regulations. This ensures that in states where foreign banks are welcome they will have a State-Federal option which is similar to that of domestic banks. In providing these alternatives, the Act establishes a comprehensive regulatory and supervisory framework for the U. S. offices of foreign banks. Finally, the U. S. nonbanking activities of foreign banks operating in the U. S. are placed under the same restrictions as their domestic counterparts, and FDIC insurance is made available to foreign branches desiring such coverage.

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