INTERNATIONAL OPERATIONS OF U.S. BANKS: GROWTH AND PUBLIC POLICY IMPLICATIONS

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Change and innovation dominate the contemporary banking scene both in this country and abroad. In the United States, considerable attention has been directed to a number of changes in banking that have already occurred, are taking place, or are in prospect as they affect the structure of financial institutions, the functioning of markets for money and credit, and the ways in which financial transactions are effected. Automation, credit cards, the checkless society, the role of banks as financial intermediaries—these are but a few of the current topics of study, discussion, and debate. Abroad, too, though perhaps to a less marked degree, the face and character of banking are undergoing changes of similar far-reaching significance.

One of the major areas of change in American banking in the past decade has been international operations. This rather short period has seen an unusually rapid expansion of the international activities of American banks and the extension of a growing number of domestic banking institutions into international banking and financial operations.

In contrast to the rather passive character of these operations in the early 1950s, major American banking institutions are today operating large networks of branches encircling the globe. Affiliations have been established with banking and financial institutions on every continent. Foreign loans and credits at banks in this country have undergone a nearly six-fold expansion. This lending now encompasses a full range of borrowers—foreign banks, governments, subsidiaries of U.S. corporations, and others; and, in addition to traditional financing of this country's foreign trade, credits are extended to provide working capital, to finance large-scale capital projects, and for a variety of other purposes in countries ranging from Australia to Zambia. Major American banks, together with their foreign branches and affiliates, are important intermediaries for the channeling of funds among international financial centers in quick response to changes in interest rates and in demand and supply relationships for money. Funds obtained in foreign financial markets have been used to support bank lending and investment activities in the United States, and, for a few banks, one quarter or more of their earnings are attributable to their international operations.

The expanded international operations of American banks have introduced or accelerated change in foreign banking markets and in foreign banking practices. In

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a number of foreign countries greater competition for deposits among banks, improved personal service to bank customers, the use of credit cards, and better accounting practices on the part of bank borrowers are traceable to the entry and subsequent activities of American banks.¹ In turn, some of the experience acquired in overseas operations has been applied in domestic operations. For example, some major banks are currently advertising and promoting systems of personal loans which are adaptations of the personal overdraft systems used in many foreign countries.

The growth and the evolving character of the international lending and deposit activities of U.S. banks have important implications for the balance-of-payments position of the United States, monetary and credit control in this country, and the supervision and regulation of the domestic banking industry. Some of the ramifications of this development for the U.S. payments position have been recognized in Government programs aimed at curbing the foreign lending of this country's banks. The impact of domestic banks' international operations on the structure and functioning of the banking system has, on the other hand, received little in the way of comprehensive and critical scrutiny.²

Despite the growth of recent years and the present dimensions of the international operation of American banks—which by standards as recent as a dozen years ago are extraordinary—any characterization of these activities and conclusions as of now must necessarily be tentative. Growth in international lending at banks in this country has slackened since the end of 1964 under the impact of Government balance-of-payments programs, and from late 1965 to late 1966, of heavy domestic loan demand and monetary restraint in the United States. In this same period, however, activity at foreign branches of U.S. banks has burgeoned; the number of such branches has continued to rise as additional branches have been opened by banks with existing foreign branch systems and as other banks have established their first overseas branches. Also, new affiliations have been established with banking and financial institutions abroad. New and different ways of conducting an international banking business have been sought. And banks which heretofore have played little role in this development have begun to lay the groundwork for their participation in the wider field of international finance. In this broader sense of a deepening involvement of American banks in international banking, no slackening of interest or of activity can be said to have occurred.

The first section of this article traces the evolution of the international banking activities of American commercial banks, while the second section offers a sketch of

¹ See generally *Banking Across Frontiers*, 213 THE ECONOMIST 845 (1964), for a brief account of some of the consequences of the entry of U.S. banks into foreign banking markets, and for the subsequent, not always pleased, reactions of foreign bankers.

² The absence of such scrutiny by economists and students of financial institutions is, in the circumstances, surprising. See generally Chittenden, *The Changing Role of U.S. Banks in International Financing*, 20 J. FINANCE 172 (1965), for a view of the development of the international side of American banking by an active participant. See also Moore, *International Growth: Challenge to U.S. Banks*, 1 NAT'L BANKING REV. 1 (1963).

their present-day scope and character. The third section of the article reviews the legal and regulatory framework within which this growth has taken place and these operations are presently conducted. The final section then explores some of the questions which this on-going development seemingly poses for public policy, particularly with respect to bank supervision. At the very least, it is hoped that this discussion will inspire further study and examination of this added dimension of commercial banking in the United States.

I

GROWTH OF INTERNATIONAL BANKING AND INTERNATIONAL FINANCIAL OPERATIONS

A. History

American banks are not newcomers to the field of foreign banking and financing. Early efforts by American banks to widen their foreign financing activities and to develop a foreign banking organization date back beyond the turn of the century. Prior to 1914, however, these activities remained incipient, and banking organization for this purpose was embryonic. London was the dominant financial center, and the financing of U.S. foreign trade continued to remain largely in the hands of London banks.

Early development of the foreign activities of American banks was hampered by the lack of powers of national banks to accept drafts or to establish foreign branches. This deficiency was rectified only with the passage in 1913 of the Federal Reserve Act, which included provisions granting these powers to national banks.³ Two other pieces of legislation contributed materially to the powers of commercial banks to conduct their foreign business. The first, passed in 1916, amended section 25 of the Federal Reserve Act⁴ and permitted national banks to invest in state-chartered corporations engaged in international or foreign banking and operating under an agreement with the Federal Reserve Board delineating their activities—so-called “agreement corporations.” The second, which added section 25(a) to the Federal Reserve Act, was passed in 1919 and has come to be known as the Edge Act.⁵ This act provided for federally chartered corporations—so-called “Edge corporations”—to be organized for the purpose of engaging in international or foreign banking and financial activities.

These wider powers facilitated the upsurge in foreign banking activity by U.S. banks that took place in the aftermath of the First World War. The abnormal amount of foreign banking activity associated with postwar reconstruction credits

³ Federal Reserve Act § 13, ch. 6, § 13, 38 Stat. 263 (1913), *as amended*, 12 U.S.C. § 372 (1964); Federal Reserve Act § 25, ch. 6, § 25, 38 Stat. 273 (1913), *as amended*, 12 U.S.C. §§ 601-04a (1964, Supp. II, 1965-66).

⁴ 39 Stat. 755 (1916), *as amended*, 12 U.S.C. §§ 601-03 (1964, Supp. II, 1965-66). See generally text at note 18 *infra*.

⁵ 41 Stat. 378 (1919), *as amended*, 12 U.S.C. §§ 611-31 (1964). See generally text at note 19 *infra*.

tapered off in the early 1920s, however, and through the remainder of that decade and through the 1930s the pattern and extent of the international activities of American banks paralleled movements in world trade. A substantial contraction in the volume of these activities and in banking organization abroad occurred in the 1930s, and banks' foreign business was further constricted by the dislocations of the Second World War. At the end of 1945, the number of foreign offices operated by U.S. banks and their subsidiaries had shrunk to seventy-eight, less than half as many as a quarter of a century earlier.

In the decade following the war, substantial recovery occurred in the volume of foreign lending, and there was some renewed growth in the number of banking offices maintained abroad by American banks. In this period, too, the groundwork was laid for much of the subsequent expansion in these operations. Nevertheless, as a broad generalization, it is fair to characterize the international operations of American banks up to the mid-1950s as essentially passive, comprising mainly a service operation related to the financing of U.S. foreign trade.⁶

In the period of little more than a decade since that time, the volume and scope of these operations have been many times enlarged. Moreover, in a number of banks the international banking department has attained a position of major importance in the over-all business and workings of the bank. An indication of this growth in international operations is provided by the following comparisons. At the end of 1966, dollar loans and acceptance credits to foreigners of banks in the United States totaled \$9.6 billion, as compared with about \$1¾ billion at the end of 1955.⁷ Over the same period, the number of foreign branches of U.S. banks and banking corporations increased from 115 to 248 and foreign branch assets from \$2 billion to \$12 billion. Parallel growth occurred in Edge and agreement corporations over this eleven-year span: at the end of 1955 there were only seven such corporations in operation; by the end of 1966 the number of such corporations had increased to forty-five, owned by thirty-three banks and bank holding companies.

B. Reasons for Growth

No single or simple explanation can be offered for the remarkable transformation of U.S. banks into large-scale, sophisticated international lenders and major participants in global financial transactions. Clearly, the present volume and character of these activities are the product of many and complex forces. Among the more fundamental or underlying ones that may be cited are the emergence of the United States in the postwar period as the principal economic and financial power in the

⁶ See generally Tamagna & Willis, *United States Banking Organization Abroad*, 42 FED. RESERVE BULL. 1284 (1956), for an account of the international activities of U.S. banks in the first half of this century.

⁷ These figures relate to all banks in the United States reporting claims on foreigners to the U.S. Treasury and include branches and subsidiaries of foreign banks in the United States. Unfortunately, these data are not available for U.S. banks alone.

world economy; the growth and, by historical standards, the fundamental health of the world economy since about 1950; the progressive dismantling of restrictions on international trade and capital movements; the needs of the American economy for additional resources from abroad; and the demands of U.S. consumers with rising incomes and widening tastes for an increasing variety of goods and services. These elements have all helped to create an environment conducive to the exploitation of opportunities for trade, investment, and lending on an international scale.

More direct impetus to the development of the international business of U.S. banks has been provided by the upsurge of direct investment abroad by U.S. corporations since the early 1950s. Corporations embarking on or enlarging their international ventures naturally turned to their banks for financial assistance and for information and advice on the multifaceted problems encountered in international operations. As the business of more and more U.S. corporations became globally oriented and with the emergence of the multinational corporation, it became increasingly imperative for major banks to establish an international banking organization and to acquire the competence and experience needed to provide banking services on a worldwide scale. As the movement of U.S. corporations abroad gained momentum, interior banks were initially at a disadvantage compared to those banks, particularly New York City banks, with an existing fund of experience in conducting foreign business. Corporations unable to obtain a full range of international banking services from their local bank consequently turned to banks in New York City. Faced with a potential drain of corporate business and corporate deposits, a number of interior banks had quickly to establish themselves in the international field. The widening circle of banks engaged seriously in international banking is a clear reflection of these competitive forces at work.

Two accommodating factors may also be mentioned among the forces underlying the development of international banking in U.S. banks. First of all, the technological advances in transportation and communication have greatly eased the tasks of banks in maintaining continuous and informed surveillance of foreign markets and of their overseas operations. Foreign markets and foreign customers, no matter how distant, are now easily accessible to direct contact by bank lending and supervisory officers. The second accommodating element was the easy monetary conditions that prevailed in the United States in the period 1960-65. Without that monetary environment, the speed and timing of the expansion of international business in U.S. banks would clearly have been quite different.

C. International Operations in Structural Perspective

Up to this point emphasis has been placed on the growth and altered position of international operations in American banks. In the ensuing paragraphs, too, attention will be directed to the changed and changing nature of these operations. Yet it is important to keep in mind that, despite the growth of recent years, these operations

still form a very small portion of the over-all business of U.S. banks. Moreover, participation in this development has been confined to a small number of banks. For example, foreign credits account for less than five per cent of the loan portfolios of all banks in the United States, and the number of banks significantly involved in international lending is about fifty at the most.

The confinement of this business to a relatively small number of banks is a reflection of the fact that, by its very nature, international banking is a province of the very largest banks. The provision of full-scale international banking services requires sizable organization and resources, and a substantial amount of international business is needed to support the provision of those services. Not surprisingly, therefore, the fifty banks actively engaged in international banking are, with few exceptions, among the fifty largest banks in the United States.

The concentration of international banking among U.S. banks is in fact greater than just suggested. The three largest banks in the United States alone account for more than one-third of total bank-reported claims on foreigners, and twenty banks account for nearly eighty-five per cent of these claims. However, these banks are all major money market banks, are among the most aggressively growth-minded, and in general rank high among the innovators in the commercial banking industry. For some of these banks, foreign credits run as high as twenty-five per cent of their loan portfolios.⁸ The commitment of these banks to international banking, taken together with the leading, if not dominant, role of these banks in the banking system, clearly enlarges the importance of international operations in the U.S. banking system beyond that indicated by crude aggregative comparisons.

II

A PROFILE OF INTERNATIONAL OPERATIONS OF U.S. BANKS TODAY

A. Organizational Mechanisms for Carrying on International Banking

Traditionally, the foreign business of banks has been carried on from offices in this country using the facilities of correspondent banks in foreign countries. However, the larger banks have found it imperative to have some form of direct representation abroad and some means of direct participation in foreign banking and financial markets if they are to become and to remain fully able to meet the global banking needs of their customers. This need has led to the construction of elaborate and extensive overseas organizations to supplement and to some extent to supplant correspondent bank relations. Besides representative offices, these overseas organizations consist (with considerable variation from bank to bank) of foreign branches, foreign subsidiaries, and substantial affiliations with existing foreign banks and other financial institutions. A contemporary account of the international activities of

⁸The figures and comparisons used in this paragraph relate solely to loans and other claims booked at offices in this country; for those banks with extensive branch systems abroad, the proportion of foreign credits to total loans would be higher.

American banks must therefore include the foreign lending and other international activities done at head offices in this country, the operations of foreign branches, and their relations with foreign subsidiaries and affiliates. In this account, the last named will be discussed in connection with the operation and uses of Edge and agreement corporations which until recently were the sole vehicle for the holding of ownership interests in foreign institutions.

1. *Head Office Activities*

The international banking departments of the major banks carry on a wide range of banking, administrative, and service functions. Their banking activities usually encompass all of the credit and deposit transactions of foreigners plus the international business of the bank's domestic customer. These include the usual range of banking services in connection with foreign trade transactions—letters of credit, acceptance financing, collections, remittances, etc., and foreign exchange. In addition, the credit function includes general purpose loans and advances to foreigners. In conducting this business, the department operates almost as a "bank within a bank" with a net creditor or net debtor position vis-à-vis the rest of the bank.⁹ In most cases, these departments directly conduct the bulk of the bank's international banking business. For banks with extensive overseas organizations, however, the locus of their international banking activities has been shifting to their offices abroad; and in these banks, a principal task of the department is to supervise and coordinate the credit and other activities of foreign branches and subsidiaries. A major service function of the department is to provide information, advice, and other assistance to international customers, particularly on the financial aspects of conducting business in foreign countries and over international frontiers. Most of the large banks maintain a small but growing corps of experienced officers for the express purpose of assisting with such corporate problems.

In a subsequent section, the international lending done at banks in this country is described in more detail to illustrate the changing nature of U.S. banks' international business.

2. *Foreign Branches*

In conducting their international banking business abroad, direct branches are the organizational form generally preferred by U.S. banks. In terms of size of operations, branches are far more important than subsidiaries or affiliated banks; moreover, the over-all activity of branches runs a fairly close second to the international operations of head offices. The advantage of the branch form of overseas

⁹ This element enters in an undefinable way into the complex equation by which a bank's resources are allocated among alternative uses. Those departments with an excess of international deposits over international credits apparently find it somewhat easier to obtain senior management approval for the extension of additional credits than do those in the reverse position.

operation is that the branch is legally an integral part of the parent bank with the full resources and organization behind it; in many countries, this provides stature to a branch that would not exist in the case of subsidiaries or affiliated banks. Administratively, too, the branch can be and is operated as part of the parent bank. The principal disadvantage for foreign branches is that a branch usually starts *de novo* in a foreign market with the concomitant problems of a foreign bank attempting to build up a local deposit base. For a number of banks, this disadvantage has proven an insurmountable obstacle.

Because of the need for large resources and a large organization to support branch activity overseas, only twelve banks had established direct foreign branches by the end of 1966. Extensive overseas branches are operated by only three banks: First National City Bank, Chase Manhattan Bank, and Bank of America. The other banks have branches in only a few foreign countries, and a number of them maintain branches solely in London. The geographic distribution of foreign branches by number and relative size at the end of 1966 are shown in Table 1.

TABLE 1
FOREIGN BRANCHES OF U.S. BANKS, DECEMBER 31, 1966

	Latin America	England	Other Europe	Japan	Other Foreign	U.S. Overseas Territories	Total
Number of branches.....	102	21	27	12	53	29	244
Branch assets (\$ millions).	1,052	6,411	2,056	1,239	840	787	12,385

The three large branch networks operate on a world-wide basis. This global orientation gives them a distinction not found in other overseas banking organizations. For example, the British overseas banks, while operating a far larger number of branches in many cases, generally confine their activities to one or two geographic areas; none directly operates on a world-wide basis. A global network enables a bank to meet the banking needs of large multinational companies by acting as lenders and depositories in a wide number of foreign locations and as advisers on the broad range of complex and often unfamiliar financial problems encountered by corporations with far-flung operations. Moreover, for the corporate treasurer of a multinational company, they afford a means of dealing with one bank in a number of markets and also a channel for almost instantaneous transfers of funds among the companies in his international operation. The First National City Bank has developed the most extensive network of foreign branches consisting at the end of 1966 of 124 branches located in forty countries. The Chase Manhattan Bank operated forty-two foreign branches, and Bank of America had forty-four branches located overseas at the end of 1966.

Located in such a large number of diverse countries, the range and nature of

branch activities within the three large branch networks show a large degree of variation. Some branches are located in highly developed and sophisticated loan and money markets, and in these markets the branches do a bank-to-bank business as a full market participant. In some other markets, the branches do a retail banking business in full competition with the local banking institutions. In still others, and especially among some of the newer nations, the local banking market is relatively underdeveloped, and the range and scope of branch activities is necessarily limited. These branches have also to operate within highly diverse legal systems, banking and exchange control regulations, and customary systems of banking practice and operation.

The principal locus of foreign branch activity is London. Twelve U.S. banks have established branches, and about half of all foreign branch assets are centered there. Attracting U.S. banks has been the continued status of London as a major world financial center, a status considerably enhanced by the emergence in the mid-1950s of the Euro-dollar market centered in London.

American banks in London are major participants in the Euro-dollar market and have been prime contributors to its development. The bulk of their activity, in fact, is confined to that market inasmuch as only limited business in sterling is available and sterling lending in recent years has been curbed by the Bank of England. As active participants in the market for dollars as it has developed in London, American banks offer and take dollars in the interbank market and obtain dollar funds from the market for corporate clients. The three banks with world-wide networks of branches are able to garner funds throughout their branch systems and funnel them in and out of London in response to needs and availabilities in widespread money centers. Deposits placed with these branches are not subject to any interest rate limitations such as apply to deposits at offices in the United States, a fact which together with the names of the banks has attracted large deposits from corporations abroad. Participation in this market, however, involves a highly sophisticated money and foreign exchange operation inasmuch as the basis for operations consists of potentially volatile "bought" deposits and lending operations can involve complex swap operations in and out of all the major foreign currencies.

Growth in activity at London branches surged in 1965 and 1966 as a result of the rechanneling of international financing to London and to the Euro-dollar market in the wake of the institution of the voluntary foreign credit restraint program in the United States and the imposition of the interest equalization tax on term loans by U.S. banks. Borrowers in foreign developed countries turned to the Euro-dollar market to obtain funds, and U.S. banks close to or above their foreign credit ceilings sold off parts of their foreign loan portfolios to their London and other foreign branches. Total assets of London branches more than doubled in this period from \$2.7 billion to \$6.4 billion, and alone accounted for two-thirds of the asset growth of all foreign branches of U.S. banks.

Access to the London market through a branch proved especially advantageous to U.S. banks in the summer of 1966 as monetary conditions in the United States tightened progressively. Those U.S. banks faced with substantial run-offs of certificates of deposit in this period as well as heavy domestic loan demand were able to obtain resources by borrowing in the Euro-dollar market through their London branch.¹⁰ This was an expensive way to obtain additional funds as rates in the Euro-dollar market rose to seven per cent for ninety-day funds (one and a half points higher than permissible rates on C/Ds), but with the degree of pressure on the banks, the availability of funds was of far greater importance than their cost. In the latter half of 1966, head office liabilities to foreign branches (and mainly to those in London) rose by over \$2 billion. Banks without direct access to the Euro-dollar market through a London branch were somewhat disadvantaged, being forced to rely on the federal funds market or to borrow from the Federal Reserve discount window to maintain their reserve positions. Largely because of this experience, recent months have seen further interest by some banks previously without foreign branches to seek to establish a branch in London.

Of the many other diverse types of banking conducted by foreign branches of U.S. banks, one of particular interest is the business of branches in centers such as Nassau, Beirut, Geneva, Hong Kong, and, to some extent, Panama. These centers have in common rigid banking secrecy, a favorable tax climate, reasonable political stability, and the virtual absence of exchange controls. In consequence of the resulting advantages to corporations and investors, they became financial centers in their own right, serving as gathering points for liquid wealth and other funds seeking tax or political haven or as way stations in the international movement of corporate cash balances. The U.S. branches attract a sizable portion of the funds entering these centers by reason of their association with the largest names in U.S. banking. The branches are able through the world-wide connections of their parent institutions to channel these funds into appropriate investment outlets.

3. *"Edge" and "Agreement" Corporations, Including Foreign Affiliates*

The third major institutional framework through which U.S. banks conduct their international operations consists of subsidiary corporations, the so-called "Edge" and "agreement" corporations. The activities, focus, and the size and number of these corporations, like other aspects of banks' international activities, have undergone considerable change since the mid-1950s. At the end of 1955 there were three Edge corporations and four agreement corporations in existence. Eleven years later, the aggregate number of these corporations had grown to forty-five, owned by thirty-three banks.

¹⁰ Deposits at foreign branches are not subject to reserve requirements, nor are the rates paid for such deposits subject to the interest rate limitations applied to deposits at offices in the United States. Also, liabilities of head offices to their own foreign branches (*i.e.*, borrowings) are not considered as deposits at head offices and hence are not subject to reserve requirements or to interest rate ceilings.

As these corporations have developed in size and number in the last decade, three distinct functions have appeared. First, for the non-New York banks, the Edge corporation has offered a permissible corporate vehicle for the establishment of a New York office. Second, all banks have employed these corporations as holding companies through which to acquire and hold their interests in foreign subsidiary or affiliated banks and in other foreign financial institutions. Finally, the ability of these corporations to acquire and hold shares has enabled American banks in their foreign operations to extend some equity as well as loan financing.

Establishing a New York Office by Non-New York Banks.—In the mid-1950s there were only two Edge or agreement corporations located in New York and owned by non-New York banks: Bank of America, New York, established in 1949, and First of Boston International Corporation (now known as Bank of Boston International). Because of New York's dominant position as this country's center of international trade and finance, a substantial portion of the financing of import and export transactions flows through New York City; the international customer also wants to be able to make and receive payments in New York City. The interior or West Coast bank can, of course, use the services of its New York correspondent bank in the negotiation of foreign drafts, collections, and in making and receiving foreign payments. However, in doing so, that bank's identity with the foreign financing is mitigated, if not lost, and the risk is run, under present competitive conditions in American banking, that all of the foreign business of that customer, and possibly the domestic business as well, may be lost to New York bankers. Where a substantial amount of foreign business is involved, then, an Edge corporation offers the interior bank a means of conducting part of its foreign business in New York.

Bank of America's experience with its New York Edge subsidiary, in particular, has proven the precursor to the entry into the New York market of a number of other non-New York banks. The incentive for interior and West Coast banks to establish such a New York subsidiary has grown as their own foreign business has grown and as competition among banks in general has become more acute. At the end of 1966, there were nine Edge corporations operating in New York, which were in effect arms of the international banking departments of banks in Boston, Minneapolis, Pittsburgh, Chicago, Los Angeles, and San Francisco. These New York subsidiaries carry on full-scale international banking services. However, they are limited by law and regulation to the conduct of only such business as is related to international transactions.

Affiliations with Foreign Banks and Other Financial Institutions.—The ability of Edge and agreement corporations to hold stock in other companies has been used by U.S. banks for the most part to acquire foreign subsidiary banks and ownership interests in other financial institutions abroad. Affiliations with foreign commercial banks are motivated primarily by a desire to obtain a degree of direct representation

in a foreign market or markets.¹¹ The nature of these affiliations naturally varies with the over-all market strategy of the bank as tempered by the exigencies of foreign market conditions. By and large, existing affiliations are of three types. First is the wholly-owned subsidiary, either established by the U.S. bank or resulting from the purchase of an existing bank. Banks strongly oriented toward overseas expansion through branches have preferred such subsidiaries in markets where legal impediments precluded the establishment of direct branches. In these cases, the subsidiaries are pure substitutes for branches and are for the most part operated as if they were branches. Examples of this type of affiliation are the First National City Bank (South Africa) Ltd. and The Mercantile Bank of Canada, another First National City Bank subsidiary.

A second broad type of affiliation is the controlled subsidiary with a substantial minority interest held by local shareholders. These affiliations are also close substitutes for the bank's own branches, but in these cases either local law or policy or opportunities for acquiring a larger participation in a going local institution have prevented the establishment of direct branches or the acquisition of a wholly-owned subsidiary. Sometimes, too, the presence of substantial local ownership interests assists in maintaining the indigenous character of the foreign bank, an attribute that can be advantageous in those countries with a strong nationalistic bias. The integration of such controlled but not wholly-owned subsidiaries into the international operations of the U.S. bank can pose difficulties. At times, for example, consideration of the interests of minority stockholders acts as a constraint on the operation of the foreign bank on American bank lines. In any case, it takes time to instill American standards of efficiency and American operating practices into a foreign affiliate.

A third type of affiliation is the minority interest with the ownership interest ranging from about ten to forty per cent. These affiliations may be characterized as a cementing of correspondent relations or as the establishment of a closer working relationship. This type of affiliation has been used primarily by those banks without a pronounced strategy for overseas branches or without sufficient resources to man and support branches abroad. For some, the minority affiliation has been employed as a means of gaining entry in geographic areas where they would not, for reasons of policy, be prepared to establish branches in any event. While some earlier affiliations of this type involved the acquisition of less than a ten per cent interest in the foreign bank, recent acquisitions have all been in excess of ten per cent, and banks have shown a preference for an even larger interest. Banks have discovered through experience that a greater than ten per cent interest in the foreign bank is required if the U.S. bank is to have a significant say in the management and policy of the foreign institution and if its own needs are to be properly cared for.

Aside from affiliations with foreign commercial banks to provide direct banking

¹¹ See generally Pringle, *Why American Banks Go Overseas*, 116 *THE BANKER* 770 (1966), for an illustrative list of these affiliations with foreign banks.

facilities abroad, banks have acquired through their Edge or agreement corporations numerous equity interests in a wide range of other financial institutions. At the end of 1966, affiliations ranging from wholly-owned subsidiaries to purely nominal shareholdings in such institutions numbered upwards of 150 and included interests in government-sponsored development banks, private investment banks, finance companies, factoring operations, and equipment leasing firms.

In less developed countries, a number of token investments have been made in government-sponsored development banks such as the Industrial Credit and Investment Corporation of India, the Pakistan Industrial Credit and Investment Corporation, and the Nigerian Industrial Development Bank. These investments serve to associate the investing U.S. bank with the long-term development of these countries and to cement their relationships with those governments. Other and more important interests in less developed countries are in private investment companies providing loan and venture capital to private industrial and commercial firms and in sales finance companies providing credit to finance business receivables and consumer credit extensions. In some countries, these institutions have offered specialized financing facilities not otherwise available. For the U.S. banks these investments provide, in addition to monetary returns, collateral benefits in the form of business contacts, improved knowledge of local economic and financial conditions, and an added means of providing financial services in various markets to their international customers.

In European and other advanced countries, these affiliations have been fewer in number, but interest in these types of affiliations has been marked recently. The emergence of the Euro-bond market, the growth of "offshore" financing by U.S. corporations, and the improvements and adaptations in European capital markets generally, have prompted several recent investments by U.S. banks, in conjunction with other European banks, in new financial institutions intended to provide medium- and longer-term financing of enterprises. An example of this type of venture is Ameribas, jointly owned by Bank of America and the Banque de Paris et des Pays-bas, which has already floated a major bond issue in Europe to finance its operations.

Equity Financing of Foreign Enterprises.—The third principal use of Edge corporations has been to provide equity financing in conjunction with the international lending operations of the banks. At one time, a number of banks believed that this would be a relatively important function of their Edge corporations, believing or anticipating that U.S. corporations establishing subsidiaries overseas would seek equity participations by their U.S. bankers. These expectations have failed to materialize as U.S. corporations have preferred to establish either wholly-owned subsidiaries abroad or joint ventures with local interests. Hence, acquisitions of shares by Edge corporations in nonfinancial business have amounted to less than five per cent of their stock investments. Usually these stock acquisitions have resulted

from participations in loan-equity financing projects of the International Finance Corporation or from exercise of stock rights obtained to improve the terms of loans.

Edge and agreement corporations have, on the whole, proved flexible devices by which U.S. banks seeking to develop their international banking businesses could augment their facilities and expand their organizations in a variety of ways. The New York office is almost indispensable to the internationally oriented bank located in other sections of the country. Equally indispensable are the affiliations with foreign banks and other financial institutions, for these add to the overseas banking organization needed if the American bank is to be able adequately and imaginatively to meet the banking and financial needs of globally-minded customers.

B. A Profile of International Lending

Lending is the dynamic sector of a bank's business, and this is equally true in the international business of banks. It is this sector that has seen the most profound changes as U.S. banks have developed their international activities. Earlier, an indication was provided of the credit operations at branches located abroad. In this section, attention is directed to the international lending done at banks in this country. A profile of that lending is provided together with some indication of the changes that occurred in recent years.¹²

At the end of 1966, dollar credits reported by banks in the United States totaled \$9.6 billion. An indication of the composition of these credits is given in Table 2.

TABLE 2
BANK CREDIT TO FOREIGNERS, DECEMBER 31, 1966
(in millions of U.S. dollars)

	Europe	Latin America	Japan	Other Asia	All Other Countries	Total
Short-term:						
Loans						
Banks and official institutions	352	726	562	295	16	1,996
Other	248	395	14	69	216	1,140
Acceptances	304	637	1,392	129	78	2,540
Long-term:						
Loans*	1,186	1,220	304	391	818	3,919
Total	2,090	3,176	2,272	884	1,173	9,595

*Long-term loans are all loans with an original maturity of more than one year.
Source: U.S. TREASURY DEPARTMENT, TREASURY BULLETIN, Feb. 1967.
Data related to loans and acceptance credits denominated in U.S. dollars.

¹² A major distinction between the international lending done at banks in this country and that at branches and affiliates overseas is that the overwhelming bulk of the credits extended from the U.S. are denominated in dollars. For example, dollar credits to foreigners reported by banks in the United States totaled \$9.6 billion at the end of 1966, but claims payable in foreign currencies totaled only about \$400 million. Of this amount, more than half represented deposits with foreigners—that is, principally working balances with foreign correspondent banks. At foreign branches and affiliates, foreign currency lending predominates (with important exceptions such as London).

Several points of interest emerge from an examination of this table. First of all, it reveals the dominant position of Japan, which alone accounts for nearly one-fourth of all foreign credits of banks in the United States. The phenomenal growth in these credits (a twenty-fold expansion in eleven years) paralleled an equally extraordinary growth of Japan's economy and its foreign trade. These Japanese borrowings have played a catalytic role in the development of the international business of U.S. banks. In order to meet their international credit needs, Japanese bankers sought to establish credit lines not only with banks in New York but with major banks throughout the country as well. For many banks making their initial excursions into international lending, the acknowledged credit standing of the Japanese banks and their strong demands for credit offered a prime outlet for their lendable funds. The initial expansion of the international activities of a number of banks can in a sense be said to have been underwritten by Japan.

A second point of interest in the Japanese credits is that they are acceptance credits for the most part. As such, these credits are (directly or indirectly) associated with the financing of foreign trade. However, the larger portion of these credits is not for the financing of U.S.-Japanese trade but for the financing of movements of goods outside the United States. It is this financing of so-called third-country trade that is particularly indicative of the changed role of U.S. banks in the financing of international transactions. Illustrative of this point is the fact that in 1955 acceptances outstanding to finance movements of goods between foreign countries accounted for one-sixth of total acceptances; eleven years later, they accounted for forty-four per cent of the total. Use of the acceptance instrument by Japanese borrowers as a means of obtaining credit in the United States also contributed importantly to the revival of the market for bankers' acceptances in this country, thereby adding to the facilities of New York as an international financial center.

Another feature of this portfolio is the high proportion of term loans it contains. At the end of 1966, over forty per cent of total outstanding bank credits to foreigners were loans with original maturities of more than one year. In some banks, the proportion was considerably higher. U.S. banks making international loans are the same large banks that are heavily engaged in term lending domestically. These banks have sought to adapt the techniques of term lending learned and developed domestically to the financing requirements of international borrowers. Aggregate figures, such as those presented in Table 2, do not show the degree of success attained by the banks in this type of lending, even when those data are viewed over time. For the proportion of term loans in the total foreign loan portfolio has not changed significantly over the past decade. The change has occurred in the composition and characteristics of the term lending undertaken.

In earlier years, longer-term foreign loans by U.S. banks were extended for the most part to foreign governments and official institutions. Longer-term credit to less developed and nonindustrial countries continues to be mainly to official bodies,

usually in connection with large-scale development projects. Part of these credits have taken the form of participations in the shorter maturities of loans extended by the World Bank, the International Finance Corporation, and other international financial institutions. On the other hand, by the early 1960s the banks began to extend term loans to commercial and industrial borrowers in developed and financially stable countries abroad. Price foreign corporations in countries, especially in Europe, with inadequate local facilities for longer-term financing or without access to foreign securities markets, sought and were able to obtain medium-term financing from U.S. banks for plant expansion, working capital, or refinancing of short-term debt. The high proportion of term loans in credits shown in Table 2 for Europe and All Other Countries (which category includes Canada, Australia, and South Africa) is an indication of this development. To take a more specific example, major Italian corporations borrowed heavily in 1963 and 1964 when the Italian economy went through a balance-of-payments crisis, a period of severe monetary restraint, and an industrial recession; these credits assisted importantly in the needed strengthening of the financial structures of these corporations, then heavily indebted at short-term to Italian banks, to meet the altered economic circumstances of the time; a side benefit of these credits, of course, was that they also served to shore up Italy's external reserve position. Other major uses of term loans have been to finance additions to the shipping fleets of Scandinavian and other shipping companies, and to finance purchases of commercial jet aircraft in the United States by foreign airlines, in both developed and underdeveloped countries.

The attraction of these loans to the banks extending them and to the foreign corporate borrower is that they provide a flexible means of medium-term financing (from two to eight years, though clustering more in the three- to five-year range) with terms and conditions tailored to specific financing needs and in the context of a corporation's over-all financial program. The provisions for regular amortization payments over the life of the loan also adds to the liquidity of the bank's loan portfolio.

Following the upsurge in this type of lending, however, the interest equalization tax¹³ was applied early in 1965 to bank loans to developed countries with original maturities of more than one year and for purposes other than financing U.S. exports. Imposition of this tax, which effectively raised the interest rate on such loans by one per cent per annum, was part of the Government's program to improve the balance of payments position by restricting the growth of bank lending abroad. Another part of that program, the voluntary foreign credit restraint effort, has applied to all bank lending to foreigners. Following the introduction of those measures, new term loans to developed countries effectively ceased, and as regularly scheduled repayments have been received the outstanding term loans have fallen. Whether this type of general corporate lending would be resumed on a significant scale if existing restraints were relaxed or removed is not certain, for, in the interim, important changes

¹³ Interest Equalization Tax Extension Act of 1965, 79 Stat. 954, INT. REV. CODE 1954, §§ 4911-20.

have taken place in European capital and credit markets, including the establishment of new banks and financial institutions by U.S. and European banks which could provide a good deal of the medium-term financing facilities hitherto lacking.¹⁴

The composition of this portfolio is also a reflection of the special considerations and risks encountered in international lending. For in addition to the strength and nature of foreign credit demands, the size, geographic distribution, borrower characteristics, and maturity of credits in this portfolio represent a collective judgment by the lending banks as to the political and financial stability of foreign countries. An appraisal of the so-called country risk inherent in any foreign credit is the major distinction between domestic and international lending. Besides assessing the credit-worthiness of the individual borrower, the bank has to exercise a judgment on political, economic, and social conditions in the country of the borrower as they are likely to affect foreign exchange availabilities at the time of repayment of the loan. The possibilities of exchange rate changes, foreign exchange controls, political upheaval, and the like are myriad in the large number of heterogeneous countries in which banks are lending.

Assessing the credit risk of a borrower located far from the head office is alone no easy task; in attempting to do so, the bank encounters widely varying standards of business conduct, differing financial practices, the absence of meaningful financial statements, and other imperfect credit information. The balancing of all these considerations is a delicate and subtle task requiring wide-ranging knowledge, experienced judgment, and often just a keen instinct. In this task, banks avail themselves of information gathered through foreign branches, affiliated foreign institutions, foreign correspondent banks, and frequent visits to foreign banking markets and foreign customers by lending officers.

Technological developments in communications and especially in transportation have clearly eased the job of supervising and developing international banking business in the past decade as American banks have gone through the learning process of becoming informed and knowledgeable international lenders. Still, the best information and expertise do not fully protect the bank against the risks faced in this lending. Other means employed are diversification of portfolio among countries, discrimination as to borrowers, variation in maturities, and the extensive use of guarantees from third parties—foreign banks, foreign governments, and U.S. corporations in the case of loans to their subsidiaries. In areas of political and financial instability—for example in many Latin American countries—U.S. banks have limited short-term credits to foreign trade financing and longer-term lending is largely confined to foreign governments and official institutions; lending to other borrowers is usually contingent on appropriate guarantees from banks and foreign governments.

¹⁴ See generally Rothschild & Leach, *Recent Developments in the International Capital Market*, 117 THE BANKER 297 (1967), for the view that those facilities are no longer dependent on the existence of U.S. Government restrictions on foreign borrowing in the United States.

III

THE LEGAL AND REGULATORY FRAMEWORK

The legal framework within which U.S. banks conduct their international operations has not changed materially since 1919. The relevant legislation is embodied in sections 25 and 25(a) of the Federal Reserve Act.¹⁵

As originally passed in 1913, the Federal Reserve Act in section 25 authorized the establishment of foreign branches by national banks, subject to the approval of the Federal Reserve Board.¹⁶ The Board was also empowered to establish regulations under which such branches might operate. Until that time, only state-chartered banks in certain states and some state-chartered corporations organized for the purpose of conducting an international banking business had been able to establish branches abroad.¹⁷

The existence of state-chartered corporations conducting an international banking business gave rise to an amendment to section 25 of the Federal Reserve Act in 1916.¹⁸ This amendment authorized any national bank with a capital and surplus of \$1 million or more to invest, subject to approval of the Federal Reserve Board, up to ten per cent of its capital and surplus in corporations organized under the laws of the United States or of any state and principally engaged in international or foreign banking. This opened the way for national banks to invest in existing state-chartered corporations. A condition of such investments by national banks was that prior to the investment the corporation would enter into an agreement with the Federal Reserve Board which would specify the restrictions or limitations on the operations of the corporation—hence the sobriquet “agreement corporation.” The amendment was deficient in that, while allowing national banks to invest in federally chartered international banking corporations, no express provision was made for federal chartering of such corporations.

The legislative framework governing the international operations of American banks was completed in 1919 with the passage of an act which added section 25(a) to the Federal Reserve Act.¹⁹ This act, which became known as the Edge Act after the name of its sponsor, Senator Walter Edge of New Jersey, provided for federally chartered corporations to be organized for the purpose of engaging in international or

¹⁵ § 25, 12 U.S.C. §§ 601-04a (1964, Supp. II, 1965-66); § 25(a), 12 U.S.C. § 611-31 (1964). The discussion here will concern the provisions of law as they affect national banks. For the most part, they are equally applicable to state banks that are members of the Federal Reserve System, though certain differences exist.

¹⁶ Federal Reserve Act § 25, ch. 6, § 25, 38 Stat. 273 (1913), *as amended*, 12 U.S.C. §§ 601-04a (1964, Supp. II, 1965-66).

¹⁷ One of these state-chartered banking corporations, the International Banking Corporation, is still in existence, though performing different functions. This corporation was originally chartered under the laws of Connecticut in 1901 and is now a wholly-owned subsidiary of the First National City Bank, New York.

¹⁸ 39 Stat. 755 (1916).

¹⁹ 41 Stat. 378 (1919).

foreign banking or other international or foreign financial operations. While section 25 of the Federal Reserve Act has been amended twice since 1919, as discussed later on, section 25(a) is virtually intact in its original form.

The central provisions of the Edge Act may be summarized as follows:

- (1) Edge corporations, having a minimum capital of \$2 million, may be organized with the approval of the Board.
- (2) Such a corporation may conduct banking operations, establish foreign branches, and invest in the stock of other companies.
- (3) Such a corporation may not conduct any business in the United States except such as in the judgment of the Board is incidental to its international or foreign business.
- (4) Such a corporation may not invest in the stock of another company engaged in the United States in the general business of buying or selling goods, wares, merchandise, and so forth, or conducting any business in the United States except as in the judgment of the Board is incidental to its international or foreign business.
- (5) The Federal Reserve Board was given the power to prescribe rules and regulations governing the operations of such corporations and to examine them.

In 1920, the Board issued the first regulation under section 25(a) of the act governing the operations of Edge corporations. The regulation (Regulation K of the Board's Regulations) has since that time gone through a succession of versions which have reflected a variety of concerns on the part of the Board regarding the operations of the corporations. In the early years, the larger part of Regulation K was concerned with the establishment, ownership, and organization of such corporations, the need for prior Board consent in the establishment of foreign branches, and in the acquisition of stock in other companies, and the issuance of debentures by the corporations. Few changes of substance were made in Regulation K during the rest of the 1920s as a number of corporations were liquidated and activity of others diminished. And then during the 1930s and the Second World War the remaining corporations were generally inactive.

In the mid-1950s interest revived in Edge corporations as a possible means of contributing to the restoration and development of world trade and investment. An internal study prepared within the Federal Reserve System led the way to a major revision of Regulation K, which became effective early in 1957.²⁰ That version of the Regulation provided for two distinct types of corporations—banking corporations and financing corporations. Banking corporations were allowed to exercise the banking functions permitted by the statute and to accept deposits but were not to hold stock in companies other than banks. Financing corporations, on the other hand, were not allowed to accept deposits and could hold stock only in companies not

²⁰ 21 Fed. Reg. 9899 (1956).

engaged in banking. An important motive for this distinction between banking and financing corporations was, of course, to retain the separation existing domestically between deposit banking and investment banking. The incorporation in Regulation K of this sharp distinction between banking and financing corporations led to the establishment by a number of banks of two Edge corporations. Even New York banks, which had no incentive to establish such a corporation to engage in banking operations in New York City, established two corporations: a banking corporation to hold stock in foreign banks and a financing corporation to hold equity interests in foreign nonbanking concerns. These dual corporations began to appear in some number in 1960, 1961, and 1962 as interest grew in acquiring affiliations with foreign banks and other institutions.

A principal concern of the 1957 revision was to clarify and delineate the banking activities which a banking corporation might carry out within the United States. By statute, as already noted, Edge and agreement corporations are precluded from carrying on any business in the United States except that deemed incidental to the corporation's international or foreign business. The Bank of America had established an Edge corporation in New York in 1949 (Bank of America, New York) to engage in international banking operations, and The First National Bank of Boston had had a subsidiary corporation in New York for many years. Numerous questions had arisen in the course of time as to what activities might appropriately be carried on in New York consistent with the statutory requirements and with the broad public policy of barring interstate branching of domestic banks and which would still facilitate the conduct of international operations. The revised version of Regulation K specified those activities which, in the judgment of the Board, would be considered permissible and appropriate and, by so doing, broadened the scope of activities particularly with regard to the taking of deposits.

In 1963, Regulation K was again substantially revised.²¹ The 1957 revision had represented an important step in liberalizing the regulation and broadening the permissible activities of the corporations. Nevertheless, it could be said that the highly detailed specifications as to what were and what were not permissible activities was reflective of a regulatory approach that in its essentials was restrictive. In the light of experience in the intervening six years, the necessity for some of the provisions had become suspect. In any event, and whatever the root cause, the 1963 revision drastically simplified the regulation. Perhaps most important, the distinction between banking and financing corporations was eliminated for all practical purposes. In addition, permissible banking operations in the United States were liberalized somewhat further, and a general consent provision was included allowing certain stock investments to be made without prior consent of the Board.

The essential features of Regulation K, as revised in 1963, are these: The banking powers which may be exercised by a corporation are limited to those connected with

²¹ 12 C.F.R. §§ 211.1-10 (Supp. 1966).

international transactions, and those which are considered as so connected are specified. Corporations are prohibited from underwriting in the United States. Limits based on the capital and surplus of the corporation are set as to the volume of acceptances outstanding, loans to one borrower, and the aggregate liabilities of the corporation. Prior Board approval is required for the issuance of debt obligations with a maturity greater than one year and for the opening of foreign branches. With respect to stock investments of the corporations, prior Board approval is required of all acquisitions of shares except (1) where the investment is in a foreign company and related to an extension of credit by the corporation; (2) where it consists of acquiring up to twenty-five per cent of the shares of a foreign bank; and (3) where the investment is less than \$200,000 and is likely to further the foreign commerce of the United States.

Section 25 of the Federal Reserve Act has been amended twice. In 1962, the powers of foreign branches of national banks were broadened to enable them to compete more effectively in foreign banking markets.²² The intent of the amendment was to allow foreign branches to exercise such powers, in addition to those already possessed, as are usual in doing a banking business in the foreign country in which the branch is located. Such additional powers were not to extend to being in a commercial business nor to the general business of underwriting; the additional powers they might exercise were left to the discretion of the Board. These additional powers are specified in Regulation M and, subject to certain limitations, include the power to issue guarantees, broadened acceptance powers, the right to acquire shares in foreign central banks, development banks, and similar official institutions, and the right to underwrite foreign government securities.

The second amendment was passed in 1966 and permits national banks to hold stock *directly* in foreign banks subject to such conditions and regulations as the Board of Governors shall prescribe.²³ Such stock holdings are in addition to those permitted to national banks through the medium of subsidiary Edge corporations. The amendment was passed in connection with other legislation which removed the previously strict collateral requirements on loans to foreign affiliates that had applied by virtue of section 23A of the Federal Reserve Act.²⁴ These collateral requirements had unduly limited the ability of banks to lend or otherwise extend credit to affiliated banks abroad, limitations which did not apply to credits to foreign branches.

Regulation M was revised effective March 15, 1967, to give effect to the new legislation.²⁵ The revised version of the regulation provides that prior Board consent is required for any investment in a foreign bank pursuant to section 25 of the act, as amended. It further limits the amounts so invested in foreign banks taken together

²² 12 U.S.C. § 604a (1964).

²³ 12 U.S.C. § 601 (Supp. II, 1965-66).

²⁴ 12 U.S.C. § 371c (1964).

²⁵ 32 Fed. Reg. 4399 (1967).

with investments of the national bank in the shares of Edge and agreement corporations to twenty-five per cent of the national banks capital and surplus. Prior to this change, a national bank had been able to invest only up to ten per cent of its capital and surplus in Edge and agreement corporations.

The revision of Regulation M was undertaken at a time when the ownership of The Mercantile Bank of Canada by First National City Bank had become a political issue in Canada in conjunction with the decennial revision of the Bank Act. A provision of Regulation M in its proposed form had, in keeping with an existing provision of Regulation K, specified that "when requested by the Board, a national bank shall cause any foreign bank controlled by it . . . to submit to examination by examiners selected or auditors approved by the Board."²⁶ This provision was the subject of some diplomatic correspondence between the two countries, as was reported in the press at the time,²⁷ as regards the seeming extension of the jurisdiction of a U.S. agency into a foreign country. In the regulation as promulgated by the Board, this provision was deleted, as was the corresponding provision of Regulation K, with the explanation that no extraterritorial implications had been meant but with the reservation that the Board expected each member bank to make sufficient information available regarding interests in foreign banks, held either directly or through Edge or agreement corporations, as to satisfy the Board regarding the prudence and solvency of the bank.

In sum, the statutory provisions governing the international operations of U.S. banks have not greatly changed in the past half century. The few changes that have been made have been in the direction of liberalizing and widening the powers of banks in the conduct of their international business. Similarly, revisions of regulations, particularly those of the last decade have also been in the direction of loosening restraints or relaxing regulatory requirements governing those operations.

IV

SOME IMPLICATIONS FOR PUBLIC POLICY

The long-run significance of the development of international operations of American banks lies in the fundamental commitment that has been undertaken by major commercial banks to engage in international banking on a worldwide scale and in the links that have been forged between a key segment of the U.S. banking system and financial institutions abroad. The full dimensions of that commitment are by no means clear nor are the consequences of these intimate links with foreign institutions. What is certain is that the horizons and orientation of these banks have changed materially and that this change carries important implications for public policy in three broad areas: the balance of payments or international financial posi-

²⁶ 32 Fed. Reg. 875 (1967).

²⁷ *E.g.*, N.Y. Times, Feb. 14, 1967, at 59, col. 2.

tion of the United States; monetary and credit conditions in this country and the formulation and execution of monetary policy; and the structure and regulation of the banking system.

A. Issues Concerning the Balance of Payments and Monetary Policy

The ramifications of this development for the U.S. balance-of-payments position and the conduct of monetary policy in this country are closely related. As prime generators of international credit and as principal intermediaries in international flows of funds through growing networks of branches and affiliated banks abroad, U.S. banks have become conduits through which changes in relative monetary conditions can be quickly translated into international capital flows, which in turn impinge on the external reserve positions of the countries involved and on respective credit availabilities.

Concern with the over-all balance-of-payments position of the United States in recent years has brought increased recognition of the role of commercial banks in effecting flows of credit capital to and from the United States. Government measures to reduce the payments deficit and to curb the drain on U.S. external assets have consequently included programs aimed at restraining bank lending abroad. These measures have achieved a marked success in damping the growth of foreign lending by banks in the United States but have had the further effect of altering the mode of operations and of shifting their locus to offices abroad.²⁸ One consequence has been to accelerate the development of U.S. banks as participants in European money and capital markets, as well as the development of those markets themselves.

Similarly, the monetary authorities have had to recognize the impact of this institutional development on the domestic behavior of banks and on the functioning of financial markets in the United States. Central bank interest relates, needless to say, not only to the balance-of-payments considerations just mentioned but also to the effectiveness of its operations in achieving domestic goals. For example, the behavior of neither the New York money market nor of the major banks can be fully understood nowadays without taking into account conditions in the London market and in other foreign financial centers.

The experience of 1966 was instructive in this respect both for the commercial banks and for the monetary authorities. For, as noted earlier, the major banks used their foreign branches during the summer to borrow heavily in the Euro-dollar market to support their domestic lending and their domestic reserve positions. Their ability to do so, without regard to ceilings on interest rates paid and with no reserve requirements against such borrowings, affected the impact and incidence of a restrictively aimed monetary policy. To a minor degree, too, this development

²⁸ See generally *Bank Credits to Foreigners*, 51 FED. RESERVE BULL. 361 (1965), for an account of these measures and background to their introduction. See also the regular reports on the balance of payments appearing in the March, June, September, and December issues of U.S. OFFICE OF ECONOMICS, DEP'T OF COMMERCE, SURVEY OF CURRENT BUSINESS.

encumbered the ability of the monetary authorities to judge the effectiveness of their action and current developments in financial markets. Similarly, when a less restrictive policy became appropriate in late autumn, the major banks had an overhang of relatively expensive short-term debt to their foreign branches; as monetary conditions eased in the United States, repayment of this debt was one element in the reconstitution of bank liquidity and tended to retard renewed growth of domestic lending. The lessons of that experience were not lost on the banks availing themselves of those borrowing facilities; moreover, that experience provided an incentive to other banks to establish branches allowing future access to the Euro-dollar market. In analogous situations in the future, therefore, possibilities of even greater recourse to such borrowings will be among the many uncertainties faced by the makers and executants of monetary policy.

The international lending and other operations of U.S. banks are still small in relation to the aggregate activity of the U.S. banking system. International flows of funds are similarly still small in relation to the aggregate flows of funds within the U.S. economy with which the monetary authorities are concerned. But at the margin, which the foregoing example was meant to illustrate, both have been and can be significant.

Recognizing this marginal importance, what are the respective roles of interest rates, credit availabilities, and credit demands as between the United States and foreign countries in determining outflows of credit and capital from the United States? To what extent and under what conditions will an easing of monetary policy in this country lead to outflows of capital from the United States and impinge on domestic lending capabilities? Under conditions of monetary restraint, to what degree are banks likely to favor domestic over foreign borrowers? Have institutional changes in European credit and capital markets proceeded far enough to lessen potential demands on U.S. financial institutions by European borrowers should present restraints on foreign lending be loosened?

These are among the many questions raised for balance-of-payments and monetary policy and still outstanding. Experience under the changed and changing institutional conditions that are the subject of this article has been so limited that questions such as these are likely to remain unsettled for some time to come. Even a preliminary examination of these questions is well beyond the scope of this article, but they are mentioned here to suggest that what the development of U.S. banks as international banking institutions actually portends for policy in these areas is ripe for a considerable amount of additional research and study.

B. Issues Concerning Bank Supervision

The third area of public policy affected by this development is that of the supervision of the banking system. Banking is a highly regulated industry in the United States, governed by a complex set of laws, rules, and regulations. The circumscription

of commercial bank activities in this country has arisen, of course, from the recognition of the unique role of the banks in the workings of the financial system and of their contribution to the economic growth and material well-being of the country. The consequent strong public interest in the orderly and sound functioning of banks is expressed not only in laws but also in the continuous supervision of their activities by designated supervisory authorities.²⁹

Banking in the United States has also several characteristics which distinguish it from many other banking systems. First, it is a dual banking system involving an overlapping and diffusion of supervisory authority and with geographic limits imposed to prevent undue concentration of banking power. A second characteristic is the separation of banking from commercial activity. And a third and more recent characteristic is the divorce of commercial and investment banking.

This background has been repeated here because it is related to a central problem faced by the supervisory authorities in viewing and regulating the international operations of commercial banks. The sole expression of public policy regarding these operations is contained in the provisions of law reviewed earlier in this article. Those provisions are imbued with two broad considerations: the facilitation of the foreign operations of banks and, simultaneously, the preservation of the essential structure, character, and soundness of the U.S. banking system. To this end, departures from the general body of laws, rules, and regulations governing banking in the United States were authorized, but they were limited ones and subject to regulation. Aside from a few specific statutory restraints, Congress has largely left to supervisory authorities—and principally to the Board of Governors of the Federal Reserve System—the responsibility for maintaining a fine balance between these considerations. Law and regulation have on the whole fulfilled the first aim of facilitating the foreign operations of U.S. banks. Few substantive amendments to the basic governing legislation have been found necessary in nearly a half-century. Moreover, the growth of these activities in the past decade could not have occurred had either law or regulation provided serious impediments.

At the same time, the growth of international operations to their present size and importance has obviously enhanced the emphasis to be given by the supervisory authorities to the second and balancing consideration mentioned. Augmented interest in the impact of these operations on the structure, character, and soundness of the banking system raises questions, first of all, regarding the use and adequacy of bank examinations.

1. *Examinations of Banks Having International Operations*

In the supervisory process, examinations of commercial banks have as a first purpose the determination of the conformity to law and regulation of the operations of banks. Second, and more important, they serve to develop the information neces-

²⁹ See generally *Symposium—Banking Regulation*, 31 LAW & CONTEMP. PROB. 635 (1966).

sary to judgments by the supervisory authority as to the soundness of banks and the prudence and capability of their managements.

With the growth of international business, this aspect of a bank's operations can no longer be relegated to a minor or neglected place in the examination of a bank's affairs. This is especially true for those banks which not many years ago conducted very little in the way of foreign business but which now have a significant amount of international loans in their portfolios. Even for banks in major centers such as New York whose foreign business has been sufficient to warrant specialized attention by examiners for a number of years, the altered character of that business together with its enlarged volume has made more intensive scrutiny necessary.

An examination of the international operations of a bank necessarily involves inclusion of a number of factors not found in domestic banking and the experience of bank examiners with domestic operations is not wholly transferable. To render an independent and informed judgment on the competence of bank management in this field, the examiner himself must be fully knowledgeable about the problems of international banking, including those associated with operations in highly different countries with varying degrees of information and risks. As suggested earlier in this paper, this is a difficult and complicated task for the banks themselves. An important problem for the supervisory authorities, if they are adequately to appraise these operations, is the development and maintenance of a corps of examiners with sufficient background and expertise in international banking and finance.

Another question for the supervisory authorities relates to the scope and extent of examinations of overseas banking offices to be conducted by U.S. authorities. Foreign branches, like domestic branches, are integral parts of the parent U.S. bank. Foreign subsidiary banks, though occupying a different position from a legal point of view, are substitutes for or the equivalent of branches. An examination of a U.S. bank with an extensive overseas organization would be incomplete if the operations at those overseas offices were disregarded. However, those branches and subsidiary banks operate under the laws and regulations of the countries in which they are located; indeed the subsidiary banks are chartered under foreign law. In many cases, both are examined by foreign banking authorities. Also, in a number of countries, such as Switzerland, Lebanon, and the Bahamas, banking secrecy regulations prohibit the release to outside persons of the records of banks and banking offices. On-the-spot examinations by U.S. supervisory authorities can, in these circumstances, raise questions concerning the exercise of extraterritorial jurisdiction; as has already been mentioned, such a question was encountered in principle in connection with The Mercantile Bank of Canada. But, failing on-the-spot examinations, how can the supervisory authorities discharge their responsibilities and exercise adequate surveillance of banks and their international operations?

A further problem, relating principally to the exercise of the examining function, arises from the development by the banks of highly integrated organizations for

the conduct of their international operations. A single bank may have a full-scale international department at its head office, an Edge corporation conducting part of its foreign business in New York, branches overseas, wholly-owned or controlled subsidiaries in some countries, and minority interests in still other foreign commercial banks and foreign financial institutions. In contrast, the supervisory approach to such an extensive yet integrated operation is fragmented.

The fragmentary approach may be illustrated as follows: The international operations of head offices are supervised and examined by the Comptroller of the Currency in the case of national banks and by the Federal Reserve System in the case of state member banks. The Federal Reserve Board authorizes the establishment of all foreign branches, but their subsequent supervision again depends on whether the branch belongs to a national or state member bank. The supervision of Edge and agreement corporations is within the sole jurisdiction of the Federal Reserve Board regardless of the nature of their parent banks. This leads to the following anomalous situation, to take one specific example: the Bank of America conducts part of its international operation in this country from its California offices and part from its Edge subsidiary in New York; abroad, its operations are conducted partly through branches and partly through subsidiaries. The bank's operations in California, and in foreign branches, are supervised by the Comptroller of the Currency, while those in New York, and in subsidiaries abroad, are supervised by the Federal Reserve Board.

Diffusion of supervisory authority necessarily creates possibilities of differences of view, approach, and emphasis. Conceivably, such differences could detract from adequate supervision of these operations and could operate to the detriment of satisfactory protection of the public interest. So far this has not occurred. Nevertheless, the development of a more unified and integrated approach among the supervisory authorities is clearly needed to assist the orderly and sound development of this rapidly evolving area of commercial banking.

2. Regulatory Problems

A second broad area in which questions arise for the supervision of these enlarged operations is that of regulation and regulatory actions. Two general problems are discussed here. The first concerns the regulation of subsidiary and affiliated institutions abroad. The second relates to the permissible activities in the United States of Edge corporations and of foreign affiliates.

The law is pretty much silent on the regulatory treatment to be accorded companies in which Edge corporations invest.³⁰ The only relevant statutory provision, found in section 25(a) of the Federal Reserve Act, allows Edge corporations

generally to exercise such powers . . . as may be usual, in the determination of the Board of Governors of the Federal Reserve System, in connection with the transac-

³⁰ Apart from limitations on their activities in the United States.

tion of the business of banking or other financial operations in the countries, colonies, dependencies, or possessions in which it shall transact business . . .³¹

The recent amendment to section 25 of the Federal Reserve Act permitting direct investments in foreign banks³² contains no provision regarding regulation of those foreign banks.

Supervisory interest in foreign institutions in which minority interests are held, directly or indirectly, by U.S. banks is limited. In these cases, concern centers primarily on the risk of loss attendant on the investment. On the other hand, where a controlling interest is held in foreign financial institutions, supervisory concern and responsibility extend further, inasmuch as these subsidiaries are in effect integral parts of the U.S. bank. The general aim of legislation in this field—to facilitate the international operations of U.S. banks—together with the language of section 25(a) of the Federal Reserve Act just cited suggest that foreign subsidiaries should be allowed wide latitude in the conduct of their operations under the diverse banking customs, laws, and regulations prevailing in their respective locations. However, Edge corporations are themselves subject to specific statutory and regulatory restraints and limitations, and a number of their activities also require permission of the Federal Reserve before they can be undertaken. The extension of those limitations and requirements for prior approvals by U.S. supervisory authorities to the activities of foreign subsidiaries can reduce the flexibility of their operations and impede their ability to compete effectively with other foreign institutions. Still, without some such limitations and regulations, those subsidiaries could be used to avoid or evade law or regulation as it applies to their parents. The reconciliation of these somewhat conflicting objectives is an issue increasingly faced by the supervisory authorities as banks have expanded their affiliations with foreign institutions.

Activities in the United States of Edge corporations and of the institutions in which they acquire an ownership interest have been the subject of public concern since the first legislative enactment in this field. It will be recalled that the statute provides that an Edge corporation may not invest in another company conducting any business in the United States "except such as in the judgment of the Board . . . may be incidental to its international or foreign business."³³ An equivalent statutory provision applies to the activities of the corporations themselves.³⁴ Underlying these provisions was congressional concern with maintaining prevailing geographic limitations on commercial banking in the United States. Thus, national banks were authorized to invest in Edge corporations, which could be located anywhere in the United States, but the activities of those corporations were circumscribed in

³¹ 12 U.S.C. § 615(a) (1964).

³² 12 U.S.C. § 601 (Supp. II, 1965-66).

³³ 12 U.S.C. § 615(c) (1964). The same provision was included in the recent amendment to section 25 of the Federal Reserve Act. 12 U.S.C. § 601 (Supp. II, 1965-66). The discussion here is therefore applicable to direct investments by national banks in the stock of foreign banks.

³⁴ 12 U.S.C. § 616 (1964).

order that they would not be able to conduct a domestic banking business and hence could not be used as domestic branches of their parent banks.

Inherent in the quoted statutory condition is the problem of determining, in general and in specific cases, what is "incidental" to the company's international or foreign business. The problem arises because the phrase is open to several interpretations. A narrow interpretation, requiring that all business be directly related to foreign or international transactions, has been employed in connection with the operations in the United States of Edge corporations. Such a narrow interpretation would seem appropriate so long as it remains public policy to prohibit interstate branching of commercial banks. Following this interpretation, most of the problems of specifying the permissible activities of Edge corporations conducting foreign banking operations in the United States have been resolved. The unresolved questions in this area relate to the permissible activities in the United States of foreign institutions in which Edge corporations invest.

If a bank located outside New York were to acquire a controlling interest in a foreign bank with a branch or controlled subsidiary in New York City, that branch or subsidiary would be the equivalent of an Edge corporation established by the U.S. bank. In those circumstances, it would be appropriate to require that the activities of that branch or subsidiary be confined to those directly related to foreign or international transactions, as would those of an equivalent Edge corporation. But should the same narrow interpretation be applied where, say, a New York bank acquires a controlling interest in a foreign institution with a branch or subsidiary in New York City? Or where a U.S. bank acquires a *minority* interest in a foreign institution with a branch or subsidiary in the United States? It can be argued that in a broad sense any business conducted by a foreign bank through an office in the United States is "incidental to its international or foreign business." And in these cases, no particular advantage would seem to accrue to the investing U.S. bank in allowing the foreign institution to conduct a full range of banking or financial activities. Nor would such a policy appear to constitute a breach in the prohibition on interstate branching.

These questions are in large part hypothetical.³⁵ They come to mind because of the increased emphasis placed by U.S. banks on establishing affiliations with foreign banks and financial institutions. Should that trend continue, it would seem likely that these questions would present actual rather than potential problems. Whether present provisions of law would permit discriminatory treatment among situations of the type hypothesized is a problem of legal interpretation. But within the interpretative latitude permitted by law, an appropriate policy posture has also to be determined.

³⁵ See generally *Acquisition by Edge Corporation of Stock Combination Export Manager*, 53 FED. RESERVE BULL. 752 (1967), for discussion of a problem that has been encountered in connection with operations in the United States, namely the appropriateness of an investment in a domestic company performing export sales manager services.

This discussion by no means exhausts the issues posed for the supervisory authorities by the growth of international banking among American banks. Even more fundamental questions could be raised: Given the risks involved in international banking, especially in a world of uncertainty, are there limits beyond which this involvement in international banking might pose a serious potential threat to the soundness and functioning of the domestic banking system? Will the movement into international banking accelerate the consolidation of banks in this country through mergers and expanding bank holding companies? These are more far-reaching and speculative questions; they are nonetheless worthy of serious consideration.

Perhaps the clearest implication of this development for the supervisory authorities is that, like the banks, they must go through a learning process. For only by acquiring a sophisticated understanding of the problems and possibilities of international banking, can they fully discharge their responsibilities in the public interest.

CONCLUSION

The present size and significance of international operations in many banks are less surprising when viewed in retrospect and in full appreciation of the strength and nature of the forces underlying their growth. What is far less certain is whether these activities have attained their full maturity in the context of the over-all development of American commercial banking. That the future will bring further growth and development of the banks' international operations cannot be questioned, for those forces and elements underpinning the thrust of American banks into international banking in the past decade are still present and, for the most part, still strong. It is rather the extent and rapidity of future growth and the shape of these activities in the years to come that are matters of conjecture.

Three factors are likely to slow the future growth of international operations of commercial banks. First, virtually all the largest banks in the United States are now committed to provide full-scale international banking services in this country and in varying degrees abroad as well. Possibilities of a new wave of banks entering significantly into this field are consequently limited. Second, increasing difficulty is being encountered in establishing and developing overseas banking organizations. The number of foreign markets not already penetrated by American banks is now relatively small, and nationalistic and other foreign restrictions are hindering new entrants into these markets. Third, efforts of the U.S. government to improve this country's international payments position are for the foreseeable future likely to result in conditions less conducive to the expansion of international operations than conditions in the early 1960s.

Another uncertainty for the future is how well the U.S. banks have learned the international lending business. The few significant loan or other losses sustained in the last decade of expansion would seem to indicate a successful learning process.

However, this period has been one of exceptional growth in the world economy and one of few major financial crises. The test of successful banking and bankers and of the quality of the credits they have extended comes when less favorable conditions prevail. U.S. banks have yet to meet that test in their international operations.

As the international operations of U.S. banks continue to evolve, the monetary and banking authorities are faced with the task of resolving some of the issues explored in this paper. More generally, they are faced with the challenge of appraising the changing nature of those activities and of attempting to discern their changing implications for public policy.