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PROCEEDINGS OF A CONFERENCE HELD IN OCTOBER 1977

FEDERAL RESERVE BANK OF BOSTON

KEY ISSUES IN INTERNATIONAL BANKING

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FOREWORD

The Federal Reserve Bank of Boston is pleased to publish these proceedings of the 18th in a series of conferences sponsored by the Bank. The papers and comments in this volume were presented at Bald Peak Colony Club, Melvin Village, New Hampshire in October 1977. The conference participants were chosen because of their recognized expertise in international banking; we believe the publication of their views in these proceedings will prove helpful to students in the field.

Frank E. Morris
President
Federal Reserve Bank of Boston

The Growth of U.S. Banking Abroad: An Analytical Survey

Norman S. Fieleke*

Among the financial phenomena of the current decade, the explosive foreign expansion of U.S. banks occupies a place near center-stage. General interest in this expansion has been sparked not only by its sheer magnitude but by the connotations of power, profitability, and risk, evoking reactions of triumph, envy, resentment, or anxiety. The foreign expansion has stimulated, in addition to these emotional reactions, a certain amount of simple curiosity, which, since we share it, we shall grace with the adjective "intellectual." If allowed its head, this curiosity demands responses to a number of elementary questions: Just how profitable for the U.S. banks has their foreign business been? Has it increased or reduced the riskiness of their operations? How can U.S. banks compete successfully against foreign banks on the latter's home territory, and what kind of business with foreigners do the U.S. banks undertake? Why are the branches of U.S. banks concentrated so much more heavily in some countries than in others?

These are the major questions addressed in this paper. It may be surprising that we offer at least partial answers to all of these questions, and some of our answers may be more surprising still; but it will come as no surprise that the answers are put with less insistence than the questions.

Measures of Expansion Abroad

To provide perspective, Tables 1-3 present summary data on the foreign branches as well as the foreign incorporated affiliates of U.S. banks.[1] With respect to the branches, seven U.S. banks operated 95 branches abroad in 1950, while 126 U.S. banks operated 731 branches abroad in 1976. Between 1965 (the first year for which asset data are available) and 1976 the total assets of the branches, measured in 1972 dollars, rose from $12 billion to $164 billion, an annual average growth of 27 percent.

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[1]The available data are often lacking in consistency or comparability, and the reader is cautioned to peruse the notes beneath the tables.

Note: The views in this paper are not necessarily those of the Federal Reserve Bank of Boston. Cynthia Peters was the research assistant for this project, and Redenta Padilla did most of the typing.

In terms of number of branches and number of banks operating them, the most rapid percentage growth occurred in 1968 and 1969, as Table 1 shows; these years also witnessed a peak percentage growth in assets (based on assets expressed in 1972 dollars), although that peak was equalled in 1973. By all measures — number of foreign branches, number of banks operating them, and branch assets expressed in 1972 dollars — the percentage rates of growth in the last three years have been low by comparison with earlier years. The decrease in the number of branches in 1976 is almost entirely attributable to the conversion of 30 branches in Colombia into subsidiaries to conform with Colombian banking laws.[2]

Between them, the United Kingdom and the Bahama and Cayman Islands account for about one-quarter of the branches abroad and for about two-thirds of their assets, as Table 2 indicates. After rising sharply from 1965 to 1969, the share of total branch assets held by branches in the United Kingdom has been steadily declining, and this decline has been paralleled by an almost equal rise in the share held by branches in the Bahamas and the Caymans; London has been losing ground to the islands.

Similar time-series data are not available for the foreign incorporated affiliates of U.S. banks, but Table 3 presents selected data that could be obtained for 1975. From these data and the data in Tables 1 and 2 it is clear that the share, in dollar terms, of U.S. banks in the assets of their foreign subsidiaries is much smaller, and much less concentrated geographically, than the assets of the foreign branches. In explaining their preference for the branch over the subsidiary as a vehicle of foreign expansion, U.S. bankers advise that the branch leaves less ambiguity as to where the responsibility lies for its liabilities.[3]

U.S. banks can lend to foreigners out of their U.S. offices or out of their foreign branches. The data in Table 4 suggest that the branches were increasing their claims on both foreign banks and nonbanks much more rapidly than the U.S. offices between 1969 and 1973; however, this generalization does not hold for subsequent years. The change may be partly explained by the termination in January, 1974 of the various governmental restrictions over capital outflows from this country, including the restrictions on bank lending under the Voluntary Foreign Credit Restraint Program initiated in 1965.[4] (Unfortunately, not all of the series shown in this table are available for years earlier than 1969.) Other U.S.

[2]Board of Governors of the Federal Reserve System, *Annual Report, 1976* (Washington: 1976), p. 418.

[3]For a discussion of other considerations influencing the choice among branches, subsidiaries, and other forms of foreign expansion, see Francis A. Lees, *International Banking and Finance* (New York: John Wiley & Sons, 1974), pp. 66-77.

[4]This is not to say that the VFCR reduced the overall U.S. balance-of-payments deficit, or any VFCR-induced reduction in gross U.S. bank lending to foreigners could have been offset by other balance-of-payments flows.

Table 1

Foreign Branches of U.S. Banks, Number and Total Assets, 1965-76

End of Year	U.S. banks operating foreign branches: Number[1] (1)	U.S. banks operating foreign branches: Percent change from preceding year (2)	Foreign branches: Number[1] (3)	Foreign branches: Percent change from preceding year (4)	Total assets of foreign branches: Billions of current dollars (5)	Total assets of foreign branches: Billions of 1972 dollars: Dollar amount[2] (6)	Total assets of foreign branches: Billions of 1972 dollars: Percent change from preceding year (7)
1965	13		211		8.9	12.0	
1966	13	0	244	+16	12.4	16.2	+35
1967	15	+ 15	295	+21	15.3	19.4	+20
1968	26	+ 73	373	+26	22.8	27.6	+42
1969	53	+104	460	+23	35.3	40.7	+47
1970	79	+ 49	532	+16	46.5	50.9	+25
1971	91	+ 15	577	+ 8	59.8	62.3	+22
1972	107	+ 18	627	+ 9	78.2	78.2	+26
1973	125	+ 17	699	+11	121.9	115.2	+47
1974	125	0	732	+ 5	151.9	130.5	+13
1975	126	+ 1	762	+ 4	176.5	138.7	+ 6
1976	126	0	731	- 4	219.2	163.9	+18

[1] In 1950 seven banks operated 95 branches abroad, and in 1960 eight banks operated 124 branches abroad.

[2] Deflated by U.S. GNP implicit price deflator.

Note: Only Federal Reserve System member banks and their branches are included in columns (1)-(4), although branches of all U.S. banks are included in columns (5)-(7). In columns (1) and (2) branches in overseas areas of the United States are considered to be foreign, while in columns (3) and (4) only branches in foreign countries (excluding branches on military bases) are so considered. From 1965-68 columns (3) and (4) include branches of all size; after 1968, these columns include all branches in the Bahamas, branches in Europe with at least $10 million of total liabilities payable in U.S. dollars, and branches elsewhere abroad with at least $30 million in liabilities payable in U.S. dollars.

Source: Columns (1) and (3) are from *Annual Reports of the Board of Governors of the Federal Reserve System.* Column (5) is from *Treasury Bulletin*, November 1970, p. 126, from Board of Governors of the Federal Reserve System, *Annual Statistical Digest, 1971-1975* (Washington: 1976), p. 216, and from *Federal Reserve Bulletin*, June 1977, p. A62.

Table 2

Foreign Branches of U.S. Banks, Number and Total Assets, by Areas of Major Concentration, 1965-76

End of year	In United Kingdom				In Bahama and Cayman Islands[1]			
	Number		Total assets		Number		Total assets	
	Absolute	Percent of world total	Billions of dollars	Percent of world total	Absolute	Percent of world total	Billions of dollars	Percent of world total
1965	21	10	4.4	49	3	1	N.A.	N.A.
1966	21	9	6.9	56	3	1	N.A.	N.A.
1967	24	8	8.6	56	3	1	N.A.	N.A.
1968	32	9	13.5	59	8	2	N.A.	N.A.
1969	37	8	23.2	66	32	7	3.0	8
1970	41	8	28.2	61	60	11	4.6	10
1971	45	8	34.2	57	73	13	8.2	14
1972	49	8	43.5	56	94	15	12.6	16
1973	52	7	61.7	51	123	18	23.8	20
1974	55	8	69.8	46	124	17	31.7	21
1975	54	7	74.9	42	129	17	45.2	26
1976	56	8	81.5	37	129	18	66.8	30

N.A.: Not available.

[1]Caymans are not included until 1973, when the number of branches was 32 and their total assets were $3.1 billion.

Source: *Treasury Bulletin*, November 1970, pp. 126, 132; and the following documents of the Board of Governors of the Federal Reserve System: selected *Annual Reports; Annual Statistical Digest, 1971-1975* (Washington: 1976), pp. 216-25; *Federal Reserve Bulletin*, June 1977, p. A62; and unpublished machine runs.

Table 3

Selected Data on Foreign Subsidiaries of U.S. Banks, Bank Holding Companies, and Edge Act Corporations, for Selected Countries, 1975

Country (in order of size of assets held by U.S. parents)	Number of subsidiaries	Number of U.S. parents	U.S. parents' share of assets[1]		U.S. parents' share of net income[2] as percent of U.S. parents' share of equity[3]	U.S. parents' share of net income[2] as percent of U.S. parents' share of assets
			In millions of dollars	Percent of column total		
United Kingdom	175	28	4,878	19.6	8.9	0.52
Canada	93	23	2,975	11.9	11.8	1.21
Italy	13	7	2,511	10.1	10.2	0.38
Germany	40	10	2,356	9.5	4.5	0.54
Bahama Islands	25	13	1,975	7.9	22.7	1.00
Luxembourg	24	9	1,725	6.9	7.7	0.34
Australia	60	10	1,705	6.8	3.2	0.52
Belgium	17	6	1,581	6.4	9.2	0.45
France	25	11	1,265	5.1	10.4	0.55
Hong Kong	44	22	1,139	4.6	19.6	1.31
Brazil	56	23	759	3.0	31.5	3.60
Israel	18	4	649	2.6	25.6	0.90
Cayman Islands	20	13	512	2.1	1.2	0.04
Switzerland	27	16	390	1.6	2.8	0.47
Austria	3	3	283	1.1	4.2	0.10
Colombia	5	2	193	0.8	22.9	1.71
Total, above countries	645	*	24,896	100.0	10.1	0.75

* Because these parents may have subsidiaries in more than one country, the figures in this column are not additive.

[1] The share of a U.S. parent in the assets of a subsidiary was computed by multiplying the total assets of the subsidiary by the fraction of the equity held by the parent. Assets are as of December 31 and include claims on affiliated organizations.

[2] Net income is after foreign taxes but before securities gains or losses.

[3] Equity includes stock, surplus, undivided profits, and reserves of capital.

Note: Essentially, the subsidiaries included are those of Edge Act Corporations and those controlled by bank holding companies or by member banks of the Federal Reserve System (see reporting instructions for Federal Reserve Form 314). Those included account for 88 percent of the assets of all foreign subsidiaries for which data are reported to the Federal Reserve. Nonbank subsidiaries are among them.

Source: Federal Reserve Bank of New York, unpublished machine run.

Table 4

Selected Claims on Foreigners Reported by Banks
in the United States and by Foreign Branches of U.S. Banks, 1969-1976
End of Year

	1969	1970	1971	1972	1973	1974	1975	1976
Total claims on foreigners:								
In billions of dollars:								
Reported by banks in United States[1]	12.2	13.2	16.3	19.7	25.1	40.4	47.6	60.9
Reported by foreign branches[2]	15.9	28.6	42.1	59.8	92.8	111.2	128.9	158.3
Percent change from preceding year:								
Reported by banks in United States[1]		+ 8	+23	+21	+27	+61	+18	+28
Reported by foreign branches[2]		+80	+47	+42	+55	+20	+16	+23
Identifiable claims on foreign banks:								
In billions of dollars:								
Reported by banks in United States[3]	1.8	1.6	2.9	3.8	5.6	8.9	9.9	14.4
Reported by foreign branches[4]	9.2	16.5	23.5	35.8	56.4	60.3	69.2	83.6
Percent change from preceding year:								
Reported by banks in United States[3]		-11	+81	+31	+47	+59	+11	+45
Reported by foreign branches[4]		+79	+42	+52	+58	+ 7	+15	+21
Selected claims on foreign nonbanks:[5]								
In billions of dollars:								
Reported by banks in United States[3]	8.5	9.7	11.0	12.6	15.2	25.0	27.4	30.9
Reported by foreign branches[4]	6.2	11.4	17.4	22.4	33.7	46.8	53.8	64.1
Percent change from preceding year:								
Reported by banks in United States[3]		+14	+13	+15	+21	+64	+10	+13
Reported by foreign branches[4]		+84	+53	+29	+50	+39	+15	+19

[1]Excluding claims of U.S. banks on their foreign branches.

[2]Excluding claims on other branches of same parent.

[3]Excluded are claims of U.S. agencies and branches of foreign banks on their head offices and on foreign branches of their head offices (except for 1969-70 when it was not possible to exclude these claims), claims of U.S. banks on their foreign branches, claims on official institutions, commercial and finance paper and securities payable in U.S. dollars.

[4]Excluded are claims on other branches of the same parent, claims on official institutions, securities (including short-term money-market paper), investments, and accrued interest receivable.

[5]Claims selected are those for which highly comparable data were reported by banks and by their branches.

Source: *Federal Reserve Bulletin*, various issues; Board of Governors of the Federal Reserve System, *Annual Statistical Digest, 1971-75* (Washington: 1976), pp. 205,211, 216-17; and *Treasury Bulletin*, June 1977, pp. 94 and 97.

regulations which promote relatively rapid growth of foreign branch assets include Federal Reserve Regulation D, which imposes reserve requirements on banks in the United States, and limitations on the interest rates payable on deposits in U.S. banks.

In any event, the total assets of the foreign branches of U.S. banks continue to rise at a much faster rate than the total assets of the domestic offices. As Table 5 shows, in every year since foreign branch asset data became available the percentage increase in assets for branches has been at least double that for domestic offices, and often four or five times as great.

Profitability of Expansion Abroad

If U.S. commercial bankers are profit-maximizers, this rapid expansion abroad presumably is motivated by a higher rate of return. Indeed, the annual reports of the Nation's largest banks do create that impression. For example, the data in Table 6 leave no doubt that earnings of the largest banks from foreign transactions have been growing much more rapidly than earnings from transactions with domestic customers. For six of these banks, earnings from foreign transactions now account for more than half of total earnings.

However, earnings are not created out of thin air, and the question arises whether the funds invested abroad might have generated even greater earnings had they been invested in this country. A definitive answer to this question may not be possible, but Table 7, which includes hitherto unpublished statistics on the income of foreign branches and subsidiaries, will at least provide a starting point. It is an intriguing starting point, because it suggests that the rate of return on banking assets abroad has been substantially lower, not higher, than the rate of return on domestic assets, except in 1975.

These data may be misleading. To begin with, what we observe are average rates of return, not rates of return on *changes* in investment, and for this reason we could not be certain that a shift of funds from foreign to domestic banking operations would raise the total rate of return, even if there were no other difficulties with the data in Table 7. This argument against a shift of funds is enhanced if we posit that all funds withdrawn from the foreign operations of the huge banks must be reinvested in the domestic operations of the *same* banks. Such reinvestment might well lower the total rate of return for the U.S. banking industry, for the untapped domestic opportunities available to the biggest banks may not be very attractive. These banks are precluded from branching across state lines (and sometimes from branching at all) within this country, and it is not surprising that a bank which is denied a place in the Sunbelt should search for growth areas abroad.

In this connection, it is interesting to see how the overall rates of return earned by the huge banks vary with the extent of their international involvement. For the 13 banks listed in Table 6 and for the entire period

Table 5

Assets of Domestic Offices of All Commercial Banks in the United States and of Their Foreign Branches, 1965-76

End of year	In billions of dollars		Percent change from preceding year	
	Domestic offices	Foreign branches	Domestic offices	Foreign branches
1965	377.3	8.9		
1966	403.4	12.4	+ 7	+39
1967	451.0	15.3	+12	+23
1968	500.7	22.8	+11	+49
1969	530.7	35.3	+ 6	+55
1970	576.2	46.5	+ 9	+32
1971	640.3	59.8	+11	+29
1972	739.0	78.2	+15	+31
1973	835.2	121.9	+13	+56
1974	919.6	151.9	+10	+25
1975	964.9	176.5	+ 5	+16
1976	1,030.7	219.2	+ 7	+24

Note: In the published statistics (shown here), assets of domestic offices include net claims, not gross claims, on foreign branches of all domestic offices having such net claims. (Banks having net liabilities to, rather than net claims on, their foreign branches report such net liabilities as a part of their total liabilities.) Data for years beginning with 1969 are not strictly comparable to data for earlier years; see "Assets and Liabilities of Foreign Branches of U.S. Banks," *Federal Reserve Bulletin*, 58 (February 1972), pp. 106-21 and Board of Governors of the Federal Reserve System, *Banking and Monetary Statistics*, 1941-1970 (Washington: 1976), p.31.

Source: *Treasury Bulletin*, November 1970, pp. 126 and 129; and the following publications of the Board of Governors of the Federal Reserve System: *Banking and Monetary Statistics*, 1941-1970 (Washington: 1976), pp. 30-31; *Annual Statistical Digest, 1971-1975* (Washington: 1976), pp. 61, 216-17; *Federal Reserve Bulletin*, June 1977, pp. A16, A62, A63.

Table 6

Change in Net Operating Earnings, Domestic and International, after Taxes and before Securities Gains or Losses, for 13 Major U.S. Commercial Bank Holding Companies, 1970-76

Firm (in order of 1976 international earnings)	Net operating earnings						International earnings as percent of total earnings, 1976
	In millions of dollars				Compound annual rate of change, 1970-76		
	Domestic		International				
	1970	1976	1970	1976	Domestic	International	
Citicorp	87.1	112.0	58.0	293.0	4.3%	31.0 %	72.3
BankAmerica Corporation	141.5	201.5	25.0	134.4	6.1	32.4	40.0
J.P. Morgan & Co., Incorporated	77.1	95.3	25.5	107.4	3.6	27.1	53.0
Chase Manhattan Corporation	108.6	23.0	30.7	82.0	-22.8	17.8	78.1
Manufacturers Hanover Corporation	76.0	63.1	11.4	80.2	- 3.1	38.4	56.0
Chemical New York Corporation	70.2	51.7	7.7	41.0	- 5.0	32.1	44.2
Bankers Trust New York Corporation	46.3	20.7	7.8	36.9	-12.6	29.6	64.1
Continental Illinois Corporation	64.4	101.0	-0.1	30.0	7.8	[a]	22.9
Charter New York Corporation	26.8	17.9	3.7	24.7	- 6.5	37.2	58.0
First Chicago Corporation	61.0	77.1	1.2	15.8	4.0	53.7	17.0
First National Boston Corporation	37.0	29.4	4.6	13.6	- 3.8	19.8	31.6
Wells Fargo & Company	29.7	55.9	2.9	7.6	11.1	17.4	12.0
Security Pacific Corporation	57.4	71.0	0.2	5.3	3.6	72.7	6.9

[a]Continental Illinois Corporation's compound annual rate of increase calculated from a 1970 base would be infinite because 1970 international earnings were negative.

Source: Thomas H. Hanley, Salomon Brothers, except that First National Boston supplied data for that firm.

Table 7

Income and Assets for All Insured Commercial Banks in the United States, for Insured Commercial Banks with Foreign Operations, and for Selected Foreign Branches and Subsidiaries of U.S. Banks, 1970-75

(Dollar amounts in millions)

	1970	1971	1972	1973	1974	1975
Assets:						
All insured commercial banks[1]	$576,351	$639,903	$737,699	$832,658	$1,045,972	$1,095,389
Insured commercial banks with foreign operations[1] [2]	N.A.	N.A.	N.A.	N.A.	$578,454	$591,068
Foreign branches of U.S. banks[3]	$34,263	$41,956	$55,187	$80,157	$108,596	$111,167
Foreign subsidiaries of U.S. banks[4]	N.A.	N.A.	N.A.	N.A.	N.A.	$24,896
Net operating income after taxes:						
All insured commercial banks[5]	$4,954	$5,024	$5,543	$6,585	$7,167	$7,184
Insured commercial banks with foreign operations[2] [5]	N.A.	N.A.	N.A.	N.A.	$3,218	$3,263
Foreign branches of U.S. banks[3]	$58	$152	$193	$269	$374	$717
Foreign subsidiaries of U.S. banks[4]	N.A.	N.A.	N.A.	N.A.	N.A.	$186
Net operating income after taxes as a percent of assets:						
All insured commercial banks[6]	0.86	0.79	0.75	0.79	0.69	0.66
Insured commercial banks with foreign operations[2]	N.A.	N.A.	N.A.	N.A.	0.56	0.55
Foreign branches of U.S. banks[3]	0.17	0.36	0.35	0.34	0.34	0.64
Foreign subsidiaries of U.S. banks	N.A.	N.A.	N.A.	N.A.	N.A.	0.75

N.A.: Not Available.

[1]For 1974-75, asset data are from consolidated reports and include assets of foreign branches (but no intrabank claims); for 1970-73, consolidated reports are not available, and asset data include net claims on foreign branches of U.S. banking offices having such claims but do not include claims of foreign branches on other parties. Assets are as of December 31.

[2]Foreign operations means foreign offices.

[3]Data are for 11 countries listed in Table 9 except that Belgium-Luxembourg is not included in 1970 and Germany and Italy are not included in 1975 because data for those countries were not disclosed to us. Assets are annual averages of monthly data and exclude claims of branches on other foreign branches of the same parent. Income figures, as reported to U. S. Department of Commerce, are net of foreign taxes but not of U. S. taxes, and include securities gains or losses.

[4]Figures shown represent share of U.S. parents in *total* assets or income for countries covered by Table 3. Assets are as of December 31. Income is net of foreign taxes but not of U.S. taxes and is before securities gains or losses.

[5]Income is before securities gains or losses and includes contribution of foreign branches and subsidiaries.

[6]The decline shown from 1973 to 1974 and 1975 is almost entirely attributable to the change in definition of the asset base; see footnote 1.

Source: *Assets and Liabilities, Commercial and Mutual Savings Banks,* December 31, 1970 - December 31, 1975 (Washington: Federal Deposit Insurance Corporation); Board of Governors of the Federal Reserve System, unpublished machine run; U. S. Department of Commerce, unpublished machine run; and Federal Reserve Bank of New York, unpublished machine run.

1970-76, there is a correlation coefficient of 0.41 between the rate of return on net worth and international involvement (measured, in the absence of any other reasonable measure, by international earnings as a percent of total earnings).[5] In other words, among this group of banks there is a tendency for the banks with higher international involvement to earn higher overall rates of return, but the tendency is weak and not significant by standard statistical test. Of course, factors other than international involvement influence the rate of return, and their impact may obscure that of international involvement.

Aside from the fact that Table 7 necessarily presents average rates of return, another difficulty in interpreting the table is that the rate of return on assets is an imperfect proxy for the "true" bottom line — the rate of return on shareholders' equity (for which the desired domestic vs. international data are not available). In particular, a relatively low rate of return on assets is compatible with a competitive rate of return on equity if the ratio of assets to equity is relatively high, and such accounting relationships might well characterize those foreign branches that specialize in low-risk interbank borrowing and lending.[6] Moreover, banking statistics do show that the ratio of assets to capital and reserves goes up with the size of the bank. However, in the absence of further supporting data this line of argument is undermined by the fact that the rate of return on capital and reserves generally moves in the same downward direction as the rate of return on assets, as the size of the bank increases beyond a certain threshold.[7]

Perhaps the greatest deficiencies of the data in Table 7 stem from the underlying treatment of loan losses and of the cost of capital. As a rule, loan losses of the foreign branches are not charged as an expense of the branches but as an expense of the parent corporation, a practice which inflates the relative income of the branches. On the other hand, the foreign branches typically pay interest for the funds that they acquire, including short-term funds advanced to them by their parents, while the parents

[5]International earnings as a percent of total earnings may fail to measure international involvement. For example, a bank with substantial international assets or gross interest revenue might record very low international earnings in a particular year, though such a relationship would be less likely over the entire period 1970-76. Unfortunately, data on international assets are rather sparse.

[6]Note that the rate of return for foreign branches in Table 7 is computed on assets defined to exclude claims of branches on other branches of the same parent. In a consolidated statement for a bank, net incomes of the various components (including branches) are additive, but intrabank claims "wash."

[7]Board of Governors of the Federal Reserve System, *Annual Statistical Digest, 1971-1975* (Washington: 1976), pp. 314-15.

Table 8

Net Operating Income after Taxes as a Percent of Assets, Excluding Provision for Loan Losses and Including Imputed Interest on Equity and Reserves, for Insured Commercial Banks in the United States, 1970-75

(Dollar amounts in millions)

	1970	1971	1972	1973	1974	1975
Net operating income before taxes and securities gains or losses	$7,128	$6,713	$7,251	$8,707	$9,251	$8,977
Provisions for loan losses	+ 703	+ 867	+ 973	+1,265	+2,286	+3,612
Imputed interest on equity and reserves[1]	- 3,536	- 2,530	- 2,561	-5,162	- 6,969	- 4,724
Adjusted net income	4,295	5,050	5,663	4,810	4,568	7,865
Imputed income taxes[2]	- 1,310	- 1,271	- 1,333	- 1,172	-1,029	- 1,571
Adjusted net income after imputed taxes	2,985	3,779	4,330	3,638	3,539	6,294
Adjusted net income after imputed taxes as a percent of assets[3]	0.52	0.59	0.59	0.44	0.34	0.57

[1] Computed at rate for large negotiable three-month CDs, secondary market rate.

[2] At effective rates, not at nominal rates. Effective rates were computed by dividing actual taxes paid by actual net income before taxes.

[3] See footnote 6 to Table 7.

Source: *Assets and Liabilities, Commercial and Mutual Savings Banks*, December 31, 1970 - December 31, 1975. (Washington: Federal Deposit Insurance Corporation); Board of Governors of the Federal Reserve System, *Annual Statistical Digest, 1971-1975* (Washington: 1976).

record no interest or other continuing "expense" for the equity capital (and reserves of capital) that they invest,[8] and this asymmetry deflates the relative income of the branches.[9]

Precise correction of these two distortions is not possible with the data available, but Table 8 may convey some idea of the magnitudes involved. In this table all provision for loan losses is added back into the net income of U.S. commercial banks in order to render that income more comparable with the income of the foreign branches, which generally record no loan losses. Again merely for the sake of comparability, the net income of U.S. commercial banks is reduced by a hypothetical interest charge on their capital and reserves. It seems reasonable to compute this interest charge at the rate for large negotiable certificates of deposit, since the foreign branches must pay a similar money-market rate for much of the funds that they acquire. Finally, taxes are deducted from this adjusted net income at the same rate as was paid on actual net income.

The end result is a set of appreciably lower hypothetical rates of return on assets for insured U.S. commercial banks than is reported in Table 7. Although these adjusted rates of return put the branches in a much more favorable light, especially in recent years, the adjustments made in Table 8 are rather arbitrary and not at all conclusive. Different assumptions about the allocation of loan losses, about the appropriate interest charge on equity, or about rates of taxation would, of course, yield different results.

In summary, while the available data do not support strong conclusions about the rate of return on the foreign operations of U.S. banks, it does seem that the rate of return earned by foreign branches compares favorably with that earned by all U.S. insured commercial banks in recent years if allowance is made for the cost of equity capital.[10] This is not to say that all foreign branches are relatively profitable. Indeed, some U.S. bankers acknowledge that some of their branches, evaluated in isolation, may yield a lower rate of return than domestic operations, viewed in isolation, but they maintain that a U.S. bank is compelled to service its multinational customers abroad, even though the rate of return abroad may

[8]Interviews with U.S. bankers and unpublished data gathered by the Commerce Department agree that the parents do advance some *long-term* capital to the branches but that the aggregate amount is much smaller in relation to branch assets than is the parents' equity in relation to its assets.

[9]One hopes that these two offsetting distortions comprise the bulk of the iceberg rather than the tip, but other problems do exist; for example, it is likely that the branches are charged less than their full share of home office overhead in the data reported to the Commerce Department.

[10]The comparatively low rate of return earned by branches in earlier years may be due partly to the "start-up" costs incurred in those years, when the number of branches was growing at very rapid percentage rates.

be low, if the bank is to retain their business in this country. While this argument may seem valid for the management of a particular bank, it can hardly be true for all U.S. banks collectively. More to the point, the argument has rather puzzling implications for the nature of bank competition, for what is suggested is that the multinational customers, by demanding foreign branch services at low cost, sometimes succeed in extracting for themselves a share of bank profits that they could not extract by playing the banks off against each other in any other way.

Aside from the issue of overall rate of return, it is noteworthy that there are significant differences in the rates of return on branch assets from country to country (Table 9). Although the rates of return sometimes fluctuate sharply from year to year, they have consistently been relatively high in Japan, Panama, and Switzerland and relatively low in France and the United Kingdom (and in Belgium-Luxembourg in recent years).

Reduction of Risk through Foreign Lending

Whether or not expansion abroad has raised the rate of return, it may have introduced greater stability into that rate. It is even conceivable that U.S. banks would be willing to accept a rate of profit on foreign loans below that on domestic loans in return for a reduction in variability of the overall rate of profit, for it is well known that risk (the variance of the overall rate of return) can be reduced by diversification of investments, or by spreading one's eggs among several baskets, or countries.[11] Partly because economic conditions in different countries do not change in precisely the same way, a poor investment result in one country in any given year may be offset by a very good result in another country.[12] It is not a foregone conclusion, however, that diversification will reduce risk; the outcome depends on the nature of the diversification.

Rather than attempt a precise measure of foreign diversification by U.S. banks and its impact on the variability of their rates of return — an exercise for which the necessary data are not readily available — we investigate in this section a closely related question: For major banks with foreign operations, does the rate of return become more, or less, stable as

[11]See, for example, Herbert C. Grubel, *International Economics* (Homewood, Ill.: Richard D. Irwin, Inc., 1977), pp. 536-43.

[12]Citicorp expresses the point as follows: "Overseas earnings, which contributed over 70 percent of the total earnings in 1976, are derived from doing business in more than 100 countries. Citicorp's worldwide policy of broad diversification of both assets and liabilities helps maintain earnings stability and reduces the risk of excessive concentration in any one particular country, currency or industry." See *Citicorp Reports/1976* (New York: Citicorp, 1977), p. 25.

Table 9

Net Income as a Percent of Assets for Foreign Branches of U.S. Banks, by Selected Countries, 1970-75

Country	1970	1971	1972	1973	1974	1975
Bahama Islands	0.05	0.16	0.27	0.32	0.25	1.00
Belgium-Luxembourg	(D)	(D)	(D)	0.19	0.17	0.18
France	0.12	0.24	0.13	0.20	0.13	0.28
Germany	0.09	0.49	0.44	0.72	0.43	(D)
Ireland	(D)	(D)	(D)	0.36	(D)	(D)
Italy	(D)	(D)	(D)	*	0.53	(D)
Japan	0.50	1.32	1.25	0.98	0.78	0.74
The Netherlands	(D)	*	0.17	0.36	0.19	(D)
Panama	(D)	(D)	(D)	0.78	0.88	(D)
Switzerland	(D)	0.64	0.71	1.10	2.43	1.38
United Kingdom	0.12	0.23	0.22	0.18	0.21	0.30
Total, above countries[1]	0.17	0.36	0.35	0.34	0.34	0.64

[1]Excludes Belgium-Luxembourg in 1970 and Germany and Italy in 1975 because income data for those countries were not disclosed to us.

*Net income less than ±$500,000.

(D): Withheld to avoid disclosure of information about the operations of a single branch.

Note: Income is as reported to U. S. Department of Commerce and is net of foreign taxes but not of U. S. taxes. Asset data are annual averages of monthly data. Individual country asset data here exclude branch claims on other branches of the same parent in that country, and asset data for all countries collectively here exclude branch claims on all other foreign branches of the same parent. Income and asset data probably are not perfectly comparable because of some difference in coverage of branches, and it is likely that income data are reported for more branches than asset data; see Form F. R. 502, available from the Federal Reserve, and Form BE-578(B), available from the Bureau of Economic Analysis, U. S. Department of Commerce.

the ratio of foreign to total business increases?[13] For want of any other acceptable index, we measure the share of foreign business by the share of international earnings in total earnings, as reported by the banks and shown in Table 10; unfortunately, such data are not generally available for years prior to 1970, and the reader is cautioned that the underlying accounting methods employed by the banks are not uniform. The simple correlation coefficient between the data in columns 1 and 2 is 0.46, so that for this group of banks the variability of the rate of return rises rather than declines with an increase in the reported ratio of foreign to total business. This outcome clashes with the view that foreign involvement reduces total risk.[14]

Because size may be associated with overall (not merely foreign) diversification, a simple regression was run to allow for the possible influence of size on the variability of the rate of return, as well as for the influence of foreign involvement. Where the sample consists of the 13 banks listed in Table 10, the dependent variable is the variance of the percentage rate of return on net worth, A is average assets (in millions of dollars), and I is international earnings as a percent of total earnings, all for the period 1970-76, the ordinary least squares technique yielded the following results:

$\bar{R}^2$	A	I	Intercept
0.0606	−0.0000	0.0297	0.6328
	(−0.26)	(1.52)	(1.08)

(t-ratios in parentheses)

[13]A similar approach was applied to 492 industrial firms, but not to banks, by Alan M. Rugman in "Risk Reduction by International Diversification," *Journal of International Business Studies*, Fall/Winter 1976, pp. 75-80.

[14]A related but different question is how the loss ratio on foreign loans compares with that on domestic loans. A decidedly lower ratio for foreign loans for the years 1962-74 was reported by Fred B. Ruckdeschel in "Risk in Foreign and Domestic Lending Activities of U.S. Banks," International Finance Discussion Papers Number 66 (Washington: Board of Governors of the Federal Reserve System, 1975). In this survey of ten banks, Ruckdeschel also found that the standard deviation of the loss ratio on all loans, including foreign loans, was lower than that on domestic loans alone, although he recognizes that variability of the loan-loss ratio is not the same thing as variability of earnings. A recent survey by the Robert Morris Associates, to whom 877 banks reported their domestic loan losses and 142 banks reported their international loan losses, also shows a much lower "net charge-off ratio" for international loans than for domestic loans for the years 1975 and 1976; see the Robert Morris Associates, *Domestic and International Commercial Loan Charge-offs* (Philadelphia, 1977).

Table 10

Variance in Rate of Return on Net Worth, International Earnings as a Percent of Total Earnings, and Average Assets for 13 Major U.S. Commercial Bank Holding Companies for the Period 1970-76

Firm (in order of variance in rate of return)	Variance in percentage rate of return on net worth (1)	International earnings as a percent of total earnings (2)	Average assets (millions of dollars)[1] (3)	International earnings (millions of dollars) (4)
Chase Manhattan Corporation	4.14	44.9	35,144	464
Bankers Trust New York Corporation	2.13	40.7	16,686	175
First National Boston Corporation	1.73	18.1	7,099	57
Citicorp	1.64	61.2	44,581	1,124
First Chicago Corporation	1.35	13.3	14,590	80
J.P. Morgan & Co. Incorporated	1.29	44.6	20,449	470
Chemical New York Corporation	1.27	28.0	18,616	159
Manufacturers Hanover Corporation	1.20	38.4	21,289	291
Charter New York Corporation	1.14	43.4	8,908	107
Continental Illinois Corporation	0.98	12.7	15,726	82
Security Pacific Corporation	0.53	7.9	12,758	34
Wells Fargo and Company	0.49	13.3	10,316	42
BankAmerica Corporation	0.40	30.6	50,632	505

[1] Averages of year-end assets.

Note: Earnings data are after taxes and before securities gains or losses.

In other words, no significant effect on the variability of the rate of return was detected either for size or for foreign involvement. This result is not conclusive, however, because other factors which we cannot measure, such as differences in portfolio composition from bank to bank, may operate to obscure the influence of foreign involvement. All that can be said here is that the limited evidence available to us does not support the view that the foreign activities of the major U.S. banks have reduced the risk which they face.

Our primary concern in this paper, however, is not with foreign business *per se* but with the establishment by U.S. banks of a physical presence abroad in the form of branches and subsidiaries. We next consider some hypotheses that may help to explain this expansion abroad by U.S. banks.

The Distribution of U.S. Branch Activity Abroad: some hypotheses

The two preceding sections have considered whether the foreign expansion of U.S. banks has elevated or stabilized their rates of return. Another possible motive for foreign expansion is growth itself; as we have noted, the major U.S. banks may encounter fewer obstacles to branching abroad than they do at home.[15] Nonetheless, the obstacles to successful foreign branching are not insignificant, and an explanation of the rapid growth of foreign branch activity must explain how these obstacles have been overcome.

Of course, some obstacles are insuperable; there are no branches of U.S. banks in countries which prohibit them. But altogether apart from such governmental barriers, there is a complex of obstacles which invite failure, including distance from top management (perhaps not *always* a handicap) and the need to cope with foreign languages and customs. In the standard theorizing about direct investment abroad, it is argued that these obstacles would discourage U.S. firms from establishing branches and subsidiaries to compete against foreign firms on their home turf were it not for the fact that the U.S. firms possess some offsetting advantage

[15]On this question of motivation, Alfred Miossi, Executive Vice President of Continental Illinois, has commented, "The goal of growth for the sake of growth which has characterized international banking since the early 1960s is unlikely to continue." Robert K. Wilmouth, President of Crocker National, offers the following observation: "If we are candid, we will recognize that many of those new offices, affiliates and branches were added, not because there was a proven market awaiting our talents nor because they were a logical extension of our bank's domestic activities, but rather for purposes of prestige or in the hope of being in the right place at the right time to cash in on the boom."

The first quotation is from *The Economist*, January 22, 1977, Survey p. 30, and the second is from Robert K. Wilmouth, "International Banking: New Directions, New Dimensions," *The Journal of Commercial Bank Lending*, Vol. 58, No. 12 (August 1976), p. 11.

that is consonant with an oligopolistic market structure and that they exploit via direct investment abroad either because of an oligopolistic growth objective or because of some other market imperfection.[16] This offsetting advantage, which enables U.S. branches and subsidiaries to survive in foreign territory, is commonly asserted to take the form of superior technology, or, more generally, superior know-how. Thus, current theorizing stresses both the ignorance and the wisdom of U.S. firms which locate abroad, noting their relative ignorance of foreign customs and languages but asserting that this ignorance is more than compensated by their technical wisdom.

Is there an area in which U.S. bankers possess greater knowledge or expertise than their foreign competitors? Interviews with U.S. bankers both in this country and in branches abroad reveal considerable modesty on this score, but an answer is suggested by a point that all interviewees make: banks go abroad to serve their customers.[17] This point suggests that the chief advantage of U.S. banks abroad over their competition lies in their detailed knowledge of how to service the banking requirements of the U.S. firms which locate abroad. The major U.S. banks invest considerable time (money) in learning the banking requirements of their U.S. customers and in devising and marketing ways of servicing those requirements, and it is not surprising that when the U.S. customer goes abroad his bank follows along in an effort to profit further from its previous investment. Competitive service cannot be provided to the U.S. customer abroad by the bank's U.S. offices alone, largely because of difficulties of communication; bankers, like tailors, must locate near their customers. This argument assumes, of course, that the foreign organization established by the bank's U.S. customer is endowed with considerable decision-making power.

Discussions with U.S. corporate treasurers reinforce this interpretation. Treasurers advise that the foreign branches of U.S. banks "excel in their familiarity with the company's and an American's way of doing business," that they are faster to respond, "easier to communicate with," and more efficient in effecting international loans and international transfers of funds. Foreign banks, on the other hand, commonly excel in local collections, arranging local business introductions, and knowledge of

[16]For a theoretical survey see Giorgio Ragazzi, "Theories of the Determinants of Direct Foreign Investment," *International Monetary Fund Staff Papers*, XX (July 1973), pp. 471-98. Also see Charles P. Kindleberger, *International Economics*, 5th ed. (Homewood, Ill.: Richard D. Irwin, Inc., 1973), pp. 245-49 and Richard E. Caves, "International Corporations: The Industrial Economics of Foreign Investment," *Economica*, XXXVIII (February 1971), pp. 1-27.

[17]Interviews were held at the headquarters of several major U.S. banks and at their foreign branches or representative offices in Stockholm, London, and Paris; in these cities officials of several major foreign banks also were interviewed.

local regulations. Because of these differing areas of expertise, corporate treasurers sometimes utilize both a native bank and a U.S. branch in a foreign country.

If U.S. banks succeed in bringing familiar ways to U.S. nonbanking corporations in a strange environment, the converse is also true; U.S. nonbanking corporations abroad establish a U.S. presence, or beachhead, from which U.S. banks can try to penetrate the foreign economy. U.S. bankers commonly remark that after serving their U.S. customers the next goal of their branches abroad is to develop business with local firms and citizens. To be highly successful in this endeavor, the branches must become virtually as familiar with the local customs and economy as the native banks, and corporate treasurers testify to their at least occasional success.[18] Serving one's U.S. customers abroad may be the beginning of the story, but it is not the desired end.

In any event, it seems reasonable to presume from this discussion that U.S. banks will concentrate their foreign operations in those areas where U.S. nonbanking firms are concentrated, other things being equal. Apart from the presence of U.S. nonbanking firms, a large foreign economy may well attract more U.S. branches than a small one. In addition, as is well-known, banks are attracted by relative freedom from governmental regulation or taxation. Without substantial freedom from governmental restriction, there would be no major financial center in London, where U.S. banks congregate in order to share more fully in the interbank business and the economic intelligence-gathering function,[19] nor would there be such massive funds transfers through the Bahama and Cayman Islands, which are free of income taxes as well as regulations onerous to business.[20] In this connection, during 1969, when the Federal Reserve Board began to allow U.S. banks to open Bahama "shell" branches from which loans to foreign residents could be made outside the restrictions of the VFCR, the number of U.S. branches in the Bahamas jumped from 8 to 32.[21] This shell growth should be recognized for what it is. A shell branch

[18]The advertisements of the major U.S. banks also testify to their efforts in this regard; one recently proclaimed "in-depth knowledge about the more than 100 countries where we have a physical presence" (*The New York Times*, May 25, 1977, p. 55).

[19]Several years ago a significant "shake-out" of allegedly unprofitable London branches was widely expected within the banking community. No explanations for why it did not happen seem to be forthcoming, but, then, one seldom encounters explanations for a nonevent.

[20]For a discussion of government regulations limiting the entry or activity of foreign banks in various countries, see U.S., Congress, House, Committee on Banking, Currency and Housing, *Financial Institutions and the Nation's Economy*, 94th Cong., 2d sess., 1976, Book II, pp. 981-1111 and U.S., Department of Commerce, *U.S. Service Industries in World Markets* (Springfield, Va.: National Technical Information Service, 1976), pp. C-21 through C-29.

[21]See Table 2 of this paper and the testimony of Andrew F. Brimmer in U.S., Congress, House, Committee on Banking, Currency and Housing, *Financial Institutions and the Nation's Economy: "Discussion Principles," Hearings*, before a Subcommittee of the Committee on Banking, Currency and Housing, House of Representatives, 94th Cong., 1st and 2d sess., 1975, p. 408.

is little more than a mailing address to which transactions arranged elsewhere are assigned on the books of the banking organization;[22] the standard corporation is said to have a fictitious personality, and the shell is a fictitious part of that fiction.

Even though the Bahamas and the Caymans levy no taxes on corporate profits, their lure from the tax standpoint may not be immediately obvious in view of the fact that U.S. firms are allowed a credit against their U.S. income tax liability for income taxes paid to foreign governments. However, there is a limit to this credit, established (under Section 904 of the U.S. Internal Revenue Code) by the following formula:

$$\text{Limit on foreign tax credit} = \frac{\text{net foreign source taxable income}}{\text{total taxable (including foreign) income}}$$

x U.S. tax due (on total taxable income) before credits.

Experimentation with this formula will reveal that if foreign source income is taxed on average by foreign jurisdictions at a rate above the U.S. Government rate a U.S. bank will have an incentive to shift the source of its foreign income from higher taxing to lower taxing foreign jurisdictions, e.g., from the United Kingdom to the Bahamas. In such a case the firm employs the Bahamas or the Caymans as a haven from *foreign* taxes. How strong this particular motivation may be is hard to judge, but it is easily demonstrated that some foreign nominal tax rates on corporate profits are above the U.S. rate.[23] Of course, some U.S. banks also have an incentive to place business in the Bahamas and the Caymans to avoid state and municipal income taxes within this country, since income that U.S. firms earn abroad is exempt from the income taxes levied by some states and municipalities, notably the State and the City of New York.[24]

To recapitulate, it is posited that the foreign branches of U.S. banks will concentrate in countries where U.S. nonbanking firms are concentrated, or where economic activity is substantial, or where there is considerable freedom from government regulation and taxation. In addition, since corporate treasurers report that the branches excel at arranging international loans and funds transfers, the branches may be attracted by the presence of international commerce.

[22]U.S., Congress, House, Committee on Banking, Currency and Housing, *Financial Institutions and the Nation's Economy*, 94th Cong., 2d sess., 1976, Book II, p. 825.

[23]See *Corporate Taxes in 80 Countries* (New York: Price Waterhouse, July 1976).

[24]In addition, bank customers may seek to reduce or evade taxes by placing deposits in the Bahamas and Caymans. Secrecy is maintained for accounts in these jurisdictions, as it is for accounts in Panama and Switzerland.

In order to test this set of hypotheses, the following explanatory variables were employed:

DI ≡ U.S. direct investment position;

G ≡ gross national product;

X + M ≡ exports plus imports;

R ≡ rate of return on branch assets, or net income of branches as a percent of branch assets.

If our hypotheses are correct, the level of branch assets and earnings, by country, should be influenced by the magnitudes that these variables assume. A relatively high value for DI, for G, or for X + M in a country should tend to produce a relatively high value for assets and earnings in that country. A relatively high value for R, on the other hand, should be associated with a relatively low value for assets and earnings, for it is assumed that a high value for R is the result of restrictions or other barriers which prevent U.S. branches (and other banks) from adding to their total assets (and, incidentally, to their total earnings) and from bidding down the overall rate of return; on the other hand, a low value for R would generally be expected in major money-market centers, where restrictions and other barriers are minimal. (A high rate of return might also be an indicator of high risk.)

Using the ordinary least squares technique, regressions were run to test these hypotheses, employing data for ten countries for 1974 and eight countries for 1975. Unavailability of data, especially for the variable R, made it impossible to include more countries. Difficulty in obtaining reliable data for effective, as opposed to nominal, tax rates for the years under consideration obliged us to omit tax rates from the analysis,[25] although we do not doubt their importance; therefore, the Bahamas also were omitted, since there is an overwhelming consensus that the activity of U.S. branches there is explained largely by tax considerations.

The regression results are reported in Table 11.[26] They lead us to accept the hypothesis that the U.S. direct investment position (the variable

[25]Cf. M.E. Kyrouz, "Foreign Tax Rates and Tax Bases," *National Tax Journal*, XXVIII (March 1975), pp. 61-80.

[26]With the possible exception of the variable R, it seems reasonable to assume that none of the explanatory variables in these equations is appreciably influenced by the "dependent" variables, or, more generally, that the explanatory variables are determined exogenously, outside of models purporting to explain the dependent variables. As for R, it is assumed that observed variation in that variable is predominantly attributable to exogenous variation in government restrictions. Therefore, the equations employed are viewed as reduced forms which it is appropriate to estimate directly.

DI) has a positive influence on total branch assets, on branch business with foreign nonbanks, and on branch net income, but to suspend judgment about the influence of G, R, and X + M. Even though the regression coefficients estimated for G and R display the expected signs throughout and are sometimes significant by the standard statistical tests, it happens that there is a high degree of multicollinearity, or intercorrelation, involving especially the variables G and X + M and making it impossible to identify their separate effects. The variable DI, on the other hand, is relatively free from this entanglement.

Competitiveness of U.S. Branches in Foreign Markets

In the preceding section an attempt was made to explain the level of activity of the foreign branches of U.S. banks, country by country. The present section treats the closely related subject of foreign market shares captured by the branches. On this subject, one can readily conceive of a number of interesting questions regarding the competition waged by the foreign branches of U.S. banks. What is the share of the banking market captured by the branches in each country, and how can variations in this share be explained?[27] How successful have the branches been in developing a truly foreign business, as opposed to the business of intermediating between foreign residents and U.S. residents? In dealing with foreigners, what do the branches offer that the native banks cannot match, and where do the branches fall short? What is the foreign clientele, and, in particular, what is the relative importance of the interbank business?

Interviews with U.S. and foreign commercial bankers produced a fairly consistent pattern of responses to such questions.[28] As reported in the preceding section, there is a strong consensus that U.S. banks usually go abroad for the immediate purpose of serving their U.S. multinational customers abroad. However, they also attract business from foreign multinational firms abroad, and this business comprises a significant share of their footings.[29] In addition, they draw some business from smaller (nonmultinational) firms in the countries they penetrate, although this business is much smaller than that with the multinationals; nor, as a rule, is much business done with individuals. Last, but not least, the branches of U.S. banks abroad are also active participants in the interbank markets.

[27]For a discussion of the shares of major banks in world deposits, see Robert Z. Aliber, "International Banking: Growth and Regulation," *Columbia Journal of World Business*, Winter 1975, pp. 11-13.

[28]These interviews were held in industrial countries, and the information obtained may not apply to other countries.

[29]On the correspondence between the growth of multinational banks and the growth of other multinational corporations, see Fred H. Klopstock, "A New Stage in the Evolution of International Banking," *Revue Internationale d'Histoire de La Banque*, VI, pp. 1-2.

Table 11

Regression Equations for Branch Total Assets, for Branch Business with Foreign Nonbanks, and for Branch Net Income, 1974-75

Dependent variable	Year	Number of countries	$\bar{R}^2$	Coefficients of explanatory variables and t-ratios				
				DI	G	R	(X+M)	Intercept
Branch total assets	1974	10[a]	0.92	7.9330 (9.58)	0.0947 (2.92)	-13,493 (-3.82)	-0.4315 (-4.25)	4,805.9 (1.06)
Branch total assets	1975	8[b]	0.86	7.8104 (5.12)	0.1198 (1.86)	-23,446 (-1.83)	-0.5609 (-1.98)	15,393 (1.00)
Branch claims against + liabilities to foreign nonbanks	1974	10[a]	0.91	3.3146 (8.81)	0.0494 (3.36)	-5,571.9 (-3.47)	-0.2042 (-4.43)	2,567.0 (1.24)
Branch claims aganist + liabilities to foreign nonbanks	1975	8[b]	0.81	3.0361 (4.32)	0.0568 (1.91)	-8,610.7 (-1.46)	-0.2365 (-1.81)	6,165.2 (0.87)
Branch net income	1974	10[a]	0.81	0.0157 (5.91)	0.0003 (3.02)	-14.510 (-1.28)	-0.0011 (-3.25)	9.7930 (0.67)
Branch net income	1975	8[b]	0.72	0.0227 (3.55)	0.0005 (1.66)	-46.459 (-0.86)	-0.0018 (-1.51)	39.074 (0.60)

[a]The ten countries are: Belgium and Luxembourg, France, Germany, Ireland, Italy, Japan, The Netherlands, Panama, Switzerland and United Kingdom.

[b]The eight countries are: Belgium and Luxembourg, France, Ireland, Japan, The Netherlands, Panama, Switzerland and United Kingdom.

Note: The definitions and sources of data for the variables are as follows:

Branch total assets: Annual averages of monthly data in millions of dollars. Board of Governors of the Federal Reserve System, unpublished machine run.

Branch claims against + liabilities to foreign nonbanks: Excludes official institutions. Annual averages of monthly data in millions of dollars. Board of Governors of the Federal Reserve System, unpublished machine run.

Branch net income: In millions of dollars. U.S. Department of Commerce, unpublished machine run.

DI: U.S. direct investment position at year end, all industries, in millions of dollars. *Survey of Current Business*, August 1976, pp. 48-49.

G: Gross national product in millions of U.S. dollars at market prices. *World Bank Atlas*, 1976.

R: Rate of return on branch assets, derived by expressing branch net income as a percent of branch total assets.

(X + M): Exports plus imports of merchandise (valued f.o.b.) and of services, on a balance-of-payments basis except for Luxembourg which is on a national accounts basis, in millions of U.S. dollars. *International Financial Statistics*, July 1976.

Although branches reportedly are established primarily for the purpose of serving the foreign requirements of U.S. multinational firms, U.S. bankers interviewed abroad were unanimous that dealings with such firms, which bargain very vigorously, are less profitable than transactions with other business firms abroad, especially nonmultinational native firms. However, it is difficult for the branches to acquire a sizable, native, nonmultinational clientele, partly because the special expertise of the major U.S. banks typically lies in providing the services that the multinationals prize. Both U.S. and foreign commercial bankers generally agree that the foreign branches of U.S. banks excel in foreign-exchange dealing, in handling foreign collections and international funds transfers, and in providing foreign-currency loans (including provision of such loans through syndicates, in whose management they are highly skilled). It is their international network that enables the U.S. banks to compete so effectively in these activities.

Aggressive marketing is one of the hallmarks of the foreign branches of U.S. banks, which are known for their active wooing of corporate customers — for making frequent calls and proffering advice on cash management, foreign-exchange markets, and so forth. According to more than one foreign banker, the U.S. banks commonly present more specific and detailed proposals to corporate prospects than foreign banks do, even though the U.S. banks also have the reputation of being highly flexible. U.S. branches abroad are known for their effort to anticipate and to respond quickly to a corporate customer's needs. As one illustration, they may designate an "account executive" (or similarly titled person) within the branch to whom a corporate customer can turn as a point of contact on all his banking problems; as another illustration, they have offered multicurrency lines of credit on which a borrower can draw in any of several specified currencies. In addition, in some countries they have been more aggressive than their competition in marketing formal term loans. U.S. branches abroad also have the reputation of engaging in vigorous price competition, particularly in foreign-exchange trading (which some foreign bankers suspect is a "loss-leader") and in commercial lending.

On the other hand, the foreign branches of U.S. banks generally find it difficult, if not impossible, to develop a substantial "retail" deposit base and usually concede this market to the native banks, with their widespread domestic branch networks. As a consequence, local currencies for relending must often be acquired in interbank markets; nonetheless, U.S. branches have the reputation, at least in Paris and London, of matching or undercutting the going local-currency lending rates. Finally, because U.S. banks do not have extensive branch networks within foreign countries, they are not well equipped to process local collections, handle local payrolls, and so on.

These generalizations based on interviews can be supplemented, and to some extent tested, by data on the foreign (including "offshore") market shares and the foreign clientele of the branches of U.S. banks abroad. To begin with, Table 12 presents market share data showing the assets of

Table 12

Total Assets of Foreign Branches of U.S. Banks as a Percent of
Total Assets of All Deposit Money Banks, for Selected Countries, 1970-76

End of Year

Country	1970	1971	1972	1973	1974	1975	1976
Bahama Islands	96.9	98.4	97.5	96.4	98.4	98.3	98.2
Panama	(D)	(D)	(D)	49.5	44.0	(D)	N.A.
Singapore	(D)	22.1	25.2	31.7	37.1	38.8	N.A.
United Kingdom	35.1	33.3	31.5	35.6	33.8	34.4	35.1
Hong Kong	N.A.	6.1	9.0	12.1	(D)	(D)	N.A.
Belgium	(D)	(D)	8.9	9.3	11.3	11.7	10.7
France	4.7	4.1	4.0	4.8	4.8	4.5	5.7
China	N.A.	1.4	1.9	1.4	2.8	3.8	N.A.
Indonesia	(D)	(D)	(D)	(D)	(D)	(D)	4.4
The Netherlands	(D)	3.2	3.8	3.1	3.7	(D)	2.9
Japan	1.7	1.5	1.5	1.6	2.5	2.5	2.3
Luxembourg	N.A.	N.A.	N.A.	12.0	(D)	3.3	(D)
Ireland	N.A.	(D)	(D)	7.1	(D)	(D)	N.A.
Italy	(D)	(D)	(D)	1.4	1.4	1.1	N.A.

(D): Withheld to avoid disclosure of information about the operations of a single branch.

N.A.: Not Available.

Note: For some countries the underlying data on assets of deposit money banks may be inadequate. In particular, these assets may well be significantly underreported for the Bahamas and Singapore, and perhaps also for Japan.

Source: U.S. Board of Governors of the Federal Reserve System, unpublished machine runs; and staff of International Monetary Fund.

U.S. branches as a percent of total assets of all deposit money banks (including the U.S. branches), for the countries for which such data are available and can be disclosed. These figures vary in precision from country to country and should be interpreted as nothing more than rough orders of magnitude; in particular, the underlying data on assets of deposit money banks may well be significantly underreported for Singapore and the Bahamas.

According to these data, the share of U.S. branches in total deposit money bank assets approaches the upper limit in the Bahamas, where shell branches have proliferated for reasons already discussed; again, shell growth should be recognized for what it is. Other countries in which the branches of U.S. banks account for more than a third of the reported assets of deposit money banks in recent years are Panama, Singapore, and the United Kingdom. Significant growth in the branches' share of the market seems to have been taking place in Hong Kong and Singapore, but there are a number of countries, such as Italy and Luxembourg, where U.S. branches either have been unable to make any headway or have experienced a decline in their share of the market.

If, as argued in the preceding section, the *level* of branch assets in a country is a function of the U.S. direct investment position, then the market *share* of the branches in a country may well be a function of the share of U.S. affiliates in total economic activity, other things being equal. This share of the foreign affiliates of U.S. firms can be represented by the ratio of their sales to GNP. In addition, on the basis of the logic underlying the regression analysis in the preceding section, it seems reasonable to test the hypotheses that the market share of the branches will be positively related to "openness," that is, to the share of foreign trade in total economic activity, and negatively related to the rate of return on branch assets.

The regression results are reported in Table 13, where S is sales by foreign affiliates of U.S. firms as a percent of GNP, R is as defined in the preceding section, and O is half the sum of exports and imports, as a percent of GNP. According to these results, the share of U.S. affiliates in GNP does seem to exert a positive influence on the market share held by the branches of U.S. banks, but no influence is revealed for openness or for the rate of return.

It is also possible to marshal some statistical evidence on the proportion of the branches' business (assets and liabilities in this case) that is placed with foreign addressees, although these data must be suppressed for many countries in order to avoid disclosing information about the operations of a single branch. In Table 14 the ratio $(C_F + L_F)/(C_T + L_T)$ indicates the share of branch claims and liabilities that are due from or due to foreign addressees (including the foreign affiliates of U.S. nonbanking firms, which are not distinguished from other foreign addressees in the data); this ratio and the other ratios shown are fully defined at the bottom of the table. For the year 1976 this particular ratio varies between 0.41 for Bahrain and 0.87 for Indonesia. Over the period 1970-71 to 1975-76 there is an appreciable rise in this ratio in a number of countries, as

Table 13

Regression Equations for Branch Total Assets as a Percent of Assets of All Deposit Money Banks, 1974-75

Year	Number of countries	$\bar{R}^2$	Coefficients of explanatory variables and t-ratios			
			S	R	O	Intercept
1974	8[a]	0.6211	0.6518 (3.17)	-27.504 (-1.26)	-0.4338 (-1.29)	24.352 (1.53)
1975	7[b]	0.6378	0.8396 (2.57)	-16.587 (-0.85)	-0.4530 (-1.30)	19.024 (1.32)

[a]The eight countries are: Belgium and Luxembourg, France, Ireland, Italy, Japan, The Netherlands, Panama and United Kingdom.

[b]The seven countries are: Belgium and Luxembourg, France, Ireland, Japan, The Netherlands, Panama and United Kingdom.

Note: The definitions and sources of data for the variables are as follows:

Branch total assets: In millions of dollars for end of year; from Board of Governors of the Federal Reserve System, unpublished machine run.
Assets of deposit money banks: In millions of dollars for end of year; from staff, International Monetary Fund.
S: Sales of majority owned foreign affiliates of U. S. companies as a percent of gross national product at market prices. Sales data are from *Survey of Current Business,* May 1976, p. 31, and February 1977, p. 36. GNP data are from *World Bank Atlas,* 1976.
R: See definitions and source notes to Table 11.
O: Openness, or half the sum of exports and imports (national accounts basis) as a percent of gross national product at market prices; from *International Financial Statistics,* June 1977.

Table 14

Foreign Branches of U.S. Banks: Proportion of Business Done with Foreign Addressees, Selected Measures

	$\frac{C_F}{C_T}$ (1)	$\frac{L_F}{L_T}$ (2)	Lower of (1) or (2) (3)	$\frac{C_F + L_F}{C_T + L_T}$ (4)	$\frac{C_{FB} + L_{FB}}{C_T + L_T}$ (5)	$\frac{C_{FN} + L_{FN}}{C_T + L_T}$ (6)
Bahamas						
1970	0.56	0.85	0.56	0.71	0.48	0.21
1971	0.76	0.71	0.71	0.73	0.43	0.27
1975	0.78	0.54	0.54	0.66	0.37	0.21
1976	0.78	0.46	0.46	0.62	0.35	0.19
Bahrain						
1975	0.43	0.09	0.09	0.26	0.04	0.21
1976	0.49	0.34	0.34	0.41	0.16	0.25
Belgium						
1975	0.68	0.77	0.68	0.73	0.54	0.16
1976	0.75	0.83	0.75	0.79	0.53	0.21
Cayman Islands						
1975	0.88	0.53	0.53	0.70	0.43	0.22
1976	0.86	0.43	0.43	0.65	0.37	0.21
France						
1970	0.43	0.89	0.43	0.66	0.45	0.17
1971	0.62	0.84	0.62	0.73	0.48	0.21
1975	0.74	0.82	0.74	0.78	0.52	0.21
1976	0.70	0.82	0.70	0.76	0.50	0.19
Germany						
1970	0.50	0.56	0.50	0.53	0.39	0.11
1971	0.49	0.51	0.49	0.50	0.37	0.09
1975	0.69	0.67	0.67	0.68	0.49	0.18
1976	0.65	0.63	0.63	0.64	0.46	0.16
Hong Kong						
1976	0.89	0.18	0.18	0.54	0.10	0.39
Indonesia						
1976	0.76	0.99	0.76	0.87	0.10	0.67
Italy						
1975	0.67	0.75	0.67	0.71	0.41	0.25
1976	0.67	0.74	0.67	0.71	0.37	0.27
Japan						
1970	0.74	0.43	0.43	0.60	0.18	0.30
1971	0.75	0.41	0.41	0.60	0.18	0.33
1975	0.86	0.33	0.33	0.61	0.18	0.39
1976	0.88	0.32	0.32	0.61	0.15	0.43
Luxembourg						
1975	0.68	0.71	0.68	0.69	0.54	0.11

(continued on next page)

Table 14 (continued)

Foreign Branches of U.S. Banks: Proportion of Business Done with Foreign Addressees, Selected Measures

	$\frac{C_F}{C_T}$ (1)	$\frac{L_F}{L_T}$ (2)	Lower of (1) or (2) (3)	$\frac{C_F + L_F}{C_T + L_T}$ (4)	$\frac{C_{FB} + L_{FB}}{C_T + L_T}$ (5)	$\frac{C_{FN} + L_{FN}}{C_T + L_T}$ (6)
The Netherlands						
1971	0.64	0.75	0.64	0.69	0.46	0.20
1976	0.61	0.69	0.61	0.65	0.34	0.27
Panama						
1976	0.88	0.53	0.53	0.70	0.29	0.33
Singapore						
1971	0.51	0.64	0.51	0.58	0.23	0.33
1975	0.58	0.77	0.58	0.68	0.47	0.18
1976	0.53	0.73	0.53	0.63	0.44	0.14
Switzerland						
1971	0.42	0.55	0.42	0.48	0.22	0.25
1975	0.86	0.69	0.69	0.78	0.39	0.33
1976	0.86	0.71	0.71	0.79	0.39	0.34
Taiwan						
1976	0.91	0.61	0.61	0.76	0.20	0.54
United Kingdom						
1970	0.53	0.87	0.53	0.70	0.48	0.18
1971	0.72	0.85	0.72	0.78	0.50	0.21
1975	0.75	0.84	0.75	0.80	0.47	0.20
1976	0.72	0.83	0.72	0.77	0.47	0.19
Median, All Countries*						
1970	0.60	0.63	0.48	0.59	0.28	0.24
1971	0.72	0.64	0.51	0.60	0.24	0.25
1975	0.76	0.68	0.54	0.68	0.34	0.30
1976	0.78	0.62	0.53	0.66	0.32	0.27

*Includes the following countries, which are not shown individually in order to avoid disclosing information about the operations of a single branch:

1970; Austria, Belguim, Greece, Hong Kong, Italy, The Netherlands, Panama, Singapore, Switzerland;

1971: Austria, Belguim, Greece, Hong Kong, Ireland, Italy, Panama;

1975: Austria, Brazil, Dubai, Greece, Hong Kong, Indonesia, Ireland, Korea, Malaysia, The Netherlands, Panama, Philippines, Romania, Taiwan;

1976: Austria, Brazil, Dubai, Greece, Ireland, Korea, Luxembourg, Malaysia, Philippines, Romania

Note: Branch claims on and liabilities to other foreign branches of the same parent are not included in C_F or L_F, because these branches are really an extension of the U.S. parent.

$C_F \equiv$ branch claims on identifiable foreign addressees.

$C_T \equiv$ total branch claims for which U.S. or foreign addressee is given.

$L_F \equiv$ branch liabilities to identifiable foreign addressees.

$L_T \equiv$ total branch liabilities for which U.S. or foreign addressee is given.

$C_{FB} \equiv$ branch claims on banks with foreign addresses (excluding official institutions).

$C_{FN} \equiv$ branch claims on nonbanks with foreign addresses (excluding official institutions).

$L_{FB} \equiv$ branch liabilities to banks with foreign addresses (excluding official institutions).

$L_{FN} \equiv$ branch liabilities to nonbanks with foreign addresses (excluding official institutions).

Source: Board of Governors of the Federal Reserve System, unpublished machine runs.

well as a rise in the median for all countries (shown at the bottom of the table), but the rise is not universal. In other words, there has been a tendency for foreign business to comprise a larger share of the branches' business over time, but experience differs from country to country.

Similar conclusions may be drawn about the proportions of branch business accounted for by private banks with foreign addresses (column 5) and by nonbanks with foreign addresses (column 6).[30] There is a rise in the median for both of these proportions over the period 1970-71 to 1975-76; but some countries display decreases, and there is considerable variation in each proportion from country to country. In addition, the share of business with foreign nonbanks is generally higher for branches in less developed countries than for branches elsewhere, for reasons that seem obvious.

The foregoing ratios are indicative of how much of the branches' business is with foreign residents, but they do not indicate how much of the branches' activity consists of intermediating *between* foreign residents. To illustrate, $(C_F + L_F)/(C_T + L_T)$ could assume the value of 0.5 even if C_F or L_F were zero, but if L_F, say, were zero, the branches would be deriving all of the funds that they loaned to foreigners from the United States; and in this case the branches would be engaged in absolutely no intermediation between foreigners, even though half of their business was with them. For the share of branch business involving intermediation between foreigners, we must seek another measure.

The *smaller* of C_F/C_T and L_F/L_T is such a measure. If for a certain country one of these ratios were zero, there would be no intermediation between foreigners, even if the other ratio were as high as one in value. On the other hand, if both ratios assumed the value of one, all intermediation undertaken by the branches would be between foreign addressees. Very low values for both ratios would indicate that foreign branches were engaged primarily in intermediation between U.S. addressees, and such a phenomenon would probably be attributable to some market imperfection or interference such as government controls.

There is substantial variation in this measure from country to country, as shown in column 3 of the table; in 1976, this index ranged from 0.18 in Hong Kong to 0.76 in Indonesia. If the index rose appreciably over time in the great majority of countries, we might conclude that there was a strong tendency for U.S. branches to become more competitive in and dependent upon the business of intermediating between foreigners as the branches gained experience in foreign countries. Such a strong conclusion is not warranted by the behavior of the index, although it does rise more often than it declines. It should be noted that the failure of the index to rise is not confined to countries with exceptionally high index values.

[30]A compelling theoretical explanation for the high volume of interbank business is offered by J. Dean and H. Grubel in their "Regulatory Issues and the Theory of Multinational Banking" (Simon Fraser University, Department of Economics and Commerce: Discussion Paper 77-13-1), pp. 8-9.

In sum, the ratios in Table 14 offer little support for sweeping generalizations about changes in the competitive position of the branches or about changes in the share of their business that is with foreigners. It is clear that there have been more rises than declines, by country, in the share of branch business that is with foreigners and in the share of branch business that involves intermediation between foreigners. However, there is considerable variation from country to country.

Of course, it should be recognized that these ratios, being derived from aggregate data, may fail to depict the experience of the typical branch over time. For example, if every branch did a larger share of its business with foreigners (up to a certain limit) as the years went by, and if new branches were continually being established, the aggregate data might understate the trend toward a larger share of foreign business that the typical branch was experiencing. The reader should also bear in mind, when examining the data in Table 14, that branch activity is influenced by government interventions as well as by market forces.

Conclusion

For at least the past decade the foreign operations of U.S. banks have been growing much more rapidly than their domestic operations. This remarkable foreign expansion may have raised the overall rate of return earned by U.S. banks in recent years, but we have not been able to show that the rate of return for an individual bank is rendered more stable by such foreign involvement. Statistical support was discovered for the strong consensus that U.S. bankers go abroad largely to serve U.S. nonbanking firms abroad, although some of the data suggest that business with foreign natives has become relatively more important in a number of countries with the passage of time.

Discussion

George E. Phalen*

Whether it be the Federal regulatory authorities, Congress, security analysts, or bank stockholders, there is little doubt that they all conclude commercial banks in the United States have expanded rapidly overseas. In this paper, Tables 1 to 3 show dramatically the expansion in both assets and profitability.

In this section of the survey, there is reference to the growth being slower in later years, specifically 73-76. I think we should recognize in terms of percentage of increase in assets that in the earlier years we were starting from a much lower base. Thus, the percentage of slower growth in later years may be a little misleading.

It was also noted that there was less asset growth in subsidiaries than in the branches of U.S. banks abroad. One factor which could significantly affect comparability of total assets is the fact that subsidiaries tend to concentrate on commercial activities (leasing, consumer credit) whereas branches are engaged in Eurocurrency or money-market transactions.

Before my focusing on the four questions set forth in the report, I have recently read Ray Vernon's new book, *Storm Over Multinationals.* Ray is presently serving as Director of the Center for International Affairs at Harvard. He states, "If scientists and engineers had not found a way to shrink space, the odds are high that multinationals would be a rarity today. The telephone, the computer, the aircraft have been indispensable to their growth." Without these technological advances, I doubt that we would be focusing on this subject today.

In view of the limited time and interest in having more general discussions on this paper, let me comment briefly on each question.

1. *How Profitable for the U.S. Banks Has Their Foreign Business Been?*

Norm Fieleke gives us great credit as profit maximizers; presumably we could see higher rates of return overseas as compared to employing our assets domestically. I am not sure that many of the international banks in this country had the elaborate strategic planning groups that developed models in those years that gave them the answer "go" or "no go." I am inclined to think that the incremental profit factor was of paramount importance in some of the decisions that were being made.

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One must keep in mind that what really motivates top management decisions in allocating funds in domestic versus international outlets is preservation and improvement of the rate of return on shareholders' equity, what Fieleke calls the "true bottom line." It is generally agreed that during the past three years of declining or flat domestic loan demand the major U.S. banks preserved their return on equity by a rapid increase in international earnings. I do not think we have reliable data, especially on foreign assets, to make a firm conclusion that the return on foreign assets is greater than domestic assets. All we can say is that based on step-by-step management experience and given limited domestic opportunities in the past few years the net income on an extra dollar of assets placed abroad has seeemed higher.

This study in measuring profitability is one that a number of us have tackled with extreme difficulty. Norm refers to loan losses being charged all to domestic, but I don't believe that this is the case in all of the banks engaged in international activities. The question of allocation of capital and capital costs to the international sector is far from uniform by the banking industry. Head office or home office charges that are allocated to international performance I believe vary from institution to institution. Thus, to attempt at this stage to measure accurately the return on capital or the return on assets is most difficult and could be misleading. I again would like to emphasize the incremental profit factor as being of prime importance.

2. *Has It Increased or Reduced the Riskiness of the Banks' Operations*?

Diversification generally is considered to reduce risk. However, in this study it is stated that the limited data do not support the view that foreign diversification reduces risk. I think it is difficult to generalize in answering this question as in some cases diversification has permitted the riding of the economic cycle throughout the world to provide a steadier growth of international earnings for some of the larger institutions. Obviously, if you are covering the world you should be able to take advantage in countries having tremendous growth while others may be at the lower end of the spectrum. However, in some international expansion this has not been the case. The rush to London has not proven to be the right answer for all banks.

It may or may not have stabilized risk but as I again repeat the overseas earnings picture of the major commercial banks helped cushion the enormous domestic loan losses of the last few years. While discussing this particular point, I do think we must not be lulled by the history of low or almost no chargeoffs in the international loan portfolio. Not that I forecast any radical change in these past averages. However, I think most of us will recognize that there will be more loan losses in the international arena and the percentage will not be the fantastically low figure of yesteryear. We have exported the philosophy of Chapter XI, and the private sector lending on an international basis will see more compromises and settlements in the future.

3. There are two parts to question 3. First:

How Can U.S. Banks Compete against Foreign Banks on the Latters' Home Territory?

I fully agree with the views expressed in the paper that in interviews with multinational financial personnel U.S. bank personnel abroad have been most innovative. In the complicated area of multicurrency loans, pricing and financial services, we will continue to lead, but the length of that lead may narrow. An example of the creative type of service that may be offered by U.S. bank personnel is the First National Bank of Boston's experience with the introduction and promoting of export schools in both Argentina and Brazil. Our personnel conducted classes for Argentine businessmen who were interested in knowing more about the complexities of export financing, and this program was so popular that we introduced this feature to other of our Latin American branches.

As for domestic activity within the country, I would argue that the days of full-service branches overseas increasing are numbered. This is not because of a lower return on overseas assets but rather because there will be growing political and legal barriers to the creation of wholly owned subsidiaries and branches of U.S. banks in the host countries. In the increasingly nationalistic "Third World," local commercial banking is part of the visible "high ground" like utilities, railroads, ports, and mining. Foreign ownership of these sectors will not be politically tolerated.

In short, I don't think we are going to be encouraged to compete strongly with the local banks for domestic business. Second:

What Kind of Business with Foreigners Do U.S. Banks Undertake?

I found the data presented in Norm's paper difficult to follow in determining any conclusions, and frankly I was pleased that he concluded that statistics are inconclusive.

I repeat that the business with foreign addresses is closely impacted by the country both as to its banking regulations and the competitiveness of the commercial banking system within the country.

4. *Why Are U.S. Banks Concentrated So Much More Heavily in Some Countries than Others?*

As shown in the study, U.S. banks follow their customers. Some 60 years ago, the First National Bank of Boston was encouraged by its local wool clients to go to Argentina. This was also repeated by our entrance into Cuba following the sugar interests that we financed in the Boston area.

Another reason in the past ten years was stated by Bob Wilmouth of the Crocker and I quote, "If we are candid we will recognize that many of those new offices, affiliates and branches were added not because there

was a proven market awaiting our talents nor because they were a logical extension of the bank's domestic activities, but rather for purposes of prestige or in the hope of being in the right place at the right time to cash in on the boom."

In conclusion, Norman Fieleke's paper is an excellent attempt to gain an overview of the factors behind rapid expansion by U.S. banks abroad. Our impression and economic reasoning suggest that the return on international activities with the possible exception of the major European countries should continue to be higher than the return on domestic activity. Further expansion of a physical presence overseas, however, may be limited by nationalistic pressures. The current condition of the data does not permit an empirical conclusion as to whether the return on international business is significantly greater than that on domestic activity. Although banks are already inundated with reporting requirements, it would be mutually beneficial for the Federal Reserve and the Comptroller's office to work with the banks to establish uniform standards for allocating income, assets, and funds between domestic and international activity.

Discussion

Robert Z. Aliber*

We are indebted to Norman Fieleke for a comprehensive analytical survey of the issues arising from the very rapid expansion of the branches of U.S. banks in other countries. The rapidity of the expansion is phenomenal — in a decade, the number of U.S. banks with foreign branches increased by a factor of ten, while their assets increased by a factor of 25. Over the same period, the assets of U.S. nonbank firms abroad increased from $60 billion to $150 billion.

The major conclusions in the Fieleke paper are first summarized and then evaluated. The first few pages of the paper review the measures of expansion of U.S. banking establishments abroad. The data indicate that "in every year since foreign branch asset data became available the percentage increase in assets for branches has been at least double that for domestic offices and often four or five times as great."

The profitability of the foreign branches of U.S. banks is discussed, in the form of rates of return on assets; this issue is especially important because five or six large U.S. banks report more than 50 percent of their earnings from their international activities. Fieleke notes a weak, non-statistically significant tendency for banks with higher international involvement to earn higher overall rates of return. That the results are not stronger is surprising, for foreign assets are smaller than domestic assets, and foreign earnings exceed domestic earnings, then the return on foreign assets should exceed the return on domestic assets. One problem in obtaining meaningful rates of return on the components of an integrated international enterprise, as Fieleke notes, involves allocation of costs among units in different legal or tax jurisdictions. With major international banks, loan losses must be allocated between the home office and branches, the parents must be reimbursed for their investments in branches, and overhead costs appropriately allocated. Fieleke concludes "that the rate of return earned by foreign branches compares favorably with that earned by all U.S. insured banks if allowance is made for the cost of equity capital."

In equilibrium, the rates of return should either be the same, or somewhat higher abroad if the foreign activities are deemed riskier. There are, however, sharp fluctuations in rates of return on foreign branches from year to year, although Fieleke observes that the rates of return have been

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relatively high in Japan, Panama, and Switzerland, and relatively low in France and the United Kingdom. This distinction about variability of earnings and level of earnings is less surprising than it seems and reflects the two very different activities of the foreign branches of U.S. banks in various centers, as well, perhaps, as differences in tax rates.

Fieleke asks whether extension of bank activities into foreign markets has reduced the variability in the income of the banks — has international diversification led to greater stability in the profit rate? Because of data limitations, the question asked is whether the rate of return becomes more stable as the ratio of foreign to total assets increases. Fieleke examines a cross-section of banks at particular intervals rather than the experience of individual banks over time; he concludes that the variability of the rate of return to the total return rises with increases in the ratio of foreign to total assets. No story is suggested to connect international involvement and variations in the earnings stream.

Fieleke considers some hypotheses for the rapid growth of foreign branch activity; he follows the arguments about the theories of direct foreign investment generally applied to nonbank firms. The critical question involves the advantage that U.S. firms and banks have in competing against foreign firms and foreign banks on their home turf. One answer is that U.S. banks have a comparative advantage in servicing the banking requirements of U.S. firms, especially in effecting international loans and international transfers of funds and in foreign exchange transactions. The implication is that the pattern of concentration of U.S. banks abroad should more or less parallel the pattern of concentration of investment of U.S. firms abroad, on the assumption that entry into various foreign countries for banks is as unconstrained as it is for nonbanks — an assumption tested by the Canadian, Mexican, and Japanese experiences. Fieleke concludes that the U.S. firm's foreign investment has a positive influence on total bank assets, on bank business with foreign nonbanks, and on branch net income.

The last section of the paper examines the share of the foreign market captured by the foreign branches of U.S. banks. Interviews suggest the typical pattern is that U.S. banks first service U.S. firms abroad, then foreign multinationals, then nonmultinationals. He finds that market shares of U.S. banks in foreign banking markets vary across countries, and are as high as 98 percent in the Bahamas, 50 percent in Panama, 40 percent in Singapore, and 35 percent in the United Kingdom.

Comments on the Fieleke Study

The questions in the Fieleke paper are central. The answers, however, might be more useful if the data on the growth and expansion of the foreign branches and their assets were decomposed to reflect the two very different types of banking activities that the branches engage in.

One business, the traditional foreign banking activity, involves participation in host-country banking activities in competition with host-country

banks, selling deposits and buying loans in the currencies of the host countries. This business was the principal activity of the foreign branches of U.S. banks prior to 1960, and it is still the major activity of most branches of U.S. banks abroad. But only a relatively small proportion of the 125 U.S. banks with offices abroad set up these offices to engage in foreign banking business.

The second business, and the reason most U.S. banks have established foreign branches, involves participation in offshore banking, primarily but not exclusively in dollars. The growth of the offshore banking business accounts for the sharp growth in the number of U.S. banks with overseas branches in the 1960s and much of the sharp increase in the assets of U.S. branches abroad. Without offshore banking activities, there probably would be no more than one or two U.S. banks with branches in the Bahamas and Panama, and none with branches in Luxembourg or the Cayman Islands. At the end of 1976 the branches of U.S. banks in the Bahamas and Cayman Islands totalled 129, and their assets totalled $67 billion; at the same time, the 56 branches in the United Kingdom held $82 billion of assets. One-fourth of all foreign branches of U.S. banks abroad are in the United Kingdom and the Caribbean, and these branches account for two-thirds of the assets of all branches. The average branch of a U.S. bank in the United Kingdom and the Bahamas and the Caymans has assets six times as large as the average branch elsewhere. Most of the 50 plus U.S. banks with branches in London are there to participate primarily in the offshore money market, and especially the offshore market in dollars; indeed relatively few of these banks — probably no more than 10 or 12 — have made a dent in the sterling credit market.

The assets of foreign branches of U.S. banks can be allocated between these two activities in a two-step procedure. At the end of 1975, $132 billion of the $176 billion of U.S. banks abroad involved dollar-denominated assets; at the end of 1976, about $170 billion of the $220 billion of the foreign assets involved dollar assets. At the end of 1965, the Bank for International Settlements reported Euro-dollar assets of $15 billion, perhaps half of which represented the liabilities of foreign branches of U.S. banks. Over the last decade, the dollar liabilities of foreign branches of U.S. banks have increased from $5 or $6 billion to $170 billion, while their nondollar business has increased from $4 or $5 billion to $55 billion. Part of the nondollar business represents participation in the offshore markets for other currencies; perhaps 40 percent of the nondollar business is offshore, involving marks, Swiss francs, and other assets and 60 percent domestic foreign. The liabilities in the offshore market, primarily dollars but a few other currencies, have grown about five times as rapidly as the liabilities of foreign branches denominated in the currencies of the countries in which they are located.

This distinction between the two types of activities of foreign branches is important, for the offshore banking business is much more competitive; the foreign banking business involves participation in a cartel, frequently at deposit-loan markups higher than those in the United States. In contrast, the markups in the offshore markets are more highly variable over the monetary cycle.

The questions asked by Fieleke about the profitability of the foreign branches of U.S. banks, and their contribution to the stability of the earnings of U.S. banks, can be asked about each of their principal activities — about their offshore banking business and their foreign banking business. Numerous explanations have been given for the growth of the offshore market; the most comprehensive involves the differential regulation, and the less severe regulation on offshore transactions than on domestic transactions. The U.S. banks set up offshore offices to circumvent domestic regulation, especially the interest rate ceilings and reserve requirements. U.S. banks were pushed abroad by U.S. exchange controls, including the Interest Equalization Tax of 1963, the Voluntary Credit Restraint Program of 1965, and the Mandatory Balance of Payments Program of 1969. Initially the very largest U.S. banks set up offshore branches — in effect, the branches previously established in London to do a sterling business began to do an offshore business to enhance their share of the total dollar-denominated deposit market. Subsequently, other U.S. banks established foreign branches to avoid or minimize the reduction in their share of the aggregate dollar market to the banks already in London. The growth of the offshore dollar market developed its own momentum, with many banks setting up branches for the defensive reason to avoid or minimize loss of market share. New entrants attracted customers in the way that new entrants always do — they cut prices or raise interest rates. The spurts in the growth of assets of the foreign branches engaged in offshore banking are traceable to domestic events — more severe exchange controls on capital outflow and more restrictive monetary policies.

Data are not available to determine whether profits on offshore banking have been sufficiently high to reflect the greater risk. The ideal comparison is between the returns on the marginal unit of capital allocated to the offshore banking activity with that allocated to the domestic banking activities. In general the capital-deposit ratios and the capital-asset ratios of offices established to do an offshore banking business are lower than on domestic activities. So the return on assets of these foreign branches could be lower than on domestic activities, and, at the same time, the return on capital could be higher.

The offshore banking market is more competitive than the regulated domestic markets. Interest rates are more volatile than are comparable interest rates in domestic money markets; during periods of tight money, offshore dollar deposit rates have exceeded domestic dollar deposit rates by 3 percentage points. Moreover, interest rate spreads in the offshore markets are more volatile than those in the regulated domestic markets. Consequently, the income of offshore branches is almost certain to be more volatile than the income of the domestic offices. Moreover, the phasing of variations in income will be similar. Hence, the cyclical variability in income of offshore branches may increase the amplitude of cyclical variability of the income from domestic banking activities.

The geographic distribution of branches engaged in offshore banking is explainable in terms of several factors — the extent to which particular

centers are monetary havens, and the extent to which these centers are tax havens. Rates of return in Panama and Switzerland are high because they are tax havens; rates of return in France and Britain are low because they are not. Banks take deposits in London, and then transfer funds, at an attractive transfer price, to their offices in Panama, which arrange the loans to nonbank borrowers.

The assets of branches of U.S. banks abroad involved in foreign banking business increased from $5 billion at the end of 1965 and to $35 billion at the end of 1976 — or much more rapidly than the growth in the foreign investments of U.S. banks. Despite the rapid growth, these branches have a small share of the deposit and credit markets of the countries in which they are involved. Three U.S. banks — First National City Bank, Bank of America, and Chase Manhattan — had 60 percent of the branches of U.S. banks abroad, and probably 80 percent of the branches set up to do foreign banking. The first one or two U.S. banks to go abroad did so to increase market share; they hoped to serve their domestic customers abroad, and they also wanted to serve the clients of other U.S. banks, and then use the toehold gained in the foreign business of these firms to increase their own share of the U.S. business of these firms. Subsequently, other U.S. banks went abroad for the defensive reason to limit the size of the toehold. Yet foreign markets were not large enough for a replication of the oligopolistic pattern of U.S. banking; even if U.S. bankers were eager to set up more branches in each country, the foreign regulatory authorities were not. Entry was frequently restricted, in some cases absolutely; in others, by a reciprocity formula which matched the number of branch offices of U.S. banks with the number of branch offices that their own banks set up in the United States. The first banks to land on the checkerboard spaces abroad frequently preempted much of the space.

Profit data on foreign domestic banking of U.S. branches are not available. Banking in some markets appears highly profitable, largely because banks are dealing at rates set by a cartel. In general, the rate spreads abroad are higher than in the United States. Moreover, the spread between the prime rate and transfer price — a proxy for the rate at which banks buy funds from others — is higher. So it would be expected that profits would be higher if branches are large.

Casual empiricism suggests a strong relationship between the size of U.S. foreign investment and U.S. foreign trade, and the geographic distribution of the foreign branches of U.S. banks established to deal in the currency of the host country. The relationship would appear weakened for two reasons. Some countries — Canada, Mexico, and Australia, and the Scandinavian countries — have forestalled the expansion of foreign banks into their jurisdiction; others have restricted the number of banks that can set up branches. And branches have been established in a number of countries, not necessarily because the countries are important in U.S. trade and investment, but because the big banks have wanted to complete their foreign banking systems.

The rapid growth of both the offshore banking business and the foreign banking business of U.S. banks in the last decade leads to the question of whether rates of growth are likely to be similar in the next decade. Some of the factors to the growth of offshore banks in recent years, such as exchange controls and peculiar interest ceilings, appear not likely to be repeated. In absolute terms the offshore market will grow, but its growth is likely to diminish relative to the growth of the domestic market. Moreover, the growth of the foreign branch banking systems seems likely to slow, since entry is increasingly difficult, and since the foreign investment of U.S. firms will grow less rapidly. Nevertheless, the deposits and credits may continue to grow at a rapid rate as U.S. banks seek to increase their market share at the expense of host country competitors.

Response

Norman S. Fieleke*

George Phalen no doubt is correct in his belief that not all banks charge all loan losses of their foreign branches to the parent corporation, but it is our understanding that the bulk of branch loan losses are allocated to parents, in the aggregate. We heartily agree with his recommendation for uniform reporting standards.

Robert Aliber's central point is that the "distinction between the two types of activities of foreign branches is important, for the offshore banking business is much more competitive; the foreign banking business involves participation in a cartel. . ." (p. 47). By "foreign" banking Aliber means accepting deposits and making loans in the currency of the host country, while "offshore" banking is accepting deposits and making loans in currencies other than those of the country in which the branch is located.

For some purposes this is a useful distinction. Nonetheless, we may still want to know, as a measure of market position, what is the share of U.S. branches in the total market supply — regardless of currency denomination — that is provided by the banks within a country. Thus, to say that U.S. branches in the United Kingdom account for 35 percent of the total assets of all deposit money banks there is to convey some idea of the share of the U.S. branches in the total activity of deposit money banks in that great financial center. For further analysis, one can then proceed to break this aggregate market down into a host of submarkets classified according to one's particular interest: the markets represented by various customer groups (individuals, nonbank firms, other banks, etc.); the markets for various banking services (loans in various currencies, deposits in various currencies, foreign-exchange trading, processing of collections, etc.); or the markets for various geographic subdivisions (London, Paris, etc.).

Such market classification schemes are not mutually exclusive, and the nature and impact of competition can be analyzed in terms of any or all of them. In the last two major sections of our paper the primary focus was on the submarkets represented by various customer groups. This focus did not inhibit our recognition of barriers to competition (pp. 26, 28, 30), which Aliber considers so important; it does not seem necessary

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to divide banking markets into "offshore" and "foreign" in order to discern the existence and impact of these barriers.[1]

The more general point to be made in this connection is that the choice of market classification scheme is less important than the method of measuring competition. Measures are available which recognize that there are differing *degrees* of competition within various "offshore," "foreign," and other submarkets, as well as within aggregate country markets, however defined. One such measure, employed in our study as fully as the data would permit, is the rate of profit (p. 30).[2]

Nor is it clear that the distinction between foreign (local currency) and offshore (primarily dollar) business leads to special insight into the variability of the rate of profit. Greater insight into this question is probably to be gained by focusing initially on the kinds of customer groups the banks deal with than by focusing initially on the currency denominations of the transactions. To illustrate, if the foreign branches of U.S. banks deal with the same multinational customers abroad that their parent banks deal with at home, the foreign branches might contribute relatively little to the diversification of the overall portfolio. Unfortunately, detailed data on classes of customers were not available to us.

Aside from the matter of offshore banking, we question whether the rate of taxation in Switzerland fully accounts for the high rate of return reported by U.S. branches there; profitability may be high at least partly because of limitations on competition.[3] It is interesting that the virtually zero tax rate in the Bahamas has not typically been accompanied by a high rate of return on assets there.

To avert confusion, two clarifications of points raised by Aliber are in order. First, the assumption that entry into various foreign countries is as unconstrained for U.S. banks as for other U.S. firms should not have been attributed to us. In fact we state that "U.S. banks will concentrate their foreign operations in those areas where U.S. nonbanking firms are concentrated, *other things being equal*" (p. 28, emphasis added). Among those "other things" are barriers to entry, which are taken into account in

[1]It should also be remembered that the "offshore" business in some countries where U.S. branches are excluded (e.g., Canada, Sweden, and Norway) may be *less* competitive than the "foreign" business in certain other countries (perhaps the United Kingdom, for example).

[2]There is room for argument, of course, as to how the rate of profit should be defined. It would probably be agreed that it should encompass native banks within a country; because of data limitations, however, we were obliged to use the rate of return earned by U.S. branches (on their assets). It is arguable, however, that we should have measured this rate over a period longer than a year.

[3]See U.S., Congress, House, Committee on Banking, Currency and Housing, *Financial Institutions and the Nation's Economy*, 94th Cong., 2d sess., 1976, Book II, p. 1013.

the analysis (pp. 26, 30). Second, our analysis actually asks whether the rate of return earned by large U.S. banks becomes more stable as the ratio of international to total earnings increases, not, as Aliber puts it, whether the rate of return becomes more stable as the ratio of foreign to total assets increases, although we wish that the data had allowed us to address the question as put by Aliber.

We wish to stress our agreement with Aliber's assertion that U.S. regulations, including balance-of-payments controls, operated to stimulate the growth of foreign branches of U.S. banks; our paper did recognize this stimulus (pp. 10-11), although there did not seem to be any compelling reason to accord these regulations a strong role in explaining the *distribution* of foreign branch assets among various countries, once the total amount of assets was given. In addition, Aliber's contention that local currency business abroad is relatively profitable for U.S. branches agrees with our information as far as dealings with business firms are concerned, but the retail business may be another matter (p. 33).

The Growth of Foreign Banking in the United States: An Analytical Survey

Henry S. Terrell* and Sydney J. Key**

I. *Introduction*

One of the most significant recent developments in both international banking, and the structure of banking within the United States, has been the rapid growth in the activities of foreign banks in the United States. This growth has resulted from an expansion of the activities of banks with existing U.S. operations as well as *de novo* entry into the U.S. market by additional foreign banks. The U.S. offices of foreign banks currently offer a broad range of banking services to both foreign and domestic customers, and their increasing importance in U.S. markets has resulted in various legislative proposals to establish a uniform Federal policy concerning their activities.

To understand this growth it is necessary to understand the motives and the business orientation of the nearly 100 foreign banks operating banking facilities in the United States.[1] One reason the United States is an attractive location for these foreign banks is the size of its domestic financial markets, which provide foreign banks with a convenient investment outlet as well as a source of dollar financing. The attractiveness of establishing a banking facility in the United States is enhanced by the role of the dollar as a transaction currency in world trade and investment. In addition, the relaxation of capital controls in January 1974 clearly increased the desirability of U.S. markets to foreign banks since they could extend credits to foreign borrowers free of restraint.

Other important motivations for entry include providing financial services for the foreign bank's corporate clients doing business in the United States, developing closer contacts with U.S. corporations which may be

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[1]This number comprises foreign banks that operate one or more banking facilities in the United States, but does not include foreign banks that have only representative offices.

operating in the foreign bank's home country, and developing a profitable retail banking business in the United States, which in some cases is linked to a particular ethnic appeal.[2] Some U.S. offices of foreign banks offer a broad range of both wholesale and retail services in addition to conducting money-market transactions for their parent organizations, while others have preferred to develop only specialized services. A number of foreign banks that initially entered the U.S. market in order to service the U.S. activities of their home country corporations and to finance transactions between the United States and their home country have used the contacts and expertise developed through their U.S. presence as a base to compete for the domestic business of the *Fortune* 500 companies.

This paper will attempt to provide an analytic survey of the U.S. activities of foreign banks.[3] These activities are properly considered international banking because they are conducted by banking offices located outside of their home countries and therefore may be expected to differ in important respects from the activities of indigenous banks. Since, from the U.S. point of view, these offices are domestic banking institutions that have an important impact on domestic banking markets, this paper will also consider the role of the foreign banking institutions in relation to banking within the United States.

Before analyzing the U.S. activities of foreign banks it should be noted that this analysis refers only to the segment of the foreign banks' activities that are on the books of their offices in the United States.[4] Aggregate balance sheets of these offices illustrate the nature of the activities that foreign banks conduct in the United States and reveal the general impact of foreign banks on banking structure in the United States. However, these aggregate data represent institutions engaged in a wide range of operations and often conceal the diversity of their activities.[5]

[2]For a more detailed description of the motivations for foreign bank entry see: Fred Klopstock, "Foreign Banks in the United States: Scope and Growth of Operations," *Monthly Review of the Federal Reserve Bank of New York,* June 1973, pp. 140-154.

[3]Previous survey articles include: Henry S. Terrell and John Leimone, "The U.S. Activities of Foreign-Owned Banking Organizations," *The Columbia Journal of World Business,* Winter 1975, pp. 87-97; Jane D'Arista, "Foreign Bank Activities in the United States," *Compendium of Papers Prepared for the Fine Study,* U.S. House of Representatives, June 1976, Book II, pp. 733-800; Francis A. Lees, *Foreign Banking and Investment in the United States: Issues and Alternatives,* (New York: John Wiley and Sons, 1976); and "Recent Growth in Activities of U.S. Offices of Foreign Banks," *Federal Reserve Bulletin,* October 1976, pp. 815-824.

[4]In fact many foreign banks transact business with U.S. residents at their banking offices outside the United States.

[5]Fred Ruckdeschel, in an unpublished paper entitled "A Microeconomic Comparison of the Activities of Foreign Banks in the United States with Domestic U.S. Banks," has utilized discriminant analysis to show that there is considerably more diversity among the balance sheets of foreign banking "families" operating in the United States than among the balance sheets of major U.S. banks or a selected sample of nonmember domestic banks.

This paper is presented in two parts. The body of the paper discusses the aggregate size and growth of the U.S. offices of foreign banks, emphasizing the general nature of their activities and their impact on banking structure in the United States, including their multistate banking activities. An appendix presents a preliminary microanalytic analysis of the balance sheets of individual foreign banking institutions in the United States.

II. *The Activities of Foreign Banks: An Overview*

A. *Asset Structure*

1. *Size and Growth*

Tables 1 and 2 provide data on the size and growth of major asset and liability categories for the U.S. offices of foreign banks and for banks that report weekly to the Federal Reserve.[6] The data are as of November 1972, the month for which data on the foreign banks were first collected by the Federal Reserve, November 1974, the month before legislation affecting the activities of the foreign banks was first proposed; and the more recent month of May 1977.[7]

The data in Table 1 reveal the dramatic growth in the U.S. activities of foreign banks compared with the domestic assets of the weekly reporting banks.[8] Between November 1972 and May 1977 the standard banking assets of foreign banks — defined to exclude clearing balances[9] and balances due to directly related institutions — increased 1¾ times from $18.3 billion to $50.5 billion, while similar assets of the weekly reporting banks increased about 40 percent from $353 billion to $488 billion. The dramatic

[6]The banks that report weekly to the Federal Reserve are in large part the money-market banks, the closest competitors of the U.S. offices of foreign banks. Since these data do not refer to all U.S. banks but only to the sample of weekly reporting banks (which account for about 54 percent of total assets of all banks in the United States), these data do not measure the impact of foreign bank activity on the entire U.S. banking system. We are indebted to our colleague John Leimone who developed a format for comparing the balance sheets of the foreign and weekly reporting banks.

[7]November and May data are useful because they do not contain the distortions caused by end-of-year and end-of-quarter "window-dressing." The selection of the three dates is arbitrary. The growth of the U.S. activities of foreign banks has not proceeded at a constant pace within the two periods.

[8]Four foreign-owned banks, European-American Bank and Trust Company, California First Bank, Lloyds Bank of California, and Sumitomo Bank of California, also report weekly to the Federal Reserve. The data for these banks have been subtracted from the data for the weekly reporting banks so that the data refer only to domestically owned weekly reporting banks. The data for both the weekly reporting banks and the foreign-owned banks are as of the last Wednesday of the month. It should be noted that the two banking samples are distinct and thus any percentage comparisons *do not reflect shares* but indicate only relative size and growth.

[9]Clearing balances comprise cash items in process of collection, demand balances due from banks in the United States, and deposits due from banks in foreign countries.

Table 1

Comparison of U.S. Offices of Foreign Banks with Weekly Reporting U.S. Banks by Asset Category
(in millions of dollars)

	November 1972			November 1974			May 1977		
	U.S. Offices of Foreign Banks	Weekly Reporting Banks	Foreign as Percent of Weekly Reporting Banks	U.S. Offices of Foreign Banks	Weekly Reporting Banks	Foreign as Percent of Weekly Reporting Banks	U.S. Office of Foreign Banks	Weekly Reporting Banks	Foreign as Percent of Weekly Reporting Banks
I. Standard Banking Assets	18,346	353,195	5.2	35,506	459,939	7.9	50,519	487,667	10.4
A. Loans and Credits	10,000	201,103	5.0	20,594	280,535	7.3	25,656	262,391	9.8
1. Commercial and industrial loans	8,878	88,406	10.0	17,815	129,375	13.8	20,669	115,689	17.9
a. United States	(7,169)	(83,583)[a]	(8.6)	(13,764)	(123,703)[a]	(11.0)	(15,351)	(108,312)[a]	(13.7)
b. Foreign	(1,709)	(3,715)[a]	(46.0)	(4,051)	(4,305)[a]	(94.1)	(5,319)	(5,320)[a]	(99.4)
2. Other loans	1,122	112,697	1.0	2,779	151,160	1.8	4,986	146,702	3.4
B. Money-market assets	4,232	29,244	14.5	7,744	34,359	22.5	15,203	39,470	38.5
1. Interbank loans and time deposits due from banks	3,047	16,341	18.6	7,307	23,811	30.7	14,431	24,135	59.8
a. United States[b]	(2,433)	(13,412)	(18.1)	(5,826)	(17,647)	(33.0)	(9,423)	(18,571)	(50.7)
b. Foreign[c]	(614)	(2,929)	(21.0)	(1,481)	(6,164)	(24.0)	(5,008)	(5,564)	(90.0)
2. Loans for purchasing or carrying securities	1,185	12,903	9.2	437	10,548	4.1	772	15,335	5.0
C. Securities	2,066	84,319	2.4	3,560	84,896	4.2	4,233	112,969	3.7
D. Miscellaneous assets	2,048	38,529	5.3	4,608	60,149	7.7	5,427	72,837	7.5
II. Clearing Balances	2,000	39,669	5.0	4,669	49,893	9.4	6,390	50,695	12.6
A. Demand deposits due from U.S. banks	1,620	10,017	16.2	3,439	11,187	30.7	3,885	12,853	30.2
B. Deposits due from foreign banks[d]	244	531	46.0	897	911	98.5	1,882	2,485	75.7
C. Cash items in process of collection	136	29,121	0.5	333	37,795	0.9	623	35,357	1.8
III. Due From Directly Related Institutions	4,286	--	--	9,273	--	--	11,845	--	--
A. United States	1,773	--	--	4,580	--	--	4,740	--	--
B. Foreign	2,513	--	--	4,693	--	--	7,105	--	--
TOTAL ASSETS	24,633	392,865	6.3	50,447	509,833	9.9	68,754	538,362	12.8

Sources: 886(a) and 416

[a]Does not include acceptances held in loan portfolio.

[b]Includes Federal funds sold.

[c]Does not include time deposits.

[d]Includes time deposits.

Note: Details may not add to totals due to rounding.

growth of foreign banks' assets has resulted in a doubling of the size of their assets relative to the weekly reporting banks' assets — from 5.2 percent as of November 1972 to 10.4 percent as of May 1977.

2. *Commercial and Industrial Loans*

Aside from demonstrating the general growth of foreign banks in the United States, the data in Table 1 also reveal the growth of various categories of assets of these institutions. As of May 1977, the most important asset item for these institutions consisted of their $20.7 billion in commercial and industrial loans, which amounted to 41 percent of their standard banking assets, compared with 24 percent for the weekly reporting banks. The heavy concentration of (C & I) loans in the portfolios of the foreign banks is indicative of their wholesale business orientation. By contrast, loans other than C and I loans — which largely reflect more retail-oriented banking — amounted to only 10 percent of standard assets for the foreign banks compared with 30 percent for the weekly reporting banks.

What is even more striking than the relative concentration of commercial and industrial loans to both foreign and domestic customers in the portfolios of the foreign banks is the ability of these banks to expand their lending during a period of sluggish growth in C and I lending by the weekly reporting banks. In the two years between November 1972 and November 1974, total C and I loans at foreign banks increased from $8.9 billion to $17.9 billion, increasing from 10 percent to 13.8 percent of similar loans at weekly reporting banks. Furthermore, between November 1974 and May 1977 when C and I loans of the weekly reporting banks actually declined by $13.7 billion to $115.7 billion, C and I loans of the U.S. offices of foreign banks increased by $2.9 billion to $20.7 billion. Moreover, $1.6 billion of this increase represented C and I loans to domestic borrowers. By May 1977 C and I loans at the foreign banks had grown to 17.9 percent of the C and I lending by the weekly reporting banks.

Clearly U.S. offices of foreign banks are an important competitive factor in the market for commercial and industrial lending from banking offices in the United States. Although available evidence is not conclusive, the expected long-run results of this increased competition should be smaller net interest rate spreads on domestic U.S. lending and a closer convergence between domestic and Euro-currency lending rates.[10]

[10]The evidence on declining spreads in domestic lending is largely anecdotal and is derived in part from bank stock analysts. Declining spreads are hard to document empirically since they may occur in a variety of ways other than through reductions in posted lending rates, i.e., reductions in compensating balance requirements, reductions in margins over prime for non-prime borrowers, and some Euro-currency pricing for domestic borrowers. Furthermore, it is difficult to disentangle the impact of foreign banks on domestic loan spreads from the competitive impact of commercial paper. Morgan Guaranty, in *World Financial Markets,* compares the costs of Euro-dollar credits to the costs of issuing commercial paper.

A third interesting aspect of the C and I lending of foreign banks is the relatively high proportion made to foreign borrowers.[11] In May 1977 one-fourth of the total C and I lending by these offices was to foreign borrowers, compared with less than one-twentieth for weekly reporting banks.[12] In November 1972 the foreign C and I loans portfolio of the foreign banking offices was about one-half the size of that of the weekly reporting banks; by May 1977 their foreign C and I loans were approximately equal to comparable loans at the weekly reporting banks.

The relatively high concentration of foreign C and I loans in the portfolios of the foreign banks is not surprising given the expectation that nonindigenous banks would be relatively more specialized in foreign trade and investment than domestic banks.[13]

3. *Money-Market Assets*

Foreign banks in the United States are active participants in domestic money markets as part of their role in managing the liquid dollar assets of their parent organization. In arriving at a desired liquidity structure, a foreign bank may simultaneously have large placements and large liabilities in the U.S. market.

Between November 1972 and May 1977 total money-market assets of these institutions more than tripled from $4.2 billion to $15.2 billion; the amount of these assets relative to the weekly reporting banks increased from 14.5 percent to 38.5 percent. In May 1977 money-market assets accounted for about 30 percent of the total standard assets of foreign banks, compared to about 8 percent of the standard assets of the weekly reporting banks. The foreign banking institutions' money-market assets consist largely of loans to and time deposits with commercial banks in the United States. These assets are close substitutes for Euro-dollar placements, but

[11]The weekly report of condition for domestic banks does not disaggregate their customers' liabilities on acceptances by domestic and foreign obligors. Thus the data for foreign and domestic C and I loans for the weekly reporting banks in Table 1 are net of acceptances. As of May 1977 weekly reporting banks held $3.7 billion in acceptances, equal to 3 percent of their total C and I loans, and therefore the omission of acceptances from the domestic/ foreign disaggregation does not seriously affect the general trend.

[12]The data understate the true share of loans to foreign borrowers by the foreign banks since some of the loans that are recorded as domestic loans are really loans to foreign borrowers. For example, the Japanese agencies lend funds to the U.S. incorporated subsidiaries of Japanese trading companies.

[13]We have tested the hypothesis that the relatively lower concentration of foreign C and I loans to total C and I loans at the weekly reporting banks results from the inclusion of smaller U.S. banks that are not active in foreign lending in the sample of weekly reporting banks. For the ten largest domestic U.S. banks, all of which are active in international finance, the ratio of foreign to total C and I loans was .07 which although higher than the ratio for all weekly reporting banks is still well below the ratio for the U.S. offices of foreign banks. It should also be noted that the C and I loan figures for weekly reporting banks refer only to foreign lending from their domestic offices. For tax and other reasons, U.S. banks often book foreign loans at their foreign branches rather than their U.S. offices. As of May 1977, foreign branches of U.S. banks held $68.7 billion in claims on nonbank foreign borrowers, which were largely C and I loans.

offer the additional feature of being domiciled in the United States, thereby lacking any elements of "country-risk" associated with dollar investments in banking facilities outside the United States.

4. *Demand Balances with U.S. Banks*

A third important asset category for U.S. offices of foreign banks consists of demand balances due from banks in the United States. These balances increased from $1.6 billion in November 1972 to $3.9 billion in May 1977, and on the latter date were equal to about 30 percent of the "due from" balances of the weekly reporting banks. More striking, however, is the fact that noninterest bearing demand balances at banks accounted for 7.7 percent of the standard banking assets of U.S. offices of foreign banks compared to only 2.6 percent for the weekly reporting banks.[14]

There are three important reasons for the relatively high concentration of demand balances due from banks in the assets of the foreign banks: (1) the deposits can be used to satisfy state-imposed reserve requirements; (2) these balances are an important vehicle through which foreign banks clear and settle their dollar payments and receipts; and, (3) they are a means of compensating domestic U.S. banks for clearing, settlement, and other correspondent services.

Branches and subsidiary commercial banks in New York, agencies and subsidiary banks in California, and branches in Illinois are currently subject to state-imposed reserve requirements that are similar in magnitude to Federal Reserve requirements, but which can be satisfied by demand balances at domestic banks. Thus the foreign banks need these balances to satisfy the state-imposed reserve requirements. If, however, legislation were enacted requiring the U.S. offices of foreign banks to become Federal Reserve members, their demand for these balances would be reduced substantially because they would satisfy their reserve requirements through balances at Federal Reserve banks, and their access to Federal Reserve services would reduce their need to hold demand balances as compensation for correspondent services.[15]

The issue of demand balances maintained as compensation for services rendered by U.S. banks is complex.[16] U.S. banks perform a variety of

[14]Some of the recorded demand balances at U.S. commercial banks are deposits with clearinghouse banks which are not available for use by the foreign bank until the following business day. These clearinghouse funds are valuable to the foreign banks because they can be utilized to satisfy New York State reserve requirements.

[15]Some preliminary data are consistent with the hypothesis that Federal Reserve membership would reduce the amount of correspondent demand balances held by the U.S. offices of foreign banks. As of May 1977, the five foreign bank-owned commercial banks in New York State that are Federal Reserve members had demand balances due from banks equal to 1 percent of their total assets, while the comparable figure for the 11 foreign bank-owned commercial banks in New York State that are not members of the Federal Reserve was 7 percent.

[16]U.S. banks are also compensated with demand balances for services rendered to their domestic correspondent banks.

services for foreign banks in the United States including clearing of dollar funds, settlement (that is, effecting payment of dollar funds), access to the Federal funds market, provision of lines of credit, information on the U.S. economy or specific customers, and training services. Of this total package of services, the clearing and settlement facilities are generally the most important.

The costs and benefits of the services rendered by U.S. banks for foreign banks are continuously evaluated by both parties, and foreign banks often maintain demand balances at several major U.S. banks that offer clearing and settlement facilities. Although these balances fluctuate widely on a day-to-day basis depending upon the payments and receipts of the foreign bank, the average balance over time is computed to compensate the U.S. bank for the costs of the services provided. A foreign bank may shift its demand balances and its clearing and settlements business away from a U.S. bank which it believes is requiring too high a balance relative to the services it renders.

It is difficult, however, to draw a close parallel between the demand balances that U.S. offices of foreign banks maintain with domestic banks and the services *these offices* obtain from U.S. banks. The relationship between a major U.S. bank and a major foreign bank is evaluated on a worldwide basis and the balance may be maintained by either a U.S. or foreign office of the foreign bank.[17] Moreover, it is not easy to distinguish whether the services rendered are for the benefit of the domestic or foreign office of the foreign bank. For example, clearing and settlement services or lines of credit may be for the benefit of either the U.S. or the head office of the foreign bank. In addition, a foreign bank may render services to its U.S. correspondent bank in its home country for which it may be compensated either through a demand balance or a reduction in its required balance at the U.S. correspondent. Thus, the relatively large demand balances with U.S. banks maintained by the U.S. offices of foreign banks must be considered as part of the total compensation of their parent organization for services rendered by U.S. banks.

B. *Liability Structure*

Because of their status as nonlocal banks, U.S. offices of foreign banks have a markedly different liability structure from domestic banks. This section compares the liability structure of the U.S. offices of foreign banks to the liability structure of both the domestic weekly reporting banks and the foreign branches of U.S. banks.

1. *Deposits and Credit Balances (Liabilities to Nonbanks)*[18]

Deposits from nonbanks have traditionally played a relatively minor role in the funding of the U.S. offices of foreign banks, but in recent years

[17]As of May 1977 weekly reporting banks had $5.6 billion in demand deposits from foreign offices of foreign banks.

[18]Credit balances, which are in many ways similar to demand deposits, are counted as deposits. In addition, the data on deposits in the tables and text *include* all borrowings from nonbanks and *exclude* both demand and time deposits due to banks. Thus the data on deposits are an approximation of the ability of foreign banks in the United States to attract funds from nonbanks.

their deposit-type liabilities have grown extremely rapidly — from $6.2 billion in November 1972 to nearly $24 billion in May 1977 — and the size of these liabilities relative to the comparable liabilities of the weekly reporting banks tripled from 2.2 percent to 6.7 percent.

The pattern of deposit growth at the U.S. offices of foreign banks has varied considerably by type of institution as noted in Table 3. Between November 1972 and May 1977 the total deposits and credit balances of the agencies and branches increased by about $10 billion to $12.8 billion. Of this total increase, $6 billion was deposits due to foreign customers and only about $4 billion was due to domestic residents. Time and savings deposits, almost exclusively large CDs, accounted for $9 billion of the total increase in agency and branch deposits. The very high concentration of money-market type deposits and foreign obligations reflects the wholesale and trade orientation of the agencies and branches.

The growth of deposit liabilities of the subsidiary commercial banks has followed a different pattern. Of the nearly $8 billion in total deposit growth at the subsidiary commercial banks in this period, $7.2 billion has been to domestic residents, including an increase of $2.2 billion in demand deposits to domestic residents. The relative importance of these domestic deposits at subsidiary banks indicates their high concentration in retail banking activities. In addition, nearly three-fifths of the growth in domestic deposits at the domestic subsidiary banks has resulted from the recent acquisitions of U.S. banks by foreign banks rather than through establishment of *de novo* banks or expansion in existing commercial banks.[19]

The growth in deposits and credit balance at the U.S. offices of foreign banks, taken as a whole, has proceeded more rapidly than the growth in their standard banking assets. In November 1972 their deposit-type liabilities amounted to 34 percent of their standard banking assets; by May 1977 this figure has risen to 47 percent, while their deposits to U.S. residents increased from 23 percent to 31 percent of their standard banking assets. For weekly reporting banks, deposit liabilities to nonbanks have generally amounted to about three-fourths of their standard banking assets. Thus although the statistical averages conceal considerable diversity among the foreign institutions, the rapid growth of their deposit base has brought their overall deposit to standard asset relationship somewhat closer to the pattern of domestic banks, although foreign banks continue to rely more heavily on nondeposit sources to fund their U.S. activities.[20]

[19] Major acquisitions included Franklin National Bank by the European- American Group, First Western Bank and Trust (now Lloyd's Bank of California) by Lloyd's International Bank, and Southern California First National Bank (now California First Bank) by The Bank of Tokyo.

[20] The same general pattern of increased funding of loans to nonbanks with deposits from nonbanks has not been true for foreign branches of U.S. banks. In May 1977 the ratio of claims on nonbanks to liabilities to nonbanks for the branches of U.S. banks was 2.44 compared to a ratio of 1.94 in November 1974.

2. *Interbank Liabilities*

Interbank liabilities, which include purchases of Federal funds and other borrowings from domestic banks, are an important source of funds for the U.S. offices of foreign banks. Total interbank liabilities of these offices increased from $2.6 billion in November 1972 to $12.3 billion in May 1977, and the amount of these liabilities relative to comparable liabilities of the weekly reporting banks increased from 7.7 percent to 16.8 percent.

The data in Table 2 demonstrate the growing importance of interbank liabilities in the total liability structure of the U.S. offices of foreign banks. Between November 1972 and May 1977 the ratio of interbank liabilities to deposits for the foreign banks increased from .43 to .51.[21] As noted earlier, analysis of the gross interbank liability position of the U.S. offices of foreign banks yields an incomplete picture of their use of this market as a source of funds, since some of these offices engage actively in both deposit-placing and deposit-taking activities as part of the management of the dollar positions of their parent organizations. On a net basis the domestic interbank market has at times been an important source of funds for the U.S. offices of foreign banks. As of November 1974, their net borrowings in the domestic interbank market amounted to $3.7 billion, or 10 percent of their standard banking assets; by May 1977, however, net interbank borrowings had declined to $2.0 billion or only about 4 percent of their standard banking assets.[22]

3. *Liabilities to Foreign-Related Institutions*

While funding from affiliates abroad is important, foreign banks in the United States are reducing their dependence on advances from their head offices. As of November 1972 the U.S. offices of foreign banks had net liabilities to their related offices in foreign countries of $7.2 billion, which amounted to 39 percent of their standard banking assets. In May 1977 their net liabilities to these institutions were $8.7 billion, or only 17 percent of their standard banking assets.[23] [24]

[21]For the weekly reporting banks, the ratio of interbank liabilities to deposits increased from 0.12 to 0.20 in this same period. Thus the general trend on reliance of interbank funds has been in the same direction for both institutions.

[22]The use of aggregate statistics of net borrowings in the domestic interbank market is a useful generalization, but it obscures the fact that some foreign institutions are large lenders to and others are large net borrowers from that market.

[23]Net liabilities due to foreign-related institutions are computed excluding the capital accounts of the U.S. offices of foreign banks, which totaled $2.2 billion in May 1977. If legislation is enacted which places *either* Federal Reserve reserve requirements or minimum capital standards on the agencies and branches of foreign banks, a proportion of what is currently reported as due to their head offices would be considered as a capital contribution.

[24]The attractiveness of advances from their head offices abroad to U.S. offices of foreign banks has been reduced by the Federal Reserve's request that these offices maintain reserves (through noninterest bearing deposits at correspondent member banks) on increases in net Euro-dollar borrowings above the level of net borrowings in May 1973. Since April 9, 1975, the voluntary reserve request has been 4 percent.

Table 2

Comparison of U.S. Offices of Foreign Banks with Weekly Reporting U.S. Banks by Liability Category
(in millions of dollars)

	November 1972			November 1974			May 1977		
	U.S. Offices of Foreign Banks	Weekly Reporting Banks	Foreign as Percent of Weekly Reporting Banks	U.S. Offices of Foreign Banks	Weekly Reporting Banks	Foreign as Percent of Weekly Reporting Banks	U.S. Offices of Foreign Banks	Weekly Reporting Banks	Foreign as Percent of Weekly Reporting Banks
I. Standard Banking Liabilities	10,702	328,448	3.3	27,002	433,336	6.2	40,919	458,889	8.9
A. Deposits, credit balances, and other nonbank borrowings	6,205	278,888	2.2	12,670	344,180	3.7	23,969	359,540	6.7
1. Demand deposits and credit balances	1,863	120,920	1.5	3,650	127,120	2.9	5,338	128,386	4.2
a. United States	(1,285)	n.a.	--	(2,809)	n.a.	n.a.	(3,948)	n.a.	n.a.
b. Foreign	(578)	n.a.	--	(841)	n.a.	n.a.	(1,390)	n.a.	n.a.
2. Time and savings deposits and other nonbank borrowings	4,342	157,968	2.7	9,020	217,060	4.2	18,631	231,540	8.0
a. United States	(2,925)	n.a.	--	(5,375)	n.a.	n.a.	(11,466)	n.a.	n.a.
b. Foreign	(1,417)	n.a.	--	(3,645)	n.a.	n.a.	(7,166)	n.a.	n.a.
B. Interbank liabilities	2,645	34,507	7.7	10,635	63,939	16.6	12,336	73,604	16.8
1. United States[a] [b]	2,241	34,301	6.5	9,530	62,258	15.3	11,471	72,541	15.8
2. Foreign[b]	404	205	197.1	1,105	1,681	65.7	865	1,153	75.0
C. Miscellaneous liabilities	1,852	15,054	12.3	3,698	25,219	14.7	4,614	25,745	17.9
II. Clearing Liabilities	1,599	31,003	5.2	3,823	37,594	10.2	4,865	37,604	12.9
A. Demand deposits due to U.S. banks	377	21,277	1.8	1,039	25,424	4.1	1,360	24,728	5.5
B. Demand deposits due to foreign banks	464	2,847	16.3	703	5,086	13.8	1,371	5,571	24.6
C. Other[c]	758	6,879	11.0	2,081	7,085	29.4	2,134	7,305	29.2
III. Liabilities to Directly Related Institutions	11,671	--	--	18,134	--	--	20,800	--	--
A. United States	1,966	--	--	4,920	--	--	5,011	--	--
B. Foreign	9,705	--	--	13,214	--	--	15,789	--	--
IV. Capital Account and Reserves	658	33,414	2.0	1,488	38,902	3.8	2,170	41,869	5.2
TOTAL LIABILITIES	24,633	392,865	6.3	50,447	509,834	9.9	68,754	538,362	12.8

Source: 886(a) and 416

[a] Includes Federal funds purchased.

[b] Does not include demand balances due to banks.

[c] Includes certified and officers' checks, travelers' checks, letters of credit, etc.

Note: Details may not add to totals due to rounding.

In brief, the most important development on the liability side of the foreign banks' balance sheets has been the growth of their deposit base, which includes their ability to attract deposits from foreign as well as domestic sources. This has enabled them to reduce their reliance on net interbank borrowings and net advances from their head offices to finance their U.S. activities.

4. *Comparison with Foreign Branches of U.S. Banks*

The preceding analysis has noted that foreign banks in the United States have a relatively large concentration of interbank liabilities, both as a net and gross source of funds, and a dependence on net advances from their head offices. The balance sheets of foreign branches of U.S. banks exhibit certain similarities which suggest useful generalizations about the liability structure of nonindigenous banks.

Liabilities to banks are the single most important gross source of funds to the foreign branches of U.S. banks. Interbank liabilities amounted to $84 billion — or 52 percent of their total liabilities (excluding liabilities to directly related institutions) as of May 1977. Excluding branches in the United Kingdom and the offshore banking centers, that is, the locations where branches of U.S. banks specialize in interbank Euro-dollar trading, interbank liabilities still represented a relatively high 48 percent of the total.[25] [26] Thus one important general characteristic of offices of nonindigenous banks appears to be the importance of interbank liabilities to banks in their total liability position.[27]

A second important similarity between the U.S. offices of foreign banks and the foreign branches of U.S. banks is their reliance on funds advanced from their head offices. As of May 1977, U.S. offices of foreign banks owed $8.7 billion, on a net basis, to their related offices outside the United States, while foreign branches of U.S. banks owed $16.7 billion to their related offices inside the United States. This somewhat surprising result suggests that offices of nonlocal banks encounter demand for funds in their new markets in excess of their ability to fund themselves, and, in the absence of restraints on capital flows, tend to rely heavily on advances from their home offices.

[25]The offshore banking centers where U.S. banks conduct operations include: Nassau, Caymans, Panama, Bahrain, Hong Kong, and Singapore.

[26]By contrast, interbank liabilities of the U.S. weekly reporting banks amounted to only 15 percent of total liabilities as of May 1977.

[27]U.S. banks in the past have also relied on foreign interbank markets as an important net source of funds. In recent years the large inflows from the oil-producing countries combined with conditions favoring advances from their head offices have resulted in foreign branches of U.S. banks having a balanced asset/liability position vis-à-vis banks in foreign countries.

Table 3

Deposits and Credit Balances of U.S. Offices of Foreign Banks*
(in millions of dollars)

Agencies and Branches		November 1972	November 1974	May 1977	Percentage Increase November 1972-May 1977
Total Deposits and Credit Balances		2,818	5,563	12,750	352
Due to:	Domestic customers	1,606	2,133	5,666	253
	Demand	414	671	847	105
	Time and savings	1,192	1,462	4,819	304
	Foreign customers	1,212	3,430	7,083	484
	Demand	367	570	1,055	187
	Time and savings	845	2,860	6,028	613
Subsidiary Commercial Banks					
Total Deposits and Credit Balances		2,884	6,472	10,720	272
Due to:	Domestic customers	2,498	5,911	9,689	288
	Demand	802	2,075	3,051	280
	Time and savings	1,696	3,836	6,638	291
	Foreign customers	386	561	1,031	167
	Demand	143	202	216	51
	Time and saving	243	359	815	235
Total Deposits and Credit Balances		5,702	12,035	23,470	312

*Excludes New York State Investment Companies and foreign bank-owned Agreement Corporations.
Note: Details may not add to totals due to rounding.

C. *Institutional Structure*

1. *Type of Organization and Country of Parent Bank*[28]

Foreign banks operate in the United States through three major types of banking facilities: agencies, branches, and subsidiary commercial banks. The characteristics of these institutional forms are discussed in detail elsewhere.[29] The main distinctions are that agencies may lend funds but cannot accept deposits (although they do accept credit balances, which for many purposes are the functional equivalent of deposits);[30] branches may accept deposits, make loans, and are an integral part of their parent bank, with lending limits and deposit support based on the resources of their parent banks; and subsidiaries are separately incorporated U.S. banks with lending limits and deposit support derived from their own capital.[31]

The data in Table 4 indicate that the institutional structure of foreign bank operations in the United States has undergone substantial change since late 1972. In late 1972, agencies were the most important single form of operation with total standard assets nearly 1½ times as large as branches and subsidiary commercial banks combined. As of May 1977, branches had become the largest single form of operation with total standard assets of $20.3 billion, and subsidiary commercial banks with total standard assets of $13.1 billion were almost as large as the agencies.

The decline in the importance of agencies can be traced to three specific factors: (1) the relatively slow growth in the activities of the Canadian agencies which were established and active in the United States well before 1972;[32] (2) the extremely rapid growth since 1972 of the branches and subsidiaries of European banks which for the most part had not been very active in the United States prior to 1972; and (3) a shift in emphasis by Japanese banks from the agency to the branch and subsidiary form of operations.

[28]These two important institutional characteristics are discussed together because of the preferences (or requirements) of banks from specific countries for particular institutional structures.

[29]For a more complete treatment of the characteristics of the different institutional forms see the references cited in footnote 3.

[30]In California, however, an agency, subject to the approval of the Superintendent of Banks, may accept deposits from foreign sources.

[31]The legal responsibility for a subsidiary commercial bank is limited to the parent bank's investment. However, to protect their reputations in international markets, parent banks often extend support to their subsidiaries for which they are not legally liable.

[32]Canadian banks are limited to the agency form of operation in New York State, since New York State law requires reciprocal treatment for New York State banks as a condition for permitting a foreign bank to operate a branch in New York.

Table 4

Selected Balance Sheet Characteristics of
U.S. Offices of Foreign Banks, by Type of Institution and Country of Parent
(in millions of dollars)

	Agencies			Branches			Subsidiary Commercial Banks		
	Nov. 1972	Nov. 1974	May 1977	Nov. 1972	Nov. 1974	May 1977	Nov. 1972	Nov. 1974	May 1977
All Countries									
Standard Banking Assets	9,959	17,776	15,693	3,283	8,218	20,284	3,747	8,606	13,117
Loans and Credits	5,691	10,965	8,745	1,466	3,987	8,848	2,140	4,528	7,589
C & I Loans	5,585	10,651	8,211	1,259	3,662	7,935	1,417	2,450	4,111
Deposits and Credit Balances	794	2,030	2,520	2,024	3,533	10,230	2,884	6,472	10,720
Number of Institutions	(50)	(70)	(95)	(26)	(50)	(81)	(25)	(29)	(34)
Japan									
Standard Banking Assets	6,857	12,573	9,918	---	832	3,658	1,914	2,817	5,116
Loans and Credits	4,580	8,598	6,055	---	693	2,875	1,179	1,747	2,990
C & I Loans	4,549	8,520	5,977	---	693	2,798	833	1,201	1,798
Deposits and Credit Balances	387	1,362	1,458	---	71	995	1,477	2,103	4,072
Number of Institutions	(21)	(28)	(28)	(1)	(5)	(14)	(6)	(7)	(10)
Canada									
Standard Banking Assets	2,617	3,959	3,115	244	372	670	339	492	664
Loans and Credits	956	1,986	1,733	223	334	563	159	284	408
C & I Loans	882	1,791	1,496	147	206	443	69	148	200
Deposits and Credit Balances	200	330	292	449	324	644	283	370	510
Number of Institutions	(9)	(11)	(12)	(4)	(6)	(6)	(8)	(8)	(8)
Europe									
Standard Banking Assets	252	810	1,525	2,493	5,991	14,419	1,348	4,914	6,785
Loans and Credits	63	226	546	979	2,350	4,653	721	2,248	3,884
C & I Loans	62	218	518	887	2,194	4,105	484	987	1,929
Deposits and Credit Balances	139	147	305	1,232	2,654	7,735	1,012	3,743	5,597
Number of Institutions	(11)	(14)	(22)	(13)	(29)	(44)	(9)	(11)	(12)
Rest of World									
Standard Banking Assets	234	424	1,135	502	1,023	1,537	---	---	551
Loans and Credits	93	155	412	255	610	757	---	---	306
C & I Loans	92	122	219	216	569	589	---	---	185
Deposits and Credit Balances	68	191	464	303	484	856	---	---	541
Number of Institutions	(9)	(17)	(33)	(8)	(10)	(17)	(2)	(3)	(4)

Quantitatively, the growth of the major European banks through branches and subsidiaries has been the most important factor. In many cases these European banks have had business relationships with European subsidiaries of U.S. companies. As shown in Table 5, between November 1972 and May 1977 total standard assets of the U.S. offices of European banks more than quadrupled to $22.7 billion, and during that same period their deposits and credit balances increased from $2.4 billion to $13.7 billion. The European banks' share in total standard banking assets of all foreign banks increased from 24 percent to 46 percent, and they accounted for 63 percent of the increase in total deposits at all offices of foreign banks in the United States. Of their total deposit growth of $11.3 billion, $4.6 billion, or about two-fifths, was from foreign customers.

The ability of the European banks to expand their deposit-taking activities from both domestic and foreign sources is related to the fact that these offices, although relatively new, tend to be branches of the largest banks from the major industrial countries whose names are well-known in the United States and abroad. In some cases the deposit growth has reflected an attempt by these institutions to develop a retail-oriented business in the United States, in part through the major acquisitions noted earlier. Finally, the major European countries of the home offices of these banks offer reciprocal treatment to American banks so that banks from these countries are not limited to nondeposit-taking institutions by reciprocity statutes in New York and Illinois.

The shift in the organizational preference of the Japanese banks is related to four developments: (1) a desire to compete for CDs and other deposit sources in the United States; (2) the growth through acquisition and expansion in their retail activities, particularly in California; (3) the improved capital position of some of the major Japanese banks, which has resulted in part from the appreciation of the yen and which has reduced the constraint of their lending limits; and (4) a desire to have a branch in New York State as a result of the proposed International Banking Act.[33]

In sum, the major structural changes in foreign bank activities in the United States are largely the result of the growth and deposit orientation of European banks, the changing character of the Japanese banks, and the slow growth in the U.S. offices of Canadian banks.

2. *Operations by State*

Foreign banks entering the United States have overwhelmingly elected to operate in New York, California, or Illinois. Although several other states permit foreign banks to operate, these three states have been most attractive because of their international trade and money-market orientation. Since November 1972 the New York share of total standard assets of foreign banks has declined from 71 percent to 68 percent, but its continued preponderance reflects the importance of the New York money market, and the fact that many major corporations have their national and international headquarters in New York.

[33]That Act was passed by the House of Representatives in 1976 and required either a branch or subsidiary presence in a state for a bank to elect that state as its home state.

Table 5

Shares of Different Parent Countries
in the Total U.S. Activities of Foreign Banks

	November 1972		November 1974		May 1977		Percentage Increase
	Amount ($ mill.)	Share (percent)	Amount ($ mill.)	Share (percent)	Amount ($ mill.)	Share (percent)	November 1972-May 1977
All Countries[a]							
Standard Banking Assets	16,989	100.0	34,590	100.0	49,094	100.0	189
Loans and Credits	9,298	100.0	19,481	100.0	25,182	100.0	171
C & I Loans	8,261	100.0	16,763	100.0	20,257	100.0	145
Deposits and Credit Balances	5,702	100.0	12,035	100.0	23,464	100.0	312
Japan[a]							
Standard Banking Assets	8,814	51.9	16,222	46.9	18,692	38.1	112
Loans and Credits	5,768	62.0	11,038	56.7	11,920	47.3	107
C & I Loans	5,390	65.2	10,414	62.1	10,572	52.2	96
Deposits and Credit Balances	1,904	33.4	3,536	29.4	6,525	27.8	243
Canada							
Standard Banking Assets	3,200	18.8	4,824	13.9	4,449	9.1	39
Loans and Credits	1,338	14.4	2,604	13.4	2,705	10.7	102
C & I Loans	1,098	13.3	2,145	12.8	2,139	10.6	95
Deposits and Credit Balances	931	16.3	1,024	8.5	1,432	6.1	55
Europe[a]							
Standard Banking Assets	4,092	24.1	11,715	33.9	22,729	46.3	455
Loans and Credits	1,764	19.0	4,824	24.8	9,083	36.1	415
C & I Loans	1,432	17.3	3,399	20.3	6,553	32.3	358
Deposits and Credit Balances	2,383	41.8	6,544	54.4	13,637	58.1	472
Rest of World							
Standard Banking Assets	883	5.2	1,830	5.3	3,223	6.6	265
Loans and Credits	428	4.6	1,016	5.2	1,474	5.9	244
C & I Loans	340	4.1	806	4.8	993	4.9	192
Deposits and Credit Balances	484	8.5	931	7.7	1,861	7.9	285
Number of U.S. Offices							
Total	101	100.0	149	100.0	210	100.0	108
Japan	28	27.7	40	26.8	52	24.8	86
Canada	21	20.8	25	16.8	26	12.4	24
Europe	33	32.7	54	36.2	78	37.1	136
Rest of World	19	18.8	30	20.1	54	25.7	184

[a]Excludes New York State Investment Companies and foreign bank-owned Agreement Corporations.
Note: Details may not add to totals due to rounding.

The data in Table 6 relate the growth in the activities of foreign banks to the weekly reporting banks in the three major states. The data indicate that in all three states the deposit and lending activities of foreign banks have been expanding more rapidly than the weekly reporting banks, their primary competitors. In New York State, for example, foreign banks currently have C and I loans equal to 37 percent of the C and I loans of the weekly reporting banks located in New York, while in California the foreign banks' C and I loans are equal to 31 percent of the large domestic banks' C and I loans. Clearly foreign banks are a significant factor in commercial and industrial lending in these two states. In Illinois, foreign bank C and I loan activity has expanded rapidly compared to the weekly reporting banks, but remains relatively small because Illinois law did not permit entry by branches of foreign banks until 1973.

Foreign bank offices in all three states have also expanded their deposit bases relative to those of the weekly reporting banks. Although still relatively small compared to the weekly reporting banks, it is interesting to note that in all three states the rate of foreign banks' deposit growth has been faster than the rate of growth of either their standard assets or their total loans and credits, so that in all three states foreign banks are funding an *increasing* proportion of their lending activities with deposits.

3. *Multi-state Activities*

With few exceptions, U.S. banks are prohibited from operating banking facilities in more than one state. By contrast, foreign banks can operate banking facilities in more than one state because they are not subject to either the provisions of the National Banking Act prohibiting multi-state banking by national banks or to provisions of state law prohibiting entry by banks chartered in other states. In view of this opportunity, many foreign banks have elected to operate banking facilities in more than one state.

Table 7 presents data on the growth and extent of multi-state banking by foreign banks in the United States. As of May 1977, 50 foreign banks operated banking facilities in two or more states, and on that date the total assets of offices of foreign banks outside their principal state (defined using a total assets criterion) were $19.7 billion; their total loans and credits were $8.7 billion, and deposits and credit balances were $6.0 billion. Between November 1972 and May 1977 the figures for these categories more than tripled.

The utilization of the multi-state networks of the foreign banks varies from institution to institution. The multi-state option has permitted foreign banks to tailor their institutional form to the environment in the particular states; for example, a foreign bank might operate a money-market agency or branch in New York and a subsidiary bank offering state-wide retail services in California.

In general there is coordination and planning among U.S. offices, although each office is usually considered an independent profit center and is "charged" an internally determined interest rate for funds received from

Table 6

Comparison of Selected Balance-Sheet Items
for U.S. Offices of Foreign Banks and Weekly Reporting
U.S. Banks by State
(in millions of dollars)

	New York[a]			California			Illinois		
	U.S. Offices of Foreign Banks	Weekly Reporting Banks	Foreign as Percent of Weekly Reporting Banks	U.S. Offices of Foreign Banks	Weekly Reporting Banks	Foreign as Percent of Weekly Reporting Banks	U.S. Offices of Foreign Banks	Weekly Reporting Banks	Foreign as Percent of Weekly Reporting Banks
Standard Banking Assets									
November 1972	12,983	96,139	13.5	3,679	59,493	6.2	33	25,112	0.1
November 1974	25,764	127,758	20.2	8,314	76,376	10.9	426	37,582	1.1
May 1977	34,286	128,009	26.8	11,774	84,396	14.0	1,702	38,407	4.4
Loans and Credits									
November 1972	6,537	53,372	12.2	2,508	35,557	7.1	16	14,430	0.1
November 1974	12,411	79,059	15.7	5,850	48,526	12.1	282	24,441	1.2
May 1977	15,217	62,522	24.3	7,770	48,413	16.0	1,043	21,053	5.0
Commercial and Industrial Loans									
November 1972	6,208	28,952	21.4	1,977	13,212	15.0	15	7,878	0.2
November 1974	11, 248	43,876	25.6	4,350	18,856	23.1	255	14,747	1.7
May 1977	13,124	35,622	36.8	5,147	16,847	30.6	967	11,340	8.5
Deposits and Credit Balances									
November 1972	3,339	68,963	4.8	1,736	50,486	3.4	5	19,009	b
November 1974	7,824	86,351	9.1	3,594	62,354	5.8	158	25,345	0.6
May 1977	15,100	79,797	18.9	6,605	70,136	9.4	757	24,649	3.1

[a]Excludes New York State Investment Companies.

[b]Negligible.

Table 7

Multi-state Activities of Foreign Banks in the United States[1]

	November 1972	November 1974	May 1977
Number of U.S. banking facilities operated by foreign banks	100	147	209
Number of foreign parents operating these U.S. banking facilities[2]	52	69	96
Foreign parents operating U.S. banking facilities in only 1 state	29	37	46
Foreign parents operating U.S. banking facilities in 2 states	20	17	27
Foreign parents operating U.S. banking facilities in 3 or more states	3	15	23
Number of foreign parents operating banking facilities over $500 million in 2 or more states	2	9	8
Balance sheet data for U.S. operations of foreign banks in nonprincipal state[3] (in millions of dollars)			
Total Assets	5,539	14,342	19,698
Loans and Credits	2,479	6,623	8,687
Deposits and Credit Balances	1,298	2,761	5,969

[1]Excludes offices in Puerto Rico and U.S. Virgin Islands.

[2]Consortia such as European-American counted as a single parent organization.

[3]Defined using a total asset criterion.

other related offices in the United States and abroad.[34] Loans arranged at a specific office are usually placed on the books of that office, although in some cases a subsidiary bank with a limit on its ability to lend to a single borrower may pass on the excess of a large loan to its related agency or branch.

It has sometimes been argued that multi-state banking by U.S. offices of foreign banks is analogous to multi-state banking conducted by major U.S. banks through their "out-of-state" Edge Corporations, and that it is equitable to permit foreign banks to operate in more than one state because they are not permitted to own Edge Corporations. However, the data in Table 8 suggest that the analogy between muti-state banking of foreign banks and the activities of out-of-state Edge Corporations is not very close. As of June 1977 the total loans and credits of the out-of-state Edge Corporations were only $1.6 billion, and their deposits amounted to only $1.4 billion. In terms of total activity, these institutions are highly concentrated in New York because they provide non-New York banks with access to New York money and foreign exchange markets.

The lack of similarity between Edge Corporations and multi-state activities of foreign banks, and the relatively small size of the deposit and lending activities of the Edge Corporations, result in large part from the statutory provisions that limit Edge Corporations to conducting international activities while U.S. offices of foreign banks are free to compete for domestic business.[35] In recognition of this difference and to implement a policy of comparable treatment for the U.S. offices of foreign banks, the Federal Reserve has proposed that in the future multi-state agencies of foreign banks be limited to powers that are similar to federally chartered Edge Corporations.[36]

Out-of-state Edge Corporations are, of course, not the only facilities by which U.S. banking organizations operate on a nationwide basis. Loan production offices and bank holding company affiliates, such as finance companies, are ways that U.S. banking organizations can compete nationwide. However, a banking facility is the only place where a U.S. bank can accept deposits and extend large amounts of credit. Since the option of

[34]Japanese agencies in California borrow large amounts of funds and advance them to related offices in New York because liabilities to directly related institutions are exempt from the New York State requirement that foreign banks maintain assets equal to 108 percent of their liabilities.

[35]Section 25(a) of the Federal Reserve Act states explicitly: "No corporation organized under this section shall carry on any part of its business in the United States except such as, in the judgment of the Board of Governors of the Federal Reserve System, *shall be incidental to its international or foreign business.*" (emphasis added).

[36]Statement of Stephen S. Gardner, Vice-Chairman, Board of Governors of the Federal Reserve System, U.S., Congress, House, Committee on Banking, Finance and Urban Affairs, Subcommittee on Financial Institutions,Supervision, Regulation and Insurance, *International Banking Act of 1977, Hearings...*on H.R. 7325...July 12-19, 1977, pp. 36-41.

Table 8

The Activities of "Out-of-State" Edge Corporations*
(in millions of dollars)

	Total			New York			Others		
	Nov. 1972	Nov. 1974	June 1977	Nov. 1972	Nov. 1974	June 1977	Nov. 1972	Nov. 1974	June 1977
Total Assets	3,348	8,313	8,473	2,982	6,834	6,560	366	1,479	1,913
Total Loans and Credits	849	1,442	1,639	689	959	1,009	160	483	630
Total Deposits and Credit Balances	638	1,042	1,448	519	601	773	119	442	676
Memorandum: Number of Corporations	38	55	57	20	22	22	18	33	35

*Corporation whose parent bank is domiciled in another state.
Note: Details may not add to totals due to rounding.

nationwide representative offices or loan production facilities is available to foreign banks, and since under the Bank Holding Company Act their parent organizations can invest in the same range of nonbanking activities as domestic bank holding companies, it appears that the ability to offer deposit and loan services from banking offices in more than one state gives foreign banks an improtant advantage over domestic banks.

III. *Conclusion*

This paper has analyzed the rapid growth in the U.S. activities of foreign banks and their impact on major U.S. banking centers. The size and rapid growth of these activities makes it increasingly apparent that the U.S. offices of foreign banks have expanded to such an extent that they have an important impact on national money and credit markets and on the international transactions of the United States, as well as on the competitive environment affecting the profitability and growth of individual banking organizations in the United States.

It is, of course, difficult to predict the future activities of these institutions. However, the size of domestic U.S. banking and capital markets and the opportunities presented by these markets suggest that many foreign banks will continue to expand their U.S. activities, although the pace of this expansion will no doubt slow down somewhat from the extremely rapid pace of expansion in recent years. While in the past regulation of foreign bank activity in the United States has been largely a matter of state jurisdiction, the expansion of this activity and its impact on macroeconomic magnitudes will continue to stimulate debate over the appropriate Federal regulatory and supervisory policy that would afford foreign banks in the United States the same range of opportunities and subject them to the same restrictions as domestic banks.

Appendix

A Micro-Analytic Analysis of the U.S. Activities of Foreign Banks

As noted in the body of this paper, the aggregate figures on the activity of the U.S. offices of foreign banks conceal considerable diversity in their operations. This appendix quantifies some of that diversity by computing some simple statistical measures for particular balance-sheet categories, and compares the diversity of operations among U.S. offices of foreign banks with the diversity of operations of the weekly reporting banks. This appendix also uses regression analysis to analyze some of the cross-sectional variation in balance-sheet structure for the U.S. offices of foreign banks as of May 1977.[37]

A. *Selected balance-sheet categories*

The major asset categories analyzed include: loans, which are divided into C & I loans (domestic and foreign) and other loans, and money-market assets. As noted in the paper, C & I loans have become increasingly

[37]The results in this appendix are preliminary.

important in foreign banks' portfolio. Other loans, which are less important at foreign banks, tend to reflect involvement in retail-oriented banking business. The major liability categories include deposits and other nonbank borrowings, money-market liabilities, and liabilities due to related institutions abroad. It is often useful to examine the latter two categories on a net basis since foreign banks have large placements and liabilities in domestic money-markets, and large due-to and due-from accounts with their foreign affiliates. Each dependent variable is scaled by total assets since the purpose is to explain variation in balance-sheet structure and not absolute amounts.

B. *Structure and Diversity of Activity*

Table A-1 presents the mean, standard deviation, and coefficient of variation for each of these variables for: (a) the U.S. offices of foreign banks;[38] and (b) the weekly reporting banks.[39] Because of the diversity of their parent organizations and because the foreign banks' U.S. activities represent a relatively small proportion of their total business, the U.S. offices of foreign banks would be expected to display more variation than the weekly reporting banks.

Weekly reporting banks have higher average ratios of total loans to total assets and non-C and I loans to assets, while the foreign banks have higher average ratios of C and I loans and money-market assets.[40] For each characteristic the coefficient of variation (the ratio of the standard deviation to the mean) is substantially higher for the foreign banks (except for money-market assets where it is only slightly higher), confirming the greater diversity of their activities.

On the liability side, the foreign banks have a higher average ratio of money-market liabilities to total assets, and the weekly reporters have a higher average ratio of deposit liabilities to total assets. Again the coefficients of variation are substantially higher for the foreign banks, emphasizing the diversity in their funding structure.[41]

Table A-2 presents similar statistics for two groups of the foreign institutions: (1) agencies and branches; and (2) subsidiary commercial banks. In almost all characteristics, the mean ratio for the subsidiary commercial banks lies between the mean for the agencies and branches and

[38]Foreign bank-owned agencies, branches and subsidiary commercial banks are included in these figures; foreign bank-owned agreement corporations and New York State investment companies are excluded.

[39]The four foreign bank-owned subsidiary commercial banks that report weekly to the Federal Reserve have been excluded from the weekly reporter figures.

[40]The mean figures for both groups represent unweighted averages.

[41]The statistics shown in Table A-1 were also computed for comparable balance-sheet categories for (a) all foreign branches of U.S. banks, (b) branches of U.S. banks in the United Kingdom, and (c) branches of U.S. banks in Nassau and the Cayman Islands. They indicated that, in general, the extent of diversity among foreign branches of U.S. banks is closer to that for the U.S. offices of foreign banks than to that of the weekly reporting banks.

Table A-1

Descriptive Statistics for
Weekly Reporting Banks and U.S. Offices of
Foreign Banks for Selected Variables, May 1977

Variable (x)	Weekly Reporting Banks (312 observations)			U. S. Offices of Foreign Banks* (207 observations)		
	Mean $\bar{x}$	Standard Deviation s_x	Coefficient of Variation $s_x/\bar{x}$	Mean $\bar{x}$	Standard Deviation s_x	Coefficient of Variation $s_x/\bar{x}$
Asset categories as a fraction of total assets:						
loans	.51	.10	.19	.41	.27	.66
C & I loans	.19	.06	.34	.35	.27	.77
other loans	.32	.09	.29	.07	.12	1.79
money-market assets	.05	.05	.95	.23	.24	1.05
Gross liability categories as a fraction of total assets:						
deposits	.75	.11	.15	.29	.28	.95
money-market liabilities	.13	.08	.66	.25	.27	1.09
due to foreign directly related institutions	--[b]	--[b]	--[b]	.26	.27	1.03
Net liabilities categories as a fraction of total assets:						
net money-market liabilities	.07	.07	--[a]	.02	.38	--[a]
net due to foreign directly related institutions	--[b]	--[b]	--[b]	.17	.29	--[a]
Total assets ($ billions)	1.75	3.81	2.21	.32	.49	1.51

*Agencies, branches and subsidiary commercial banks.

[a]Not computed because misleading statistic for net figures.

[b]Not available.

Note: Figures have been rounded.

the mean for the weekly reporting banks. In addition, the coefficient of variation for the subsidiary commercial banks, in almost all balance-sheet categories, is considerably smaller than the coefficient of variation for the agencies and branches and much larger than that for the weekly reporting banks. Thus, although the balance-sheet structure of the subsidiary banks appears closer to the weekly reporting banks, the element of foreign ownership results in a different and more diverse structure for the subsidiaries than for the large domestic commercial banks.

B. *A simple linear regression model*

A more complete model is being developed to explain the variation in allocation of assets, including the interaction between asset structure and sources of funding for the foreign banks using pooled cross-section and time-series data. The present analysis simply investigates some of the institutional hypotheses suggested by the aggregate data on a micro-level by applying linear regression analysis to cross-sectional data. The analysis investigates the effects of size and of specific sources of funds on allocation of assets. All of the results should be considered preliminary.

For the regression analysis, the U.S. offices of foreign banks have been divided into the two groups shown in Table A-2: (1) agencies and branches; and (2) subsidiary banks. This partitioning was performed because different structural relationships are to be expected. The economic rationale is that in many cases the foreign-owned subsidiary commercial banks function more like domestic U.S. commercial banks, whereas agencies and branches are more likely to serve specialized functions for their parent bank.

The regression equations represent an attempt to "sort out" the various institutional factors that might be expected to influence the balance-sheet structure of the agencies and branches, as well as the effect of size. For these estimates, the selected balance-sheet ratios are assumed to be influenced by the home country, whether the institution is the parent bank's only U.S. banking office, whether the institution is located in New York State, and size as measured by total assets.

The country of the parent institution is a relevant variable, since banks from a particular country are often motivated by the same factors in establishing U.S. offices, and as noted in the body of the paper, there have been clear differences in overall activity by parent country over time that might be reflected in cross-section data. The country-of-parent variable may reflect a wide variety of factors specific to a particular country, including the average length of time banks from that country have been operating in the United States, relative exchange rates and interest rates in that country and the United States, and the size and growth of trade and investment flows between that country and the United States.

Whether an individual office is the parent bank's only U.S. office is expected to have opposite effects on the importance of loans and money-market assets in an institution's portfolio. If a foreign bank has only one institution in the United States, it would be expected to specialize in

Table A-2

Descriptive Statistics for Two Groups of
Foreign Banking Institutions in the United States
for Selected Variables, May 1977

Variable (x)	Agencies and Branches (173 observations)			Subsidiary Commercial Banks (34 observations)		
	Mean $\bar{x}$	Standard Deviation s_x	Coefficient of Variation $s_x/\bar{x}$	Mean $\bar{x}$	Standard Deviation s_x	Coefficient of Variation $s_x/\bar{x}$
Asset categories as a fraction of total assets:						
loans	.41	.29	.70	.45	.21	.47
C & I loans	.36	.28	.78	.29	.17	.58
domestic	.26	.25	.96	.25	.16	.66
foreign	.10	.16	1.60	.05	.07	1.42
other loans	.05	.10	2.15	.16	.15	.90
money-market assets	.25	.25	1.03	.14	.13	.92
Gross liability categories as a fraction of total assets:						
deposits	.22	.24	1.07	.65	.19	.29
money-market liabilities	.28	.29	1.03	.10	.08	.82
due to foreign directly related institutions	.30	.27	.89	.04	.08	1.96
Net liability categories as a fraction of total assets:						
net money-market liabilities	.04	.41	--[a]	.04	.17	--[a]
net due to foreign directly related institutions	.20	.31	--[a]	.01	.06	--[a]
Total assets ($ billions)	.30	.44	1.48	.45	.65	1.46

[a]Not computed because misleading statistic for net figures.

Note: Figures have been rounded.

Table A-3

Agencies and Branches: Correlation Matrix for Selected Balance-Sheet Ratios
(all variables as a fraction of total assets)

	Loans	Money-market Assets	Deposit Liabilities	Money-market Liabilities
Assets				
Money-market assets	-.57			
Gross Liabilities				
Deposit liabilities	.03	.01		
Money-market liabilities	.02	-.13	-.36	
Liabilities to foreign directly related institutions	-.06	.14	-.29	-.48

money-market activities rather than lending activities. Institutions that are part of multi-office U.S. operations of a foreign bank would be likely to be more heavily involved in lending activities, reflecting the broader base of their operations and their wider contacts with loan customers.

The only independent variable derived from the balance sheet itself is absolute size, measured by total assets of an individual institution. The size variable was first assumed to have an effect independent of parent country, and later the effect of a size variable dependent on parent country was tested. This latter estimation was based on the assumption that that size has a different effect on structure of institutions from different countries.[42]

Since New York is the major financial center of the United States, it is expected that location in New York will influence balance-sheet structure, particularly the extent of involvement in money-market activities. There is, however, a strong positive correlation between location in New York and total assets and a strong negative correlation between location in New York and the existence of other offices. Therefore, New York location was not used as an independent variable in conjunction with the size and multi-office variables.[43]

Table A-4 presents regression results for all agencies and branches based on the hypothesis that the variation in each balance-sheet ratio can be explained by parent country, whether or not the reporter is part of a multi-office family, and size. The major country groupings are the same as those used in the body of the paper: namely, Europe, Canada, Japan and Rest of World. Dummy variables have been created for the four country groups, and the existence of a related office in another state. The coefficients for the country variables are simply the individual intercepts for institutions from that country.

The ratio of total loans to total assets is the dependent variable in the first equation. The individual intercepts for Canada and Japan — countries whose banks have been operating in the United States for the longest time — are highest and not significantly different from each other. The European banks, the relatively fast growing newcomers, have the next highest intercept. Banks from the other countries, in large part from the developing countries, have the lowest coefficient, suggesting that these institutions may lack both the resource base for lending and established contacts with multinational firms. As expected, other things being equal, the ratio of loans to total assets tends to be higher when banks are part of

[42]For the cross-section sample used here, estimating a coefficient for total assets specific to each country group did not indicate significant differences in the effect of size among the country groups.

[43]Separate equations were estimated for New York agencies and branches to examine the effect of location in New York, but there does not appear to be any pattern of particular interest. As would be expected, the other office variable is insignificant and the impact of size is smaller.

Table A-4

Agencies and Branches: OLS Estimates for Selected Balance-Sheet Ratios*

Dependent variable (as a fraction of total assets)	Europe	Canada	Japan	Rest of World	Other Offices	Total Assets ($ billion)	DF	R^2
Assets								
Loans	.38 (7.67)	.51 (7.05)	.57 (10.05)	.22 (4.77)	.10 (2.05)	-.20 (-4.49)	167	.25
C & I Loans	.33 (6.82)	.39 (5.44)	.55 (9.84)	.17 (3.60)	.09 (2.04)	-.18 (-4.03)	167	.27
Domestic C & I Loans	.22 (5.02)	.33 (5.16)	.42 (8.55)	.08 (1.90)	.10 (2.37)	-.16 (-4.07)	167	.29
Money-market assets	.43 (9.72)	.19 (2.93)	.17 (3.33)	.37 (8.85)	-.14 (-3.27)	.09 (2.19)	167	.25
Sources of funds								
Net money-market liabilities	-.19 (-2.70)	-.04 (-0.40)	.30 (3.77)	-.16 (-2.46)	.16 (2.44)	-.14 (-2.11)	167	.27
Net liabilities to foreign directly related institutions	.41 (6.83)	.29 (3.26)	.26 (3.73)	.30 (5.31)	-.15 (-2.72)	-.02 (-.34)	167	.09

*The t-ratio is shown in parentheses below each coefficient.

multi-office U.S. operations. Results generally similar to the results for total loans were obtained in the equations for both the C and I loan and domestic C and I loan ratios.

Increased size, as measured by total assets, tends to *reduce* the ratio of loans to total assets, and conversely, increased size tends to *increase* the ratio of money-market to total assets, the dependent variable in the fourth equation shown in Table A-4. For the money-market to total assets ratio, the intercepts for the European and rest-of-the-world institutions, which are not significantly different, are higher than the intercepts for the Canadian and Japanese institutions, which are also not significantly different from each other. As expected, the other office variable has a negative coefficient; in other words, institutions that are the only U.S. office of their parent have a higher proportion of money-market assets.

Insofar as sources of funds are concerned, the equation for net money-market liabilities suggests that, other things equal, Japanese institutions tend to be net borrowers and European institutions tend to be net placers in the domestic money market. Other things equal, increased size tends to make an office a net placer of funds in the domestic money market, while being part of multi-office U.S. operations tends to make an office a net borrower. The ability to explain the variation in net liabilities due to directly related institutions was notably poorer. The country intercepts were positive but not significantly different, and variation in this category was insensitive to institution size. The equation suggests that institutions that are part of multi-office operations and have, therefore, a broader funding base in the United States, rely less heavily on advances from their parent.[44]

Table A-5 shows results (for all agencies and branches) when the ratio of net liabilities due to parent to total assets is added to the set of independent variables.[45] Since advances from their parents are often an important source of funds for the U.S. offices of foreign banks, relative reliance on these funds may have an impact on the distribution of their assets. The net advances from foreign directly related institutions variable has a positive impact on the selected asset categories shown in the table; the impact is about twice as great for the loan categories as for money-market assets, suggesting that institutions which bring in funds from their

[44]One statistical difficulty with the estimates should be noted; specifically, there is a problem of simultaneous equation bias, since total assets and the ratio of particular asset categories to total assets are not determined independently. Consequently, the error term could be correlated with total assets, which violates one of the assumptions of ordinary least squares.

[45]Since this variable nets out assets due from directly related institutions, which is a component of total assets, the scope for simultaneous equations bias is greater than in the previous equations.

Table A-5

Agencies and Branches: OLS Estimates for Selected Asset Ratios*

Dependent variable (as a fraction of total assets)	Europe	Canada	Japan	Rest of World	Other Offices	Total Assets ($ billion)	Net Liabilities to foreign directly related institutions (as a fraction of total assets)	DF	R^2
Loans	.30 (5.52)	.46 (6.25)	.52 (9.04)	.17 (3.36)	.13 (2.68)	-.20 (-4.52)	.19 (3.06)	166	.29
C & I Loans	.27 (5.04)	.35 (4.78)	.51 (8.94)	.13 (2.50)	.12 (2.50)	-.18 (-4.02)	.14 (2.30)	166	.29
Domestic C & I Loans	.15 (3.20)	.28 (4.41)	.38 (7.59)	.03 (.70)	.12 (2.96)	-.16 (-4.08)	.16 (2.87)	166	.32
Money-market assets	.40 (7.96)	.17 (2.51)	.15 (2.83)	.35 (7.68)	-.12 (-2.92)	.09 (2.23)	.08 (1.39)	166	.26

*The t-ratio is shown in parentheses below each coefficient.

parents tend, all other things equal, to have a greater proportion of loans than money-market assets in their portfolios.[46] For all asset categories, the addition of this variable to the set of independent variables lowers all of the country intercepts somewhat compared with the results in Table A-4, since the new equation has captured the positive impact of advances from their parents. The relative country differences and the effects of size remain the same.

No results are shown for subsidiary commercial banks. The sets of independent variables used here could not successfully explain variation in their balance-sheet ratios. This tends to confirm, in a negative way, that their operations are more similar to those of domestic banks than those of the agencies and branches.

[46] Causality may, of course, run in the other direction if institutions with large loan demand request funding from their parent institutions because of difficulties raising funds in domestic markets.

Discussion

Richard E. Caves*

Terrell and Key have provided us with a useful exploratory analysis of the balance sheets of foreign banks' operations in the United States, shedding light on various questions about their motives and the effects of their presence. The behavior described by their data invites interpretation by the armchair analyst. My aim is to relate multinational banking operations in the United States to our knowledge about foreign direct investment in nonfinancial industries. Can the models of foreign investment that have shown predictive power in the nonfinancial sector perform effectively in explaining the evidence cast up by Terrell and Key? If so, what implications result for the further development of multinational banking?

The following model has proved fruitful for explaining the behavior of the manufacturing enterprise that acquires production facilities in foreign markets to produce goods similar to those it makes and sells in its home market.[1] We start from the observation that the enterprise investing in an alien national market is disadvantaged by the very fact of its alien status and resulting lack of familiarity with the economic characteristics, laws, customs, etc. of the foreign market. For it to make a foreign investment in the face of these difficulties, it must hold some intangible asset that yields potential profits for it in the foreign market, and that can be exploited more profitably via foreign investment than by any other method (such as exporting its goods to the foreign market, or entering into a licensing agreement with a local producer). That asset is likely to be some market-oriented skill wrapped up in a trademark, an ability to design and adapt the product to the market's needs, or some proprietary form of marketing-related managerial skill or stock of information. This model correctly predicts that the most foreign investment will occur in industries producing differentiated consumer goods subject to elaborate marketing requirements, or in industries making producer goods which must be tailored to the customer's needs.

This model can be adapted to explain the occurrence of multinational banking. The relevant intangible asset of the potentially multinational bank lies in its established goodwill relations with large commercial and

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[1]See R.E. Caves, "International Corporations: The Industrial Economics of Foreign Investments," *Economica*, 38 (February 1971), 1-27.

industrial customers who are its borrowers and depositors in its home market. For its large steady customers, the bank's package of services amounts to a differentiated product. At a given set of bank charges (interest rates, compensating-balance requirements, etc.), they find its services preferable to those of competing banks, or they would incur transactions costs in making a major switch to another bank. Also, the bank itself possesses a stock of knowledge about the major customer and his business that is valuable and costly to acquire. If a significant number of the bank's steady customers operate in foreign markets and must have their banking needs serviced locally, the bank can maximize the returns to this goodwill by following its major customers abroad. My impression is that the evidence in Terrell's and Key's paper conforms to this model and several of its corollaries.

1. They find that the assets of foreign banking offices in the United States run more to commercial and industrial loans than do those of domestic weekly reporting banks, and that these commercial and industrial customers are often multinational businesses — either domiciled in the foreign bank's home country or U.S. firms with subsidiaries in that country which have dealt extensively with the bank's parent. That prediction flows directly from the explanatory model sketched above. Foreign banking offices should have smaller proportions of assets representing purely domestic business, for which they have no general advantage at competing against domestic banks.

2. The model predicts that foreign investment by banks will flow outward from all countries that are important domiciles of nonfinancial multinational companies, and that multinational banks would "cross-haul" between pairs of major industrial countries, banks in A invading B's market and vice versa. This cross-hauling is also predicted by the product differentiation that the model indicates for the market in banking services. It suggests that the market for banking services would not be perfectly competitive, and that profitable opportunities would exist for entry into a national banking market for a foreign bank that holds established goodwill with a sufficient number of potential customers.

3. The model implies that foreign banks would move into the U.S. market following an inflow of nonfinancial foreign investment in the United States. There thus may be some connection between the increased inflow of nonfinancial investment here since the devaluation of the dollar in 1971 and the inflow of European banks. Consistent with the model, the banks' influx may also be related to the increased borrowing abroad by U.S. multinationals and their foreign subsidiaries during the 1960s, in response to U.S. balance-of-payments policies. This borrowing may have forged the goodwill links that now give foreign offices a crack at the business of the U.S. parents.

4. I suggested that the differentiated goodwill asset of the foreign banks is associated with net lending transactions with large commercial and industrial customers, and not with the net collection of deposits (say, to service loan customers in their home markets). Consistent with that

proposition is the finding of Terrell and Key that a high ratio of commercial and industrial loans to money-market assets is associated with a high level of liabilities to related institutions abroad. That is, the more success a foreign office has in finding customers for commercial and industrial loans, the more funds does it bring in from its foreign parent to supply this demand.

5. The model is consistent with multinational banking serving as a method of arbitraging funds between national capital markets, but it implies that such movements would not be the core of the activity of a foreign banking office. This arbitrage does appear in Terrell's and Key's statistics: Japanese banks are net borrowers in the U.S. money market and European banks are net placers — a pattern one would expect from casual knowledge of the tightness of their domestic funds markets. But these movements, as predicted, do not account for enormous proportions of their activities.

6. The model of the multinational enterprise predicts many differences between the subsidiary and an otherwise similar firm that operates in a single national market. One of these is a greater diversity in the structure of the subsidiary's activities (asset and liability structure, in the case of a bank), because the subsidiary functions as a component of its parent's strategy for maximizing global profits, and thus will complement the parent's activities in other national markets. Consistent with this prediction, Terrell and Key report a greater variability of the asset and liability structures of foreign banking offices than of the weekly reporting banks. The special-purpose branches and agencies naturally show more variability than the general-purpose subsidiaries.

7. The model predicts that the multinational bank enters the U.S. banking market on the basis of its goodwill assets with large commercial and industrial customers. However, if it succeeds initially, it is likely to mature into a pattern of activity more nearly resembling those found most profitable by its large domestic competitors. It should look less different from them as it grows older. Terrell and Key document this process in the foreign offices' decreasing reliance on foreign liabilities and gravitation (if permitted by their legal forms) to a liability structure more closely resembling those of their domestic competitors. This shift is evident in the greater shares of deposits being captured by the foreign offices in their principal state markets.

8. A multinational company can be viewed as a multiplant firm that happens to find some of its plants separated by national boundaries. That is, the advantages of the multinational company may to some extent be simply those of the multiplant firm over the single-plant firm. In the case of banking, nonprice competition in the capture of deposits is a factor contributing to the profitability of branch operations. The retail activities of foreign banks' subsidiaries in the United States can be expected to fill the role of pursuing deposit liabilities, and Terrell and Key correspondingly show that banks with multistate operations are less dependent on liabilities to related foreign institutions than are single-state foreign banks. That is, multiunit operations increase self-sufficiency in attracting deposit liabilities.

9. The explanation of multinational bank operations offered here neglects portfolio balancing and the spreading of foreign-exchange risks as a motive for foreign investment by banks, although it has been advanced as a motive for foreign investment generally.[2] If risk-spreading plays a significant role, the net position of the foreign offices in money-market assets should be associated with the worldwide management of exchange-rate and "country" risk by its parent. Terrell and Key note the importance of money-market assets to the foreign offices and suggest that they take preference over Euro-dollar placements because of the lack of "country risk." It might be better to regard them in the larger context of the foreign parent banks' risk management, although the distinction cannot be tested with the data we now have at hand.

I have argued that multinational banking fits rather well into an established model of foreign direct investment originally devised for nonfinancial multinational companies. My purpose has been not so much to argue the universal validity of that model as to suggest that multinational banking can be usefully thought of as a process of market competition among banking institutions. Because the model does display some explanatory power, however, it is useful to draw out its implications. It identifies foreign investment in banking as a form of market rivalry in an imperfectly competitive market, and thus the increased competition mentioned by Terrell and Key is an expected outcome. It indicates that the international arbitrage of liquid funds from easy-money countries to tight-money countries is not a necessary function for explaining multinational banking; multinational banks are likely to lubricate international capital flows, but such general arbitrage is not vital for their existence. Finally, the model indicates that cross-hauling of multinational banking operations is a natural phenomenon, likely to intensify as long as similar interpenetration continues in nonfinancial markets. Governments (such as Canada) which sharply restrict entry by foreign banks are therefore likely to find themselves under increased pressure for fair reciprocal treatment.

[2]By R.Z. Aliber in *The International Corporation*, ed. Charles P. Kindleberger (Cambridge: M.I.T. Press, 1970), Chapter 1.

Central Banks as Regulators and Lenders of Last Resort in an International Context: A View from the United States

Henry C. Wallich*

The term "lender of last resort" implies a degree of specificity which goes beyond what that function can legitimately claim. I have never seen, in visits to central banks, a door marked "lender-of-last-resort department," nor met a vice-president in charge of such an activity.

It is true that there are situations in which the function of a central bank is properly described as lender of last resort. It is true also that a market looks to a lender of last resort, functions better when it knows that there is one, and will try to push some existing institution into that role if none has been appointed by higher authority.

At the same time, markets as well as central bankers know that it is unwise to hoist crisis signals before the condition becomes obvious. Neither market stability nor the credit standing of particular institutions has much to gain from the widespread advertising of a lender-of-last-resort operation. But since concealment also is not an acceptable policy, the part of wisdom often has been not to draw a finer line than circumstances require between what is "last resort" and what is not.

My comments here will deal for the most part with Federal Reserve activities and powers.

Federal Reserve Powers

To meet its lender-of-last-resort responsibilities, the Federal Reserve has a variety of powers that reflect, at least in some measure, the variety of cases that may call these responsibilities into action. For a generalized lack of liquidity, open market powers and the ordinary facilities of the discount window are appropriate. A generalized lack of liquidity has been the characteristic feature of some historic crises that were met by central banks and, in line with Bagehot's rule, were dealt with by lending freely at a high rate. These crises sometimes focused on the failure or near failure of some major firm while in others there was no obvious single focus. The common denominator, however, was that firms perfectly solvent and under ordinary circumstances liquid, both banks and nonbanks, were unable to obtain short-term credit at almost any price. The famous British

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crises of 1867--Overend Gureny--and 1890--Baring Brothers--as well as the U.S. panic of 1907 were of that character. The last named experience finally led to the creation of the Federal Reserve.

A potential crisis of this same type that was successfully forestalled by lender-of-last-resort action was the Penn Central failure in 1970. At that time it appeared that this failure might interfere with the rollover of commercial paper by certain finance companies.

The Federal Reserve assisted a shift of finance company debt to the banks — both by granting liberalized discount window credit to the particular banks involved (under the emergency provisions of Regulation A) and by suspending the Regulation Q ceiling on 30-89 day CDs, enabling such banks to raise funds through the market.[1] These System initiatives provided needed reassurance to the financial community and helped to halt the general scramble of commercial-paper investors for higher-quality assets. At the height of the crisis, special System advances to facilitate transfers out of commercial paper rose to about $500 million, but by early fall these had been largely repaid.

The specialized emergency lending powers of the Federal Reserve are appropriate particularly for the case where illiquidity focuses upon a particular institution without spreading to the rest of the market. Here the Federal Reserve can supply credit to member banks for maturities of not more than four months and where the credit is secured to the Reserve Bank's satisfaction, at a rate at least one-half percent above the discount rate if the collateral offered is not eligible for discounting at the regular rate. For others (i.e., individuals, partnerships, and corporations that are not member banks) the Federal Reserve can, in unusual and exigent circumstances, by the affirmative vote of not less than five members of the Federal Reserve Board, provide emergency credit. Rates on such credit would be set by the Board of Governors at the time credit was granted. To qualify for such credit, the party in liquidity straits must be unable to secure adequate credit from other banking institutions.

The foregoing provisions provide broad powers to deal with liquidity problems of particular institutions. It should be noted, however, that all types of discounts and advances must be secured by assets and in the manner specified in the Act and the regulations or "to the satisfaction of the Federal Reserve Bank," i.e., to the satisfaction of the Directors of the Federal Reserve Bank making the loan. The requirement that Federal Reserve credit must be secured has meant, in terms of the Board's policies to date, that Federal Reserve lending to any bank can continue only so long as that bank is solvent; the reason for the Board's view has been that collateral obtained from a bank in a state of insolvency might be exposed to legal challenge. Reasonable questions can be asked whether insistence on

[1]Under Section 201.2(e) of Regulation A: "Federal Reserve credit is available to assist member banks in unusual and exigent circumstances such as may result from national, regional, or local difficulties, or from exceptional circumstances involving only a particular member bank."

solvency, a criterion which at critical times may be very difficult to apply, really best serves the public interest. I shall nevertheless rest my following discussion on the policies that are in effect at present with regard to the solvency issue.

Illiquidity Versus Insolvency

Power to deal with insolvency situations is in the hands of the Federal Deposit Insurance Corporation (FDIC). The FDIC, as insurer, can accept a loss. Frequently the FDIC finds it less costly to deal with an insolvency by subsidizing a merger or arranging the transfer of the deposits and the sound part of the assets to another bank through a "purchase and assumption" operation, rather than to pay off the insured depositors and liquidate the closed bank. Considerations relating to the welfare of the local community also apply in decisions whether a bank should be saved or wound up.

This dualism of functions and powers between the Federal Reserve and the FDIC is neater, to be sure, than the real world in which illiquidity and insolvency may in some cases be separable, and in other cases may merge. A bank or any other firm may be illiquid but not insolvent. Nevertheless, if illiquidity leads to a run and to the liquidation of assets at distress prices, insolvency may follow. Likewise, an institution may be insolvent but not illiquid. However, as soon as this situation is diagnosed, the bank is likely to be closed by the regulatory authorities to protect the creditors.

An institutional division of different types of rescue functions, such as exists in the United States, prevails only in a limited number of countries. Elsewhere, the central bank as lender of last resort may find it necessary to deal with the distinction between illiquidity and insolvency in a more ad hoc manner.

Interaction of illiquidity and insolvency as presently interpreted is well illustrated by the case of Franklin National Bank. While the Comptroller of the Currency had declared Franklin to be solvent, the Federal Reserve loaned Franklin, on a secured basis, up to about $1.7 billion. When solvency could no longer be assured, Franklin, under the auspices of the FDIC, was taken over by the bank that had put in the highest bid while the FDIC took over the Federal Reserve loan and that part of the assets not going to the merging bank.

The question is sometimes raised whether banks should be allowed to fail. That is not a meaningful issue. Even the most intensive supervision cannot make sure that no bank will ever suffer losses large enough to wipe out its capital. As far as the stockholders and management are concerned, the bank then has failed. The real question is whether the depositors and other creditors, and in a broader sense the monetary system and borrowers dependent on their banking connection, should be allowed to suffer the consequences. The answer may well have to depend on such

circumstances as the availability of alternative sources of credit in particular regions or local communities. Giving too much advance assurance to management, stockholders, and depositors risks losing some of the discipline of the market upon which regulators rely to some extent to keep banks "in line." Proponents of 100 percent liability insurance must keep this in mind. So must lenders of last resort. In this imperfect world, perfect safety is not an ideal condition. Regulators, central bankers and insurers would soon find the odds they had created being exploited against them. In response, they might find themselves driven to regulate and supervise bank operations to a degree inconsistent with the free flow of credit.

International Aspects

The growing internationalization of banking adds new dimensions to regulatory and lender-of-last-resort responsibilities. National legislation, regulations, and supervisory practices differ widely among countries. Nobody would dream of trying to coordinate laws and practices internationally, but increasing regulatory cooperation is possible, and considerable progress has been made. Regulators meet regularly, under the auspices of the BIS and otherwise. The result has been a better understanding of one another's problems and interests, as well as cooperative policies with respect to particular issues.

The matrix of international banking relationships has been expanded as a result of the growth not only of old established national markets, but through the appearance of new banking centers, frequently referred to as offshore centers. As regards regulation, practices among these centers range widely from technically competent and tight regulation and supervision to virtual nonexistence of such efforts. As far as lender-of-last-resort facilities are concerned, it is, of course, very difficult and often impossible for small political entities to exert such a function.

Accordingly, bank regulators and lenders of last resort will find themselves involved in different degree in the activities of their banks abroad. In the case of the United States, the foreign activities of banks and bank holding companies are closely supervised. Bank holding companies and banks need the approval of the Federal Reserve for foreign acquisitions and branches, and with regard to the nature of the activities conducted overseas. Foreign branches are examined by the Comptroller of the Currency and the Federal Reserve except in a limited number of countries where national laws bar such access. Where regulatory and supervisory laws and institutions exist, as is the case in all countries with significant domestic banking activity, it is, of course, the national authority that is the primary regulator and supervisor within its borders. Because of the special characteristic of American bank examination, which focuses upon appraising the quality of assets in a way few other supervisory systems do, reliance on local banking authorities for the direct supervision of foreign branches and subsidiaries has not yet occurred.

International banking also raises the question of lender-of-last-resort responsibility. Today, that responsibility is exercised in a framework of floating exchange rates. This eliminates one of the problems that have beset lending of last resort and that have led to probably the most spectacular failures to live up to that responsibility. I would count among those failures the unwillingness of the Reichsbank to go to the aid of its banking system in 1931, and the failure of the Federal Reserve to deal with the mass failures of American banks during the depression of the 1930s. In both cases, the constraints of the gold standard impeded, by the lights of those days, action that might have forestalled the respective crises. I would not, today, belittle the very real concerns of those who had to make traumatic decisions in those days. The Reichsbank feared that Germany's international credit would be destroyed if it violated its 40 percent gold cover requirement. The Federal Reserve had no means of knowing that the Supreme Court would some day invalidate the gold clause and in that way avoid the consequences, for many borrowers, of a departure from gold. Nor would I argue that all the superior wisdom is on the side of our days. We have not done well enough in managing paper money to be able to claim that. All I want to say is that today we do not operate under the constraints which, 45 years ago, helped to produce major financial failures.

The multiplicity of possibilities and national circumstances makes it obvious that no general rule can be established for a particular course of action in case of a banking crisis that was not of purely local character. The problem, if it were to arise, could be market-wide or focused on a single institution. It could be a problem of liquidity or of solvency or of both. It could occur in a market with a strong central bank and regulatory system, or in a center where neither exists. It could focus on the home currency, or upon the dollar and other currencies.

The need for concerted action in such a case nevertheless was recognized by the central bankers who meet monthly at the BIS in Basel. After careful examination of the issues, the central bankers arrived at the same conclusion that I have just indicated: that detailed rules and procedures could not be laid down in advance. But since considerable concern existed at that time about the state of the Eurocurrency markets, the following statement was issued: "The Governors . . .had an exchange of views on the problem of the lender of last resort in the Euro-markets. They recognized that it would not be practical to lay down in advance detailed rules and procedures for the provision of temporary liquidity. But they were satisfied that means are available for that purpose and will be used if and when necessary."

This approach reflects the experience also that the Federal Reserve has had in handling its own lender-of-last-resort responsibility. There are dangers in trying to define and publicize specific rules for emergency assistance to troubled banks, notably the possibility of causing undue reliance on such facilities and possible relaxation of needed caution on the part of

all market participants. The Federal Reserve has always avoided comprehensive statements of conditions for its assistance to member banks. Emergency assistance is inherently a process of negotiation and judgment, with a range of possible actions varying with certain circumstances and need. Therefore, a predetermined set of conditions for emergency lending would be inappropriate.

In the international field, extensive discussions of the role of host and home country central banks for extensions of emergency assistance to subsidiary and multinational financial institutions have produced a common understanding of the problem. Cooperation among central banks is clearly necessary. No central bank can avoid some degree of responsibility for events in its market. No central bank can disinterest itself in the international activities of the banks for which it is responsible at home.

An important aspect of the close cooperation among central bankers and other regulators is being implemented through central bankers' meetings at Basel and through a regulators' committee which meets periodically at other times. There can be no question, of course, of making national legislation homogeneous. The differences are too deeply rooted for that. What is possible is to develop a close understanding of the expectations, intentions, and *modi operandi* of different countries and to make them mesh. That is being achieved through institutions like those under the aegis of the BIS.

Cooperation

Cooperation is particularly important where the supervisory and lender-of-last-resort responsibilities are different. Countries meet in one market increasingly frequently owing to the internationalization of banking. As far as regulation is concerned, the role of the local regulator, in most cases the central bank, under present conditions is bound to be major. The local regulator charters and supervises foreign subsidiaries and joint ventures and where local legislation so provides, examines them. Foreign supervisors and regulators have different degrees of access to local offices of branches, subsidiaries, and joint ventures of banks and bank holding companies of their own countries, depending on local legislation.

Under these circumstances, the local regulatory authority inevitably has a concern with the liquidity and solvency of banks under its jurisdiction. The financial resolution of both types of problems, of course, is in the first instance a concern of the parent organization. For branches this goes without saying, since they are an integral part of a banking organization. For wholly owned subsidiaries, parents have historically demonstrated a strong sense of responsibility. Banks do not cast their foreign operations in the form of subsidiaries rather than branches in order to take advantage of limited liability. Nor would such subsidiaries be able to operate on a large scale if the market suspected that in case of trouble the parent would walk away from them. These foreign operations are cast in the form of subsidiaries rather than of branches principally because in

that form they enjoy broader powers, better tax status, and greater operating flexibility.

Parents, therefore, expect to back their subsidiaries, even though ultimately that must be a business decision and where the regulatory framework so provides, a decision of the regulatory authorities of the parent as well as, of course, of the host country regulator. This is one of the reasons for the Federal Reserve's requirements that adequate financial data for both branches and subsidiaries abroad be kept and made available to examiners in the United States.

As far as American banks are concerned, the great bulk of foreign operations, in dollar terms, is carried out through branches. Subsidiaries typically are small relative to the size of their parents, and usually well capitalized except in the special case of shell organizations.

Minority participations, accompanied by a management interest, so-called joint ventures, are usually those of large banks which historically have shown readiness to back their offspring, although they may want to limit their support to their own share in the venture. The Federal Reserve, in an interpretation issued in 1976, has made clear that for American banks, which by law must obtain Board approval for this as any other type of acquisition, the Board would take into account the ability of the applicant to support more than its own share in a joint venture. The Board also said that it would give great weight to the potential risks in cases where the joint venture was closely identified with its American parent by name or through managerial relationships.

The Evolving Role of the IMF

This talk has been burdened by much technical detail. I would like to end it by taking a broader and more evolutionary look at the lender-of-last-resort problem. It has often been pointed out that the function of the International Monetary Fund in helping countries in balance-of-payments difficulties has some of the characteristics of a lender-of-last-resort operation. In the course of time, this role of the IMF may expand. It is important to note where the similarities and the differences are likely to manifest themselves.

Central bank lending to money markets for particular banks in crisis conditions and IMF lending to national governments have in common that the objective is mainly to protect the monetary system, rather than to help individual banks. Neither should engage in bail-out operations for banks.

The Fund's ability to help countries with balance-of-payments problems, however, depends on the willingness of the borrowing country to meet the Fund's policy conditions. It is not an unconditional form of assistance. For that reason, banks that have lent to a country cannot take for granted that the Fund will come to the country's rescue.

An important difference between central bank and IMF lending is that the IMF, unlike central banks, need not and should not wait for a

crisis to develop. In fact, the earlier a country applies for assistance to the IMF in the upper tranches, the sooner a set of policies will be in place that should help the country overcome its difficulties. In that sense, the IMF need not be a lender of last resort.

The IMF role in imposing conditionality and guiding the policies of the borrowing country finds a counterpart in the regulatory activities of central banks. Good national policies, like sound banking policies, should reduce greatly, if not altogether eliminate, the need for lender-of-last-resort activity.

Still another difference between the lending of the IMF and the classical lender-of-last-resort operation may be noted: the Fund's normal technique is not to lend freely at a high rate, but on the contrary to pay out limited funds on a phased basis upon a showing that performance criteria are being met.

These differences reflect, of course, the inherent distinction between a country borrower and a money market or single bank. A country is inherently a stronger debtor, not because it controls a printing press, but because adequate policies will make it possible to pay except perhaps temporarily in the direst of circumstances. A country cannot go out of business after the manner of a bank or other business enterprise. Solvency is represented by the existence of the political will to deal with economic difficulties.

Given the great potentialities of the IMF's role, its further strengthening is obviously desirable. This is currently underway through the proposed Witteveen facility, and through quota increases already decided and still to be decided. More adequate resources will not only enable the Fund to meet better such needs as may arise, but also to be more effective in influencing the policies of borrowing countries and in that manner enhance the willingness to lend of the private market. In that sense, too, the activities of the Fund could come to constitute a parallel to those of national lenders of last resort — to create conditions of confidence in which the private market can again function adequately.

Discussion

Donald R. Hodgman*

Governor Henry Wallich's paper provides a narrow and circumspect view from the United States of the role of central banks as regulators and lenders of last resort. Presumably such cautious treatment reflects the weight of responsibility borne by a Governor of the Federal Reserve System not to undermine the central bank's effectiveness by stipulating its tactics in advance of their use nor to spread panic by viewing with alarm. It may also reflect a certain modesty concerning the role of the central bank in the formulation of national economic policy.

In his paper Governor Wallich touches on a variety of themes principal among which are the limits to the Federal Reserve's legal powers to provide assistance to meet the threat of illiquidity, the complementary role of the Federal Deposit Insurance Corporation in cases of insolvency, the presumed greater freedom of a central bank to provide liquidity when exchange rates are floating (Is this equally true when rates are managed?), the inevitable intertwining of the responsibilities of different national central banks and thus the need for cooperation, and the useful conditionality of IMF loans in influencing borrowing countries to adopt more creditworthy national economic policies.

Most of these observations and reflections can be accepted. But they do not meet the challenges which developments in international banking are posing for commercial bankers, central bankers, and national authorities.

The central problem is how to cope with the implications of the greatly expanded role of commercial banks in managing international capital flows at a time when these flows themselves have greatly increased in volume due to the activities of OPEC and the needs of the less developed countries. What is unique is the degree to which microeconomic commercial interests have become intertwined with national macroeconomic and political issues. Bankers have responded more promptly and flexibly to channel funds from capital surplus to capital deficit nations than have national governments or international organizations. The difficulty with this situation is that bankers cannot cope with the attendant macroeconomic issues involved. Among these issues are the balance-of-payments problems of borrowing nations, the stability of the Eurocurrency market and the international financial system, the risk exposure of national banking systems, and the effects of capital flows on national monetary and

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credit conditions and exchange rates. These macroeconomic phenomena provide the environment for the microeconomic activities of commercial bankers. It is myopic and unrealistic for a central bank to conceive its responsibilities toward international banking as limited to the role of lender of last resort, cautiously defined, and to the microeconomic aspects of bank regulation.

Governor Wallich's paper says little about the role of the Federal Reserve Board as regulator in an international environment. He notes the diversity of national regulatory codes and of the extent of national supervisory efforts — a diversity which recommends "cooperation" among national authorities. He does not explore the nature of such cooperation nor of the regulatory objectives to be served.

What should the U.S. central bank's regulatory objectives be in an international banking context? Here is a suggested list of concerns: First, the soundness of banks which influence its domestic economy including activities of U.S. banks abroad and commitments of U.S. banks to foreigners as well as activities of foreign banks in the United States. Second, equity of regulatory treatment of U.S. and foreign banks. Third, the influence of the international activities of U.S. banks and of foreign banks located in the United States on the effectiveness of U.S. monetary and credit policy. Fourth, the effects of U.S. offshore banking on monetary and credit conditions in other countries. This last point would involve a degree of multilateral international monetary cooperation that is far beyond the level of current achievement. A fifth objective of regulation, broadly viewed, is to strengthen the international financial system by preventing the overexposure of banks to illiquidity and insolvency leading possibly to international financial panic and eventually to increased reliance on national exchange controls. Regulatory supervision alone clearly cannot achieve most of these objectives, so that a narrow focus on regulation does not constitute an adequate response to the problems at hand.

It may be the part of wisdom for prominent central bankers to refrain from public discussion of the dangers to national and international banking and the international monetary system that can accompany the failure of one or more major banks. But surely participants in a conference devoted to international banking and the related responsibilities of central banks would be remiss to ignore this problem.

Suppose an important public sector borrower in a less developed country defaults. Indeed, can such a borrower be permitted to default? Options for the national authorities of the creditor nations include guaranteeing interest payments while rescheduling repayment of the principal, assumption of the defaulted loan to relieve banks of the burden, and imposition of unilateral or multilateral sanctions against the nation in default. What are the national and international economic consequences of such actions? The political consequences? How far are central banks prepared or authorized to go in dealing with such contingencies? At what point does broader governmental responsibility supplant or replace central bank responsibility? How does the character of government intervention

affect the allocation of the creditor nation's loss of real resources among domestic groups and individuals? These are some of the difficult problems that need to be addressed.

Increased roles in international lending for the IMF, World Bank, OECD or other international agencies may elevate negotiations between borrowers and lenders from a commercial to an official level. But this does nothing to reduce the scale of the capital transfer problem within the international economy. The chief hope of this approach is to require governments of debtor nations to adopt more effective national economic policies. An increased role for international lending agencies also spreads the risk among contributing nations and thus has an actuarial insurance feature for creditors.

Governor Wallich confines his discussion to more conventional regulatory and lender-of-last-resort functions of a central bank in the Federal Reserve tradition. My purpose is to stress that this approach does not suffice to meet today's needs for public policy in the sphere of international banking. Needed is greater attention to the international macroeconomic environment for commercial banking and greater reliance on intergovernmental policy cooperation to regulate that environment.

Central Banks as Regulators and Lenders of Last Resort in an International Context: A View from theUnited Kingdom

C.W. McMahon*

The implications of national sovereignty constitute a characteristic, and evolving, twentieth century problem. The nation-state, developed over previous centuries, has proved capable of horrific abuse; but at its best it has produced a legal, administrative, economic and financial framework in which its citizens have been able to prosper as never before. A natural counterpart of these developments was the emergence of at least potential conflicts with the world outside; and it has been common for people, in attempting to reconcile these conflicts or solve the problems they pose, to draw on successful domestic national experience and suggest that this should be analogically extended beyond the frontier.

There have been various kinds of challenge posed this century to the competence of a single nation-state to solve its problems alone. First, political conflicts with other nation-states, of which the first and most spectacular example was the 1914-18 war. Secondly, economic conflicts with other nation-states — particularly virulent between the wars when many countries suffered the intended or unintended effects of other countries' tariff regimes, exchange-rate movements and fiscal and monetary policies. Thirdly, and especially in the last two decades, there has been the dramatic development of private institutions large enough to affect the economic sovereignty of even quite major countries — the multinational companies and banks.

It has been tempting to many people to meet these different demonstrations of the limitation of the power of the single state by trying to envisage and bring about the development of a sovereignty over and above that of individual nations. Many saw in the League of Nations idea the germ of world government; some, though probably fewer, initially held the same hopes of the United Nations. During the last war, and at the Bretton Woods talks towards its close, there were those who hoped to develop a genuine world central bank. Later, and on a less than fully international scale, the European Economic Community was founded with the

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intention of many that it would ultimately result in full pooling of political and economic sovereignty by its members.

Clearly, there has been little progress in any of these fields, if progress is to be measured against an ideal of the creation of truly supranational institutions. Indeed in some areas, measured against this yardstick, we may be represented as having moved backward; the full membership of the International Monetary Fund (IMF) was unable in the early 1970s to produce anything nearly as systematic in the international monetary field as had been developed under an Anglo-American hegemony in 1944.

In my view, however, this is a misleading way to look at what has been happening. Progress there probably has been in most areas of international politics and economics; and in some it has been striking. But to perceive it, and indeed to further it, we must accept as a fact, now and for the foreseeable future, that nations are not going irrevocably to hand over power to an autonomous international institution. There is unlikely for a very long time to be anything which would be called a world government, a world department of trade, or a world central bank — as money creator, financial regulator or lender of last resort. Progress has been made in the rather different direction of mutual awareness, of a willingness to cooperate, agreement on rules of behaviour, developing and sharing information.

Thus, to come to the point of the present paper, it would be unwise to look for the development of a single uniform method of regulating banks and financial institutions, applying across all frontiers, or a single last-resort window with well-defined policies and the ability to carry them out. It would be equally unwise to be concerned simply because such institutions do not exist and to fear — on that ground — international monetary disaster. It seems preferable to start with the world as we have it — made up of countries with widely divergent laws, customs and procedures, and banks and other financial institutions based in one country but operating throughout the world to create a major international capital market; and then consider the contingencies it is necessary to guard against and the extent to which they are guarded against in practice. I am going to attempt to deal with my subject in this way, taking in turn actual or potential problems in international financial markets and saying something about how central banks are handling them.

Perhaps stretching my terms of reference — or the word "regulator" — a little, I shall first touch on two areas with broad economic policy implications before coming to the traditional lender-of-last-resort area of potential liquidity shortage and prudential control.

Regulation in the Interests of Broad Monetary and Economic Policy

It is sometimes suggested that the international markets constitute an unregulated autonomous source of at least potential inflationary or deflationary pressure on the world economy. For a number of reasons I think this view misleading and the fears exaggerated.

First, it is misleading to think of the international markets as if they were basically separate from domestic markets. Indeed, it is nearer the truth to think of them as simply an extension of domestic markets. Much international lending is in fact conducted in domestic currencies — particularly dollars, deutsche marks, and Swiss francs. Moreover, Eurocurrency lending proper is, of course, highly substitutable for domestic currency lending. The volume of such lending is, as we have seen over the past couple of years, closely (inversely) linked with the demand for credit in industrialized countries. Similarly, changes in domestic interest rates — primarily in the United States — are reflected fairly directly in coupons, yields and to some extent spreads, in the international markets.

Secondly, the Euromarkets themselves have acted largely as a transmission mechanism for the flow of international funds, rather than as an independent creator or source of monetary disturbance. Deposits underpinning the Euromarkets are held in the country of issue of the currency concerned — e.g., the Eurodollar market is backed by holdings of reserves in the form of dollar deposits with banks in the United States. The ability of Eurobanks to attract claims on U.S. banks will be dependent on monetary conditions in the U.S. domestic market. A tightening of domestic markets will cause a flow of funds into the United States from the Euromarkets and vice versa. The sensitivity of Eurodollar deposits to U.S. domestic rates means that Eurobanks carry substantial reserves (dollar deposits with U.S. banks), limiting the market's credit-creating ability.

Another feature of the Eurocurrency market indicating a much smaller credit multiplier than might be found in a domestic banking system is the large number of "leakages" from the Eurocurrency markets. These "leakages" might occur when, for instance, a final borrower from the Euromarket makes payments, using the proceeds of the loan, to the country of issue of the currency in question. A "leakage" may also occur if the proceeds of a Eurocurrency loan, say a dollar loan, are converted into the domestic currency of the borrower and the ultimate dollar holder chooses not to redeposit in the Eurodollar market. The scope for leakages is very much greater in a Euromarket context than in a domestic banking market; the multiplier will be correspondingly smaller as a result.

Furthermore, the close matching of assets and liabilities which is a feature of the Eurocurrency markets stands in sharp contrast to the situation typical of domestic markets, where a comparatively stable short-term deposit base permits a considerable lengthening of asset maturities. This close Eurocurrency matching is reflected in substantial inter-bank activity which gives rise to a "pyramiding" of deposits but a low degree of transformation.

All of the features I have just mentioned lead me to believe that the Eurocredit multiplier is quite small. What is more, whether Eurocurrency market growth constitutes a net addition to world credit will depend largely on the response of national authorities to the impact of Eurocurrency flows on domestic credit markets. Depending on whether national authorities act to offset changes in domestic bank liquidity in the

wake of an inflow or outflow of Eurocurrency, the credit extended through the Euromarkets would tend to be, at least in part, a substitute for domestic credit rather than a net addition to total world credit.

It is open to countries to limit very sharply the exposure of their monetary systems to strictly Eurocurrency movements. In the United Kingdom, as in many countries, the foreign-exchange operations of the banks are regulated quite tightly by means of limits on open positions. Because of these, the monetary consequences of shifts between switched-in and switched-out positions are marginal compared with those of total short-term flows. The problems caused by total external flows are of course quite a different matter, for which the presence or absence of any form of bank regulation is irrelevant.

For all these reasons there does not seem to me a case for attempting to construct any form of specifically international form of regulation of the volume of credit in the international markets through international reserve requirements, etc. And this is quite apart from the enormous practical difficulties that would be involved in doing so; and the likelihood that any move in this direction would be likely to drive the markets into unregulated areas with a consequential increase in prudential problems.

There has in fact been much less cry for international credit regulation of the Euromarkets in the past few years than there was earlier, perhaps because of the obviously important and indispensable role they have had to play in recycling the oil surpluses. However, as the international banking system has moved rather dramatically into the business of balance-of-payments financing, a new set of questions has begun to be asked. To what extent is the role of the IMF being usurped; and how far is the appropriate working of the international adjustment process being distorted or prevented? Should, for example, central banks seek to discourage banks for which they are responsible from lending too readily either to countries who would otherwise have to go to the IMF, or to countries which have already agreed on an adjustment programme with the Fund, but on the basis of specified amounts of private capital inflows? Conversely, should central banks seek actively to promote formal co-financing arrangements between the commercial banks and the IMF?

Full consideration of these important and topical questions would take us too far afield. I would simply say here that attractive as some of these ideas may seem in the occasional particular context, they bristle with difficulties. Such an activist role for bank supervisors would certainly run counter to the regulatory traditions in many countries, including my own. Quite apart from the serious political implications of such proposals, it would surely be wrong for official pressure on soundly run banks to lend or not to lend to particular borrowers seriously to limit the banks' freedom to make their own creditworthiness judgments (within, of course, the bounds of legal loan limits where they exist). The main thrust of official efforts in connection with the adjustment process ought thus, I think, to remain where it is, particularly if one makes the reasonable assumption that governmental efforts to give the IMF enough lendable resources will

be successful. For their part, the central banks should try to ensure that adequate information is available so that all the banks involved can make their loan judgments on the same basis. (I shall have more to say on this below.) It would be ironic if, after resisting domestic pressure for selective credit controls, the regulatory authorities of the G.10 countries[1] moved towards them in the international field. I would prefer to check any excesses by relying on the effect on commercial bank attitudes of continuing close general regulatory interest in their international lending.

Prudential Regulation

The prudential or lender-of-last-resort function of a central monetary authority, whether domestically or internationally, is to prevent the potentially very dangerous consequences which can flow from a sudden shortage or illiquidity, either localized or general. If the liquidity shortage actually arises, the classical remedy is, of course, to lend freely at a penal rate. In practice, however, the aim must be to prevent matters ever coming to that point: prevention is a great deal better than cure.

In the international context, as in the domestic, the development of preventative prudential control has had three aspects:

(a) the supervision, regulation and monitoring of banks' positions to minimize the danger of individual default or imprudence;

(b) the production and dissemination of information to improve the ability of banks to make appropriate judgments and decisions and guard as far as possible against surprise;

(c) instillation of the *appropriate* degree of confidence in the private banking sector about the way in which the authorities concerned will act if a crisis should occur: appropriate, in the sense of promoting neither euphoria nor unease.

We may take these aspects in turn.

(a) *Supervision.* The problem of supervision in the international context arises from differences in the laws, regulations and practices between countries. In principle, these variations could lead to conflicting decisions, misunderstanding or lacunae of regulation in cases where banks are operating directly, or through branches or subsidiaries, in several countries. It is clearly impossible to harmonize everyone's laws and regulations: and indeed it would be undesirable, a case of the tail wagging the dog, for the framework of law, administration

[1]The G.10 countries are Belgium, Canada, France, Italy, Japan, the Netherlands, Sweden, the United Kingdom, the United States and West Germany.

and custom within which banks work in their own country is likely to be deeply related to the wider legal, social and economic framework and traditions of the countries concerned.

The approach that has been followed, therefore, has been one of co-operation and coordination between the national authorities concerned. This has been greatly stepped up in the past two or three years. The loss of confidence in international markets in the summer of 1974 led first to an increase in cooperation between the national authorities in the area of foreign-exchange trading. This developed into the establishment by the Central Bank Governors of the Group of Ten of the Standing Committee of Experts under the chairmanship of my colleague, George Blunden. Their remit was not to produce new, harmonized, sets of regulations; but, as the Governors put it, to learn from each other — both exactly how each other's systems worked in detail so as to become aware of potential areas of difficulty, and how individual arrangements in one country might be modified or improved in the light of ideas and experience in others. There is also another, informal, group of supervisors which concerns itself with day-to-day supervisory questions and specific individual problems.

These committees have made a great deal of progress. Probably all the countries concerned can now point to improvements introduced, directly or indirectly as a result of their discussions. All would testify to an improvement in the capacity for rapid consultation and the devising of appropriate internationally agreed action, if problems should arise. Some detail of the progress that has been made can be found in a speech given by Mr. Blunden to the International Banking Summer School in June this year and reproduced in the Bank of England Quarterly Bulletin for September 1977. Much, of course, remains to be done; and Mr. Blunden suggests that perhaps the most intractable problems his Committee has faced have arisen from differences in the ways that responsibility is delegated between regulators in different countries.

In terms of specific regulation and monitoring procedures, many countries have tightened and improved their regulations over the permitted foreign-exchange operations and positions of their banks since the exchange losses of Herstatt and other banks in 1974. The Bank of England has for a number of years now run (and published) a quarterly maturity analysis of the Eurocurrency operations of all banks operating in London. While we do not lay down any forms of liquidity ratios, we look very closely at the degree of maturity matching for every bank. Any unusual figures, or changes from quarter to quarter, are discussed individually with the bank concerned.

(b) *Information.* It is a commonplace that competition can only function soundly and efficiently on the basis of adequate, publicly shared, information. Over recent years we have taken a number of steps to improve the information available to the banks about the international markets. I have just mentioned the Eurocurrency maturity analysis. In addition there has been much development of the

figures on bank lending to individual countries. The Bank for International Settlements publishes a quarterly series of aggregate lending by banks in the Group of Ten and Switzerland to a hundred odd individual countries. These are now being improved by the inclusion of a maturity analysis of total bank lending and a coverage of the lending by off-shore centres.

A further and rather different step is under active consideration. The Group of Ten Central Bank Governors could decide to sponsor a checklist of questions on a country's external asset/liability position. The idea would be that banks might take advantage of the existence of such a checklist to ask prospective borrowers to fill it in before loans were agreed upon. This could lead in due course not merely to a greater dissemination of existing relevant information, but also to the collection of information which at present is not available at all. There are many difficulties in the idea and many questions to be solved about the way it might be carried out. But it could prove a useful additional stabilizing influence.

(c) *Confidence.* When it appears that a generalized shortage of liquidity may be imminent, because of a sharp decline in market confidence, it will be preferable if the authorities can work to reduce the demand for liquidity — by lengthening the time-preference of asset-holders — rather than, or before, actually acting to increase the supply. This was what was in fact successfully done in 1974, during the most severe crisis through which the international markets have passed in recent times. Consideration of this leads us to the last and, to many, the major point of criticism of the regulation and stability of the international markets, the absence of a clearly defined lender of last resort.

Lender of Last Resort

Taken literally, it is perhaps true that there is no clearly defined international lender of last-resort. Certainly the IMF does not fulfill this function. As far as lending to governments is concerned its functions are perhaps somewhat analagous to those of last-resort lending — though the analogy could not be pushed far. But it does not, of course, make funds available to the private banking sector; and it would have to be transformed unrecognizably — and, in my view, inappropriately — if it were to do so.

The question, however, is whether the absence of a lender of last resort, on a precise analogy with the classical model, constitutes the weakness that taken literally it would seem to do. This question can, I believe, be answered firmly in the negative.

In the real — and complicated — world, close coordination and cooperation among the central banks most concerned with the security of the international banking markets is essential. By the same token, however, it is not possible for them to define in advance with any precision the circumstances in which last-resort finance would be forthcoming. Indeed, if they tried to do so, banks might be tempted to sail too close to

the wind with the presumption that support would automatically be forthcoming if they got into difficulties. The primary purpose of agreement among central banks on the provision of last-resort finance is to safeguard the international banking system as a whole and the domestic banking systems on which that is founded; the provision of such a safeguard does not — indeed cannot — entail the automatic provision of support to any bank facing difficulties regardless of the particular circumstances.

It was with these considerations in mind that in September 1974 the Governors of the Central Banks of the Group of Ten countries and Switzerland announced that, after discussing the problem of lender of last resort in the Euromarkets, "They recognized that it would not be practical to lay down in advance detailed rules and procedures for the provision of temporary liquidity. But they were satisfied that means are available for that purpose and will be used if and when necessary."

Because of the differences in national legislation and codes of banking practice to which I referred earlier, the precise way in which this supporting framework will operate will vary from case to case. The activities of a branch are without question the responsibility of the bank of which it is an integral part. More difficult questions arise in connection with wholly and partly owned banking subsidiaries abroad and it is here that this principle of parental responsibility — which is basic to the whole supporting framework — comes into play. The parent bank or banks are thus to be regarded as having a responsibility for subsidiaries, while the central banks of the countries in which the parent banks are established in turn have responsibility for them. At the same time the central bank in the host country is responsible for supervising and regulating — according to its own practices — foreign-owned subsidiaries operating there. That central bank in turn accepts a reciprocal responsibility for parent banks established in its own country which are held responsible for their subsidiaries overseas.

It was to establish beyond question the primacy of this fundamental principle that the Governor of the Bank of England sought from shareholders in the consortium banks in London and from the overseas parents of banking subsidiaries in London acknowledgments that they accepted a moral responsibility for their offspring in London that went beyond the narrow limits laid down by laws of limited liability and that extended in particular to the protection of depositors with those banks. It is for us a cause for some satisfaction that such assurances were forthcoming in every case. Of course, the coordination and cooperation — both formal and informal — which exist between the central banks and other regulatory agencies concerned lead us to hope that these assurances will not need to be implemented. So far as U.S.-owned subsidiaries in London are concerned, this hope is strengthened by three factors in combination: the parent banks tend to be very large and strong in absolute terms; the subsidiaries all tend to be small in relation to the parents; and the subsidiaries are all very amply capitalized.

Conclusions

In principle the motives of bank regulators in their actions in an international context are the same as in their actions in the domestic context. In practice, for a number of reasons, their motives in acting on the international scene are often rather different from their motives when acting on the domestic scene.

In the first place, whereas in acting domestically regulators are concerned with the broad national perspective, when acting in the international context they frequently do not have an international perspective — for obvious reasons they are partisan, primarily concerned with the protection of their own country, which is a small part of the world economy. There is, therefore, a potential for disharmony and conflict in the actions of regulators in the international markets that is largely absent domestically. Secondly, the power and influence of regulators in the international context is very much more limited, and for that reason their aims are usually less in terms of exerting control than of trying to influence. Thirdly, the international markets have a rather different character from domestic ones; notably they are more fluid and competitive forces are probably more quickly felt. This means that they are much less easily regimented and the principals in the market will tend to gravitate to where there is most freedom from regulation and, of course, fiscal burden.

What all this means is not that the roles of regulators and lenders of last resort are impossible to play on an international stage. It does, however, mean that the dialogue has to be complex and that the actors have to be highly sensitive to their colleagues' problems — and occasionally to pay heed to noises offstage. A successful production of this play without a director depends on the willingness of the actors to cooperate; that willingness in turn depends on a common perception of the dangers of an unsuccessful production. I believe — to return to real life outside the theatre — that there is a plenty of evidence of such a common perception and of a willingness to cooperate among the central banks and other regulators. This encourages me to believe that, even though it may not be possible to create a neat and tidy regulatory and lender of last-resort framework in an international context, the framework which we have will continue to work effectively.

Discussion

Charles P. Kindleberger*

Last spring when I contracted to comment on Mr. McMahon's presentation, I happened to be reading Walter Bagehot, the originator of the theory of the lender of last resort, and came across a description of directors of the Bank of England. I told Mr. McMahon by letter that I would share it with you today, if only to convince the pessimists and to encourage the meliorists. Mr. Bagehot wrote:

> If we refer to history, and examine what in fact has been the conduct of the Bank directors, we find that they have acted exactly as persons of their type, character and position might have been expected to act. They are a board of plain, sensible, prosperous English merchants; and they have both done and left undone what such a board might have been expected to do and not to do. Nobody could expect great attainments in economical science from such a board; laborious study is for the most part foreign to the habits of English merchants. . . .
> Unluckily, in the management of the Bank reserve, the directors of the Bank of England were neither acquainted with the right principles, not were they protected by a judicious routine. They could not be expected themselves to discover such principles. The abstract thinking of the world is never to be expected from persons in high places: the administration of first-rate current transactions is a most engrossing business, and those charged with them are usually but little inclined to think on points of theory, even when such thinking most nearly concerns such transactions. No doubt when men's own fortunes are at stake, the instinct of the trade does somehow anticipate the conclusions of the closet. . .[1]

Mr. McMahon politely replied that I sounded to him very much like the occasional modern Russian who criticizes Britain, and cites Charles Dickens as a source.

[1]. Walter Bagehot, *Lombard Street, A Description of the Money Market* (London: John Murray, 1872), New edition, 1917, pp. 165-66, 169.

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Today, I think it clear that we can "expect great attainments in economical science" from the Board of the Bank of England, and "abstract thinking of the world from people in high places." Mr. McMahon has given us an optimistic picture of the international money and capital market with which on the whole I agree. The duty of a commentator, however, is to sharpen issues, not to shovel out unstinted praise. I therefore comment on three points: 1) the mistakes of 1971-72, which perhaps Mr. McMahon was too polite to draw attention to; 2) a difference of opinion as to the money multipliers on the Euro-currency market; and 3) the problems of the lender of last resort.

Most observers blame the "distress" of the present international monetary position — and I use "distress" as a technical term to mean a position in which it is possible for a rational person to contemplate untoward outcomes — as owing to the oil price hike of OPEC in 1973. This is too simple. Our problem started with the attempt of the United States in 1971-72 to achieve low interest rates, when Germany was striving to restict inflation through tight money policies. Money poured out of the United States into the Euro-currency market, and out of the Euro-currency market into Germany and other countries. The Euro-currency market swelled up like a frog in the mating season, and started lending to developing countries in ways reminiscent of the 1820s, 1860s, 1880s, 1910-1913, and the 1920s. "John Bull can stand many things but he can't stand 2 percent." The lending that resulted in the collapse of 1825 went back to the debt conversion of 1822 and 1823. The Baring crisis of 1890 had its roots in the Goshen conversion of 1888. Low interest rates set bankers off looking for borrowers, and when they find them they sometimes (always?) overdo it.

Moreover, I am persuaded that the coordination of monetary and fiscal policy we failed to achieve in 1971-72 is needed more than ever today. Summit meetings provide very little of it. Basle meetings of central bankers help. But more thorough-going coordination is needed of the sort that Working Party # 3 of the OECD was set up to furnish.

Secondly, I recognize the argument of Mr. McMahon that money multipliers in the Euro-currency market are lower than those in domestic markets, because of greater leakages. Samuel Katz used to say that they were more akin to those of U.S. savings and loan associations than they were of U.S. commercial banks. Such was not the case of course when central banks acquiring Euro-currencies as a result of inflows from that market recycled them back to it, as in 1971-72. But even when it was agreed that such added reserves would be held in the home country — dollars for the most part in the United States rather than in the Euro-dollar market —, increased perfection of the world money market made the distinction one of no difference. A dollar deposited in New York, under increasingly perfect market conditions, would spill back to London and enlarge the multiplier.

Finally, let me deal with the lender-of-last-resort function. Mr. McMahon's paper stresses the difficulty of the role, and I concur that it is

an awkward one — despite the fact that this judgment mildy contradicts the overall optimism of his paper, and his high confidence in cooperation.

In its domestic manifestation, the role of the lender of last resort was fraught with close decisions that were accused of including, and sometimes did, elements of "bankers' quarrels." The central bank had to choose which banks to save, and which to let sink, and the criteria for decision were not always objective. The Bank of France, for example, was accused of failing to come to the rescue of the Union Generale in 1882 because Eugene Bontoux was Catholic while the Regents of the Bank were Protestant and Jewish. It saved the Comptoir d'Escompte in 1888 either because their bank was allied with the 200 families, as it was accused of doing, or because, as it said, two major bank failures in seven years would be unsettling.

The international lender-of-last-resort role has a political dimension. France was unwilling to aid Austria on the second go-round in June 1931 unless certain political conditions were met. The refusal to participate in a $1 billion loan to Germany was also political (that in the United States was owing to "no great attainments in economical science.") To come more nearly up-to-date, the French in September 1965 in "a shocking repudiation of the central bank free masonry" abstained from a swap arrangement to come to the aid of Britain.[2] The lender-of-last-resort principle presupposes a closed group, fully understanding one another, where action is taken rapidly, and the consequences sorted out more leisurely later on, much like the spirit of Lend Lease during the war. It is assumed that the whole world is in the same boat in the necessity to provide world monetary stability. Speed counts, which is why the I.M.F. won't do, as Mr. McMahon emphasizes. There is a question today, as in the past, whether the cohesion needed for the role to be properly discharged is available in sufficient abundance.

The I.M.F. works with conditionality. When swaps and the I.M.F. combine as in the highly successful December 1976 $3.9 billion credit for Britain, conditionality is called for, and may be helpful to the authorities in the country needing the funds in affecting its policy choices. In a world liquidity panic, however, there is not time.

Finally, the paper brings up the perennial question of the impact of rescue work on incentive. McMahon states that if central banks define in advance when they will aid the last resort, "banks might be tempted to sail too close to the wind." The phrase carries a familiar echo. One director of the Bank of England, Mr. Hankey, called the entire doctrine of having a lender of last resort "the most mischievous doctrine ever broached in the monetary or banking world."[3] Federal deposit insurance, indeed, was attacked through 1933 on the ground that it would weaken

[2] Quoted from G. L. Weil and Ian Davidson: *The Gold War*, London, 1970, by Susan Strange, *International Monetary Relations*, Volume 2 of Andrew Shonfield, ed., *International Economic Relations of the Western World*, 1959-1971 (London: Oxford University Press, 1976) p. 136.

[3] Bagehot, *op. cit.*, 161-162.

the self-reliance of banks in this country. The point is general. Welfare, in the eyes of the conservatives, destroys the incentive to work, etc. There is value in having it somewhat ambiguous whether there will be a lender of last resort, and whom it will aid, but the ambiguity should be limited to the public, and not to the authorities. A certain amount of dissembling is tolerable, if awkward for honorable men, but when the chips are down, and the panic is on, there must be none. If Chairman Burns of the Board of Governors, and Henry Reuss of the House Banking and Currency Committee are dissembling to keep banks guessing, I am happy to have them insist that the Fund should be the lender of last resort, and not the United States through the swap network. If they are serious, however, it strikes me as dangerous, since I agree so fully with McMahon that the Fund is not equipped for the role.

As Bagehot noted, instinct is important in these matters as well as in economical science. It was instinct to which President Harry Truman reacted in June 1950 at Korea. I trust a similar instinctive sense of responsibility will guide central bankers and monetary authorities in future financial crises. Perhaps as a text it is difficult to improve on the letter of Sir Robert Peel of June 4, 1844, addressed to the House of Commons when it was debating the Bank Act of that year:

> My confidence is unshaken that we have taken all the Precautions which Legislation can Prudently take against a Recurrence of a Pecuniary Crisis. It may occur in spite of our Precautions; and if it does, and if it be necessary to accept a grave Responsibility, I dare say Men will be found willing to assume such a Responsibility.[4]

[4]Report of the Secret Committee, House of Lords, Parliamentary Papers, *Monetary Policy, Commercial Distress*, Vol. III, 1848 (Dublin: Irish University Press, 1969) p. xxix.

Evaluation of Risk in in International Lending: A Lender's Perspective

Irving S. Friedman*

Introduction

One of the most important developments occurring during the past decade or so has been the emergence of a new dimension in international banking. I refer to the increasingly significant role of private international banks in the continuing process of economic development around the globe — particularly in those countries often referred to as the "Third World."

I have recently written at some length concerning this evolving role, and its many complex ramifications, in a separate study which has been made available to you. I shall not take the time today to comment on that subject in depth. I should note, however, that it is that development which makes the topic of my paper so important to many involved in the international lending process.

Private bank lending to developing countries has become a major factor in international development finance. This trend has introduced a long line of related questions and issues, e.g., what criteria should guide private banks in their overseas banks? are they adequately informed? what should be the role of the IMF World Bank with respect to private bank lending? would private banks be better guided in their overseas lending activities if they were able to access IMF and/or World Bank reports?

My paper is intended to share with you some thoughts I have regarding country assessments being done by the U.S. banking community; Citicorp's approach to this work; and the potential that exists for improving/refining our own efforts in this area.

In the 20 minutes allotted to me at the Bald Peak Conference, I plan to supplement this paper with some brief remarks regarding the country evaluations which are done by the International Monetary Fund and the World Bank. The underlying theme of my paper and my remarks at Bald Peak is that the country assessments and judgments of the International Monetary Fund and the World Bank Group can be useful to Citicorp and other private banks but cannot substitute for their own. Fund and World Bank assessments are greatly influenced by the purposes which these organizations serve, their institutional characteristics, and operating policies and lending criteria.

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I am guided in these observations by my previous experience in the IMF and World Bank, where I was responsible for originating, implementing and overseeing country evaluations done in those institutions. When I moved to the World Bank in 1964, I had the practical difficulty of trying to determine the usefulness of IMF country evaluations to World Bank efforts in this area. It was obvious to me that while there was much of practical use for the World Bank in an IMF evaluation, the World Bank — given its different objectives, structure and policies — had to rely on its own unique methodology for assessing countries.

Similarly, my current responsibilities for implementing and overseeing country evaluation work at Citicorp lead me to the view that private banks cannot avoid the responsibility of preparing their own country assessments and reaching their own judgments on countries for which they take full responsibility.

U.S. Private Banks and Country Evaluation

It is to be expected that official institutions such as the IMF and World Bank will arrive at very individual judgments on countries. Their assessments will be greatly influenced by the purposes for which they exist, their institutional characteristics, and their own operating policies and lending criteria. It is not surprising, therefore, that the World Bank and the IMF do not always have the same view on a country. Disagreements are sometimes far-ranging; at other times, more limited to a disparate view on specific components of a government program.

The views of the Fund and the Bank can be useful to private banks, but cannot substitute for their own because private banks differ from the Fund and Bank not only in ownership and sources of funds but also in objectives and, therefore, in management criteria and mechanisms. Private banks aim to make profits and avoid losses. Relative to the IMF and World Bank, private banks have a less stable resource base made up largely of short-term liabilities to the public at large. Some are able to tap the public markets for long-term funds sources. This, however, is the exception rather than the rule. Banks, therefore, place much greater emphasis on the protection of capital, assets, and revenue streams and ability to meet promptly and fully all outstanding liabilities or, in other words, to be adequately liquid.

Does this mean that private banks should evolve a country evaluation methodology in common and distinct from that employed by others?

There has not yet evolved any standard approach to country evaluation among the major private international banks. A recent study conducted by the U.S. Government, [1] copies of which have been distributed to you, reported as follows: that in most banks the country evaluation is undertaken at headquarters by the bank's line personnel, without critical

[1]Export-Import Bank of the U.S., *A Survey of Country Evaluation Systems in Use* (Washington, D.C.: December, 1976).

review by another group in the institution; that analytical approaches vary, with a small number of banks using quantitative techniques, generally together with more qualitative systems; that a number of banks use either a letter or numerical rating to summarize the results of their country evaluation; that a few banks use their results to help analyze the quality of their portfolio; and that none of the respondent banks use the results in fixing interest rates or fees.

The approach which I have evolved at Citibank differs significantly from the pattern just described — though it is consistent in some ways, as will be seen.

It is not surprising to me that private banks should differ in the process of analysis. Each bank has different concerns. One reason for this lies in the nature of the evolution of international banking, particularly since World War II — resulting in part from the continuing process of changes in the world economy and concomitant changes that have occurred in the demand for international banking services. Many banks initiated their international activities in a very limited way, e.g., servicing the overseas needs of domestic multinational customers. Many have still not gone beyond this stage. Other banks, however, eventually began to concentrate on the buildup of a portfolio of high quality international loans. From this base, still others are now maintaining a foreign branch/affiliate network. In addition, a relatively few of the more mature international banks have developed specialty market segments (ranging from geographic specialties to individual customer segments, e.g., government agencies and enterprises, multinationals, insurance companies, correspondent banks, shipowners, aerospace, etc.). Thus, even international banks are very different from each other in fundamental ways.

Some banks are organized along holding company lines; others are not. The former own diverse overseas subsidiaries engaged in merchant banking, real estate, consumer finance, leasing, and other specialized asset acquisition activities.

If I may, I would like to use Citicorp and Citibank as examples because I know them best and, more importantly, our country evaluations are designed to meet their needs. They illustrate well sophisticated international banking activities similar to some other banks.

Citicorp and its subsidiaries and affiliates around the world have approximately 2,000 offices in more than 100 countries. Its principal subsidiary, Citibank, offers general banking services overseas through the International Banking Group, responsible for managing Citibank's activities through branches, representative offices, banking subsidiaries and affiliates in these 100 countries, as well as handling all of Citibank's overseas client base with the exception of multinationals.

Another Citibank Division, the World Corporation Group, operates worldwide and has a physical presence in 47 countries. It serves multinational corporations whether based in the United States or abroad. This group provides credit and financial services to more than 400 multinational corporations.

Citicorp's Merchant Banking Group offers governments, corporations and financial institutions throughout the world fee-based financing and advisory services. Its activities include financial and development consulting, project finance, private-placement advisory services, acquisition and divestiture consulting, venture capital activities, and loan syndications. It also engaged in securities placement, distribution and trading insofar as legally permissible.

Citicorp's Consumer Services Group offers a wide variety of consumer finance services abroad through Citibank's overseas branches and, in addition, through Citicorp's overseas subsidiaries and affiliates in such countries as Australia, Belgium, Brazil, France, Germany, Hong Kong, Italy, the Philippines, Puerto Rico and the United Kingdom. A related group, Citicorp Services Inc., manages the sale and refund of Citibank Travelers Checks by more than 45,000 outlets in more than 160 countries.

Management criteria differ from bank to bank. Some banks are managed essentially from headquarters; others delegate as much responsibility as possible to their field activities. For example, Citicorp's global organization is set up on a decentralized basis. Decentralization reflects the diversity of Citicorp's operations around the world and makes it possible to react quickly and effectively to changing conditions. Corporation headquarters in New York, however, maintains centralized control, establishing general policies with regard to our lending activities in foreign countries and/or setting maximum permissible limits of exposure in each and every country in which we do business. In practice, this means that country evaluations are made in the field with the senior officer in a given foreign country recommending an overall limit for total exposure booked into that country by Citicorp and/or its affiliates. I review the evaluation and the recommendation, and final approval comes from my office. In most cases, however, the senior officer in a given country is allowed to allocate his country limit among individual borrowers.

Operating and lending policies differ as well. Some banks extend credit to overseas entities only when exposure is fully and unconditionally guaranteed by a public or private sector firm located in a country other than the country of the obligor. Others may additionally extend credit to the public sector in a given country or to private firms when resulting exposure is fully and unconditionally guaranteed by the central bank (or some other central government agency) in the borrower's country. Some participate in credit extensions that are only short-term trade-related; others have significant term exposure.

Despite the differences, banks refuse to invest in risk assets in any given country that have attractive income returns but are not in accord with country conditions and outlook. In addition, such banks insure that there is an adequate, independent internal auditing process — both external and internal to the country —designed to insure advanced warning of difficulties and possible losses. A cautious attitude to possible losses means that they are anticipated by way of loan loss provisions and/or offsets against current earnings or reserves.

Each bank's own manner of carrying out its country assessments will be importantly determined by its own objectives, institutional structure, operating and lending policies, as well as by the *stability* of its resources.

Banks and bank holding companies are often perceived by the public more as lenders of funds than as borrowers. Bank deposits, however, can be thought of as a form of borrowing. Traditionally, demand deposits (checking accounts) and personal savings deposits, which as a practical matter are available on demand, have provided a significant portion of bank funds. Loans (only a small portion of which are on a demand basis) and investments are thus partially funded by liabilities payable on demand. Increasingly, banks obtain their funds by borrowings on which they do pay interest. Nonetheless, the maturity periods may be quite different from maturity periods of loans. Such mismatching between asset and liability maturities creates an imbalance, but the managing of this imbalance has been a part of banking ever since silversmiths and goldsmiths started accepting deposits and making loans centuries ago.

Over the past 15 years, the development of fixed maturity liabilities, such as the negotiable certificate of deposit (CD) and the Eurodollar time deposit, has increased banking system stability by lengthening the overall maturity structure of liabilities. Such developments have reduced the imbalances between asset and liability maturities. These fixed maturity instruments further enhance liquidity because, in contrast to demand deposits, the repayment date of these instruments is known in advance. Unanticipated outflows are therefore minimized.

A bank holding company is not a bank and may not accept deposits. Citicorp therefore has had to utilize or develop other funding sources, including commercial paper, intermediate-term notes, long-term debt and floating-rate notes, in order to insure as stable a resource base as possible in support of its worldwide asset acquisition activities.

Private bank concerns are thus potentially much more heterogeneous than those of the World Bank and IMF. Many of their activities are of only marginal concern to the IMF and World Bank Group.

In addition, because they depend upon full and prompt servicing of their loans for their financial profitability and viability, private banks (in contrast to the Fund and the Bank) understandably tend to focus their activities upon the best managed countries and, within these countries, the best managed firms in the most advanced sectors of the economy. Even in many of the developing countries generally classified as the "poorest" because their national income per capita is very low, there are, however, relatively advanced sectors, which I view as "islands of modernity." These may be advanced manufacturing plants or highly modern facilities for producing or processing primary commodities for export.

As these "islands of modernity" attract financing, their growth and the development of other advanced sectors play a vital role in the structural transformation of the developing economy. These "islands of modernity" generate relatively high incomes despite the general low level of

the country. As they expand, the per capita income of the entire economy rises. The vast bulk of private lending to developing countries, for example, has been concentrated in "high-income" countries not because of the income level per se, but because these are generally the countries with a larger number of these "islands of modernity." This process will continue, as more and more developing countries continue to modernize more sectors of their economy, increasing their access to private sources of finance.

In short, one cannot generalize on the issue of what approach to country evaluation is best suited for banks. Each bank must define its concerns in relation to its activities both among and between countries. The identification of concerns must begin with the definition of "country risk."

Definition of "Country Risk"

"Country risk," as we define it at Citicorp, comprises the whole spectrum of risk arising from the economic, social and political environments of a given foreign country (including government policies framed in response to trends in these environments) having potential favorable or adverse consequences for the profitability and/or recovery of debt or equity investments made in that country (see Chart I). A few examples of what I mean are: confiscation, nationalization, branching limitations, restrictions on earning remittances, etc. They also include other developments with more indirect impact such as changing market conditions, exchange-rate fluctuations, foreign exchange controls, changes in fiscal and monetary policy, etc., affecting the liquidity of domestic borrowers and hence their ability to service domestic or external debt. As can be seen, I include within this concept of country risk events both within and beyond the control of the governments, and events both domestic and foreign to the borrower's country, as long as they have a potential impact upon our investments, directly or indirectly.

As is apparent from the above, the concept of "country risk" is much broader than that of "credit risk" related to a given borrower's individual creditworthiness; the risks to which I am now referring are all risks which are incurred as a result of our having undertaken certain activities in the foreign country involved, as distinct from considerations relating to the individual borrower.

It should also be clear that "country risk" is a broader concept than "sovereign risk": I include under "country risk" not only those events under the control of the government (or the "sovereign"), but also a wide variety of further potential risks — both domestic and international — over which the borrower's government has no control. It includes risks which affect the customer base of the bank as well as the bank directly. An adverse change in the condition of a major group of borrowers *may be the result of changes in the country environment or government policies*, rather than changes in the sector or the individual firm.

In my view a bank must include all potential risks in performing its country assessment, and not simply confine itself to those which appear most likely or imminent. It is important to try to anticipate the way in which changes in country conditions will occur, and not simply to react to the identification of today's events. It should be obvious to all of us that this is a very demanding professional task.

Not all observers will agree with my definition and views on "country risk." In particular, as I mentioned briefly at the outset, different types of institutions having different goals will define these risks in terms consistent with their own institutional purposes.

The analytical approach taken will also partially reflect the characteristics of the institution, including the diversity of its customer and funding base; its operating and lending policies; and whether or not it has a worldwide network of overseas operations and can tap the expertise of these employees as a source of firsthand information. These sources must be supplemented by a great deal of travel on the part of the senior staff, in order to permit frequent consultation both with the bank's own personnel overseas and with knowledgeable local nationals, such as central bankers and key government officials. Chart 2 identifies these and other basic sources of the information needed for country risk assessment.

My basic approach to the analytical process is to know the individual country, its uniqueness, its vulnerabilities, its longer-term historical development and outlook as well as the most detailed data available on its past and present economic performance. We must know who is really running the country (it is not always the party in power), and whether the government has the political will to carry out responsible economic programs. Basically what we are assessing is the economic management of the country and its consequent conditions and outlook.

This cannot be done simply in quantitative terms, since so many of the key political and social variables are not quantifiable in any useful manner. The major qualitative elements that should be examined in assessing country conditions are shown on Chart 3. Each qualitative aspect has many subdivisions.

In addition to the key qualitative indicators, as the chart shows, there are also many quantitative indicators which must be looked at, including such data as debt service ratios, rates of growth of exports, diversification of exports, variability of export earnings, growth of per capita income, imports in relation to GNP, compressibility of imports, changes in the level of monetary reserves, growth in external debt and debt servicing, and so forth. But no single indicator or ratio can be relied upon to tell us what we wish to know, and some can be very misleading without thorough study of the reasons behind their behavior. Of critical importance is the recognition that few indicators have the same meaning for any one country that they have for another, and there is simply no "labor-saving device" yet invented that can spare us the effort of painstakingly examining each country individually — and repeatedly, or even continuously — since changes of significance can occur rapidly. The process of knowing a country takes years to mature.

Citicorp maintains a centralized data bank on the major economic variables for each country of interest. The variables cover fiscal and monetary policy, inflation and real growth, the balance of payments, external debt, and the central bank balance sheet. Latest data are incorporated as they emerge, and the outlook is adjusted accordingly. Periodically, a world overview is pulled together to insure consistency of the various projections, particularly in respect to the current accounts in the balance of payments and the associated flows of funds.

We have also been exploring econometric methods which might be used to improve our work on country assessments. For example, we have explored the possibility of using discriminant analysis for constructing a composite index of creditworthiness of a less developed country. The results of our experiments thus far indicate that this technique does not give conclusive and unquestionable results but may be useful in identifying those countries which require more careful attention than the others.

There are two aspects of country evaluation which I would like to comment on further. The first is the obvious difficulties of predicting future actions by governments. It is difficult enough to predict behavior of governments assuming certain policy responses to different possible or probable economic trends. We can simulate what the economies response to different policies will be. We can thus have some idea as to what are the implications of one set of policies versus others. Thus, for example, we can test what a change in monetary targets or interest rates might be, or even a change in fiscal deficits financed by monetary expansion. We are, however, dealing with a dynamic interaction between domestic economic and social conditions and government responses at all levels. We are also dealing with international developments and responses of different governments to these developments. In turn, these responses change domestic and international conditions and outlook. We can give intellectual order to this kaleidescope by making simple assumptions but, unlike a cyclotron, we cannot separate out what is moving and place it within a constrained and therefore more controlled environment. Even if the International Monetary Fund had more resources and authority, we cannot even say that national currencies will remain convertible for all current payments. We have given up trying to have stable exchange rates except within limited groups. We have given up assuming market-determined freely floating exchange rates. These are merely a few examples of uncertainty among many. We cannot say, to give another example, at what level of inflation governments will shift their priorities from growth and employment to concern with inflation and vice-versa. We cannot say what are the imitative effects on one country of actions in others, not to speak of the objective effects. We are in a world of unpredictability in the precise scientific sense of the word.

Secondly, we are in a world of paradox. Policy responses to situations which, in turn, affect objective conditions, are not either historically, logically, ideologically, or theoretically determined. It would be convenient if it were so. All these aspects help give guidance, particularly

in the short run. In the longer run, we know that economic realities and market forces are powerful influences in shaping events. Repeatedly, however, if we rely on such "logical" responses, we are surprised. We can foresee the range of policy responses which are more likely than others, but the range is very wide and covers many different responses. Zambia, with its high dependence on copper exports, cannot respond to the low price of copper by exporting steel and steel manufactures. Spain cannot take advantage of the high price of oil by exporting oil, or to take a seemingly more plausible response reverting to a nonoil economy.

To take examples closer to our topic of country evaluation for private international bank lending, a creditor or donor country can decide to assist a deficit country with new official loans or grants, or expand resources of international organizations, or stockpile the exports of the country in difficulty, or reschedule or forgive public debt to the country or negotiate an international approach to these countries and see on what courses of actions other governments could agree. Similarly, there is a wide range of possible responses of the deficit country and the impact of the responses on the creditor country. What if the deficit country intensifies import restrictions; changes from a civilian to military rule or vice-versa; or tries to expand domestically to keep up employment or, to the contrary, deflates drastically to adjust more quickly to its balance-of-payments problems, etc.? Potentials for very different responses exist simultaneously. In the real work-a-day world, paradoxes are commonplace. They enhance uncertainty and unpredictability, and thus reduce the value of usual simulation exercises.

Closely related to the problem of the presence of true paradoxes are the existence of false, or apparent, paradoxes which are mainly in the eye or mind of the beholder. What will a developing country in very serious balance-of-payments difficulties do? Default on its external debt? Of course, say and write many! The country is seen as very poor and limited in alternatives and of little importance in international finance. Many are also seen as having short historical records because they are new, or others have records of defaults. But they do not default. Why not? Why the error in judgment by others? Because they simply did not know enough about the political impact of default domestically, or the sense of imperative need countries have to maintain creditworthiness, etc. Yet, these erroneous views, in turn, create changes in objective conditions. A false expectation of default, however false, can itself create severe crises and even actuality of default. The false prophets become true ones — a phenomenon known from ancient times!

We make decisions every day in this uncertain world. Private banks are risk takers. If not, their activities and usefulness would greatly diminish. Their time horizons go beyond their ability to be certain. Yet, they cannot afford damaging surprises. This is why I summarize our actions in country assessment by the aphorism that "the name of the game is anticipation" and that "it is better to be imprecisely right than precisely wrong."

Potential for Improvement in Citicorp's Country Assessment Procedures

Citicorp's approach to country evaluation can be improved in a number of areas. As far as the collection of information is concerned, we receive large masses of data, qualitative and quantitative, on an individual country basis. A large part of the information comes from representatives stationed overseas and is supplemented by data obtained from national and international organizations. The information is evaluated on an individual country basis. We make every effort to insure that our information flow is continuous, reliable, updated, and as precise and detailed as possible. We make every effort to cooperate with others to improve information. For example, last year I was Chairman of a special subcommittee appointed by the Association of Reserve City Bankers which purpose it was to survey the country exposure measurement techniques employed by ARCB member banks. This report has generated considerable interest among the regulatory authorities. It is my impression that its contents were reviewed very carefully by the Federal Reserve and the office of the Comptroller of the Currency. It was used by these regulatory agencies as a starting point to collect information regarding the magnitude of U.S. banks' exposure to foreign countries. Based on such efforts, Citibank and others are able to determine what their share of exposure is in a given country relative to all other U.S. banks.

We need to continue such efforts to improve data upon which to base sound judgments regarding our international activities. In addition, we need to continue work on the creation of a system that would provide us with the most useful worldwide framework within which the performance of individual countries would be assessed. We are making very explicit efforts to integrate economic and political situations into global criteria in order to improve policy-making and/or lending decisions in the real world. It is not enough to know a country in isolation. We must be extremely cognizant of factors exogenous to the country which may impact that country's creditworthiness, e.g., among other variables, growth of world inflation between and among countries, world trade, rise in protectionist sentiments in key countries; changing magnitudes of bilateral assistance; growth rates in industrialized countries; etc. All of these have direct or indirect impacts on any given country's performance.

The integration of individual country information into a much larger framework presents a number of problems. Basic among them is a lack of comparability of quantitative data collected in the 120 countries in which we have exposure. It is even more difficult to compress the multitude of information into a global framework of manageable proportions.

Although we want to integrate the information on individual countries into a global framework, I should emphasize that we do not intend to rank countries by any type of numerical method. I believe that a rigid ranking system would be arbitrary and unrealistic. It would not allow us to take into account the fundamental proposition that we adhere to at Citicorp that exposure in a given country is not homogeneous as to risk.

Our client base is too diversified. Some, like shipowners and airlines, have access to foreign exchange independent of the foreign exchange availability of the country in which they reside. Other customer segments would have uneven access to a country's available reserves in the event shortages were encountered relative to external debt and payments obligations. Specific country risks vary from country to country. Some, as just mentioned, have balance-of-payments vulnerabilities; in others, we are concerned that our equity investments might be confiscated; in still others, we are concerned with specific government measures which adversely impact the cash flow generation capability of private sector clients (and therefore their ability to service foreign and domestic debt), and so on. No simple ranking system can cope with such a diversity of concerns.

Our country reviews and assessments are not only based on historical data but also on projections of country performance. We are now attempting to institute more formal procedures to assess the accuracy of our past judgments and evaluations. If our country evaluations do not anticipate events which have adverse consequences for Citicorp activities in a given country, our system has failed. To the extent that we can anticipate events in a country, we are able to take appropriate defensive action to protect Citicorp concerns. The key is, as noted before, anticipation.

Finally, we must continually refine our understanding of the linkages that exist between a country's projected performance and Citicorp's specific business objectives in that country. It is this link between the country's macroeconomic performance on the one side, and the outlook for specific economic sectors and individual public and private sector enterprises on the other which provides us with the understanding we need in arriving at decisions on countries.

What I have said has obvious implications for Citicorp and other bank managements in the years ahead. Most important is that all of us will be seeking to refine our methods for assessing countries, and our approaches to applying that judgment to the management of our portfolios. No institution can afford to see this work done badly. And increasingly the rewards will go to those who see that it is done well.

There are some clear implications for personnel selection and training — particularly for the larger banks which are heavily engaged abroad and which will need to dedicate increased resources to these problems. They will need increasingly to reflect awareness of the professional nature of country analysis, and to broaden their search both within and outside their institutions in order to find the most qualified persons for this type of work. The same applies to assignment rotation and promotion policies within such banks. It takes time to develop the professional skill to evaluate countries and time to learn any country in depth.

Country-risk assessment must be made on an increasingly sophisticated level so that opportunities both for avoiding loss and for maximizing future business can be anticipated and acted upon effectively. Therein lie attractive rewards for those individual banks which can most accurately evaluate country risk and most effectively act upon that judgment.

Before I conclude, I would like to note that in addition to the work I have been describing, another essential aspect of dealing with country risk and uncertainty is the actuarial principle. Banks are acutely aware of the need to avoid *magnitudes* of risk assets in any one country that are in violation of the actuarial principles of balance and dispersion. The subject of identification of principles to guide diversification and balance are, I believe, worthy of separate treatment and, perhaps, a conference of the kind in which we are now participating.

Conclusions

The response of private banks to these interminable series of uncertainties and difficulties cannot be paralysis of decision-making and action. In appreciating the realities within which they act, there is the foundation for reducing risk to acceptable proportions by the application of the actuarial principle and by country evaluations which employ all sources of information, all known methodologies and analytical tools, all feasible judgments based on experience and sophisticated intuition. It combines the insights which can only be gained on the spot by firsthand continuous and maturing experience with the fruits of careful and systematic scholarship that has extended to the point of being truly scholarly. It is important to distinguish between the opinions of scholars and the fruits of their scholarship. The former are too often unfounded in reality. The latter are nearly always most useful and illuminating. Similarly, judgments based on past experience can be misleading, if not current and not perceived as part of the future.

Our approach to country evaluation is the opposite of oversimplification. It is testing by continuous monitoring and review of past judgments. It is not the elimination of unpredictability or uncertainty. It is the management of unpredictability and uncertainty.

CHART 1
CATALOGUE OF COUNTRY RISKS

FACTORS AFFECTING BANK BOTH *DIRECTLY* AND *INDIRECTLY* VIA CUSTOMER BASE

I. Risks External in Origin to the Country

A. War
B. Hostile or Discriminatory Acts, Short of War
C. Special Vulnerabilities of Bank and/or Customer Base to Other Types of External Events including Effects of Business Cycles, Oil Price Increases, Inflation, Food Shortages

II. Risks Internal in Origin to the Country

A. Revolution
B. Extended Civil Unrest
C. Adverse Economic Conditions and Outlook affecting Bank and/or Customer Base
D. Confiscation
E. Nationalization
F. Indigenization: Ownership and Personnel
G. Exchange Controls and Practices in Respect of
   - Repatriation of Investments
   - Transfer of Earnings
   - Minimum Tenor Limitations on Foreign Currency Borrowings
   - Other Restrictions on Foreign Currency Borrowings
   - Multiple Currency Practices Applied to Capital Flows
   - Servicing of Foreign Currency Loans
   - Exchange Declaration
   - Exchange Surrender
   - Exchange Rationing, etc.
   - Advance Deposit Requests
   - Swaps
   - Hedging
   - Future Exchange Transactions
   - Impact of Bilateral Agreements

H. Trade Controls and Practices, e.g.,
   - Tariffs on Imports
   - Quotas on Imports
   - Other Forms of Import Restrictions
   - Export Taxes/Rebates, etc.

I. Other Government Action, e.g.,
   Fiscal, e.g., Increases in
      Direct Taxes
      Indirect Taxes, etc.
      Changes in Subsidization Policy
   Monetary, e.g., Changes in
      Reserve Requirements
      Government Credit Policies: Debt/Equity Constraints, etc.
      Rate Ceilings
      Open Market Operations
      Policies Relating to Credit Allocation, etc.
   Exchange Rates
      Fixed
      Floating
      Multiple Rates
      Devaluation Policy, etc.
   International Reserves and Intervention Policies
   Public Investment
   Wages
   Prices
   Regulatory
   Change in Policy toward the United States and
   Changes in Policy toward U.S. and Foreign Multinational Firms

CHART 2
SOURCES OF INFORMATION

I. In Field

A. Information Received from the Network of Branches/Subsidiaries
B. Central Bank
C. Other Government and Municipal Agencies
D. Embassies
E. International Agencies outside the United States, e.g., OECD, BIS, Asian Development Bank, UNDP
F. Business Contacts
G. Other Private, including Professional, Groups
H. Journals and Periodicals
I. Rumor and Gossip

II. At Head Office

A. Experience of Officers
B. International Agencies Located in Head Office Country
C. Central Bank
D. Other Government Agencies

E. Foreign Embassies
F. Business Contacts, e.g., with Other Commercial Banks, Multinational Firms, etc.
G. Professional Groups
H. National and International Journals and Periodicals

CHART 3
MAJOR QUALITATIVE AND QUANTITATIVE ELEMENTS USED TO ASSESS COUNTRY CONDITIONS

I. Qualitative

Impacts on Domestic Economic Performance stemming from:
A. Global Interdependencies
B. Trade Vulnerabilities
C. Proposals and Agreements Taken in International Forums
D. Social Conditions
E. Political Outlook
F. Government Domestic Economic Management
G. Government Balance-of-Payments Management
H. Flow of Funds and Financial Intermediation — Actual and Potential
I. Principal Economic Sectors — Trends and Prospects

II. Quantitative

A. Debt Structure, Profile and Debt Servicing Ratios, e.g.,
- Debt Service Payments
- Interest Payments
- Interest in Relation to Debt Service
- Debt Service in Relation to Gross Capital Inflow
- Debt Service in Relation to GDP and Its Major Components
  - Domestic Savings
  - Consumption
  - Total Investment
  - Public Investment
- Debt Service to Total Exports of Goods and Services
- Debt Service in Relation to Imports
  - Total Imports
  - Consumption Imports
  - Capital Imports Total and Major Components
- Debt Service to Total Government Expenditures
- Debt Service to Total Government Revenues (excluding Borrowings from Central Bank)

Debt Service on Government and Government Guaranteed (Debtor Government) Debt in Relation to Debt Service on Total Debt
External Debt Outstanding in Relation to GDP
Debt Service on Debt to Lenders Guaranteed by Government
Debt Service on Debt to Lenders Not Guaranteed by Government

B. Exports
   Rates of Growth of Exports — Real and Nominal
   Diversification in Products and Markets
   Percentage Shares of Main Categories of Exports
   Variability of Export Earnings During Past Ten Years
   In Relation to GDP
C. External Debt Outstanding in Relation to Exports
D. Exports to Imports
E. Imports
   Rates of Growth of Imports — Real and Nominal
   Diversification in Products and Markets
   Percentage Shares of Main Categories of Imports
   Variability of Import Payments During Past Ten Years
   In Relation to GDP
F. Compressibility of Imports
G. Changes in Level of Reserves
H. International Reserves in Relation to
   External Debt
   External Debt Servicing
   Categories of Imports and Other Payments
   Available Credit with International Agencies, e.g., IMF, World Bank, IDB, etc.
I. Per Capita Income — Growth Rate
J. Fiscal Indicators
K. Monetary Indicators
L. Investment and Savings Ratios
   Total Investment to GDP
   Domestic Savings to Total Investment
   Foreign Capital to Total Investment
   Foreign Debt Capital to Total Investment
M. Service Items and Balance of Payments (excluding Debt Servicing)
N. Capital Flows, Disaggregated as Feasible
   Outflows
   Inflows
   Net Flows
O. Indicators Especially Constructed for Individual Countries, e.g., Capital Flight, Proportion of External Debt to GDP

Note: To the extent possible, under A a distinction should be drawn between debt guaranteed by government and nonguaranteed debt; where significant and feasible, a further disaggregation should be attempted.

Discussion

Rudiger Dornbusch*

Mr. Friedman's paper shows the balance, prudence, and lack of alarm that we would expect from a banker. The paper is not limited to a narrow, technical analysis of country risk but rather goes beyond that to emphasize the broader considerations that govern lending decisions. In my comments I shall first briefly draw out those elements of Mr. Friedman's analysis that strike me as most central and then proceed to some critical remarks and further issues.

Elements of Country Risk Analysis

Country risk analysis, we learn from Mr. Friedman, is a very specialized matter depending on the objectives of the lending institution but also on the sources and the stability of its funding. Practically, this means that lending institutions have to develop their own evaluation techniques that reflect the characteristics of their lending policies. Different methods are appropriate for loans that are externally guaranteed versus those that might be short term, self-liquidating. Or, to give another example, different evaluations are appropriate for loans to the private export sector — islands of modernity as it is in the paper — or to the public sector.

Beyond the need to develop diversified, bank-specific evaluation procedures Mr. Friedman rightly emphasizes the important point that evaluation procedures should be forward looking. They should be anticipating future problems and prospects rather than just recording past episodes and statistics. Country evaluation to a large extent is designed to develop warning signals — an ongoing process of evaluation rather than an episodic or ad hoc analysis that soon becomes irrelevant.

A further point that is sharply emphasized is the recognition that risk is not homogeneous. It makes a large difference, from the point of view of recoverability of a loan, whether the borrower is an export firm with automatic access to foreign exchange or whether it is a local firm that may be solvent in domestic currency but cannot raise the foreign exchange to meet its liabilities.

These considerations lead Mr. Friedman to argue forcefully against a single indicator or ranking index of country risk. The lack of homogeneity

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among loans to the same country already makes such indices of questionable use and relevance. Intercountry comparisons become even more doubtful. While a single, composite index is thus rejected, there is nevertheless an emphasis on a structured, technically oriented evaluation procedure that serves as one of the inputs in decisions and ongoing monitoring. The appendix to Mr. Friedman's paper shows the indicators ranging from social and political to the more habitual economic data — the famous ratios. Overriding the importance of these data, however, is a concern to evaluate the "quality of the management" in a particular country. The "management" here includes without question and even primarily the economic decision-makers in the central bank and finance ministries.

The risks perceived in a particular country do not only arise from domestic problems and policies but also from entirely exogeneous events that may, to some extent, be predictable. Much of lending is concentrated on the export sector which is a key element on the domestic macroeconomic scene. In these circumstances it is important to predict export opportunities and prospects by placing country evaluation in the broader context of a world economic evaluation and overview. Such a perspective is required because a particular country's export potential — supply constraints apart — is dominated by income growth abroad. It is also required to achieve consistency in the evaluation of countries that are competitors in the import markets of the large industrialized areas. A world perspective serves as a check on over-optimistic forecasts for each individual country because their sum will have to add to no more than the very predictable imports of developed countries.

Some Issues

Country risk analysis, along the lines suggested by the appendix to Mr. Friedman's paper, strikes me as a quite amateurish exercise. It would appear that a lot of data is brought together, in ratios, products, logs and exponents, but that no coherent or systematic framework for the analysis exists. Those who have worked on macroeconomic problems in developing countries appreciate not only that the data are precariously poor, particularly those that exist, but also that the simplest four or five equation framework does far better than an ambitious all encompassing analysis. Needless to say no small bank has the intellectual or physical resources to do a serious job on a broad scale. In these circumstances banks are much better advised to look for a simple analytical framework — perhaps the standard IMF evaluation blueprint.

These remarks are perhaps a bit strong, but they are elicited by an unqualified listing of quantitative indicators in Mr. Friedman's paper that not only include domestic saving as a component of GNP, but also show a lack of perspective in lumping together essential indicators such as the incompressibility of imports with totally irrelevant matters such as open market operations. More seriously, one cannot help asking how these data affect the decision-making process. If they are not used to develop country-ranking indicators that can be used for quantitative decisions, then

lending decisions must perforce take on a more haphazard form. I suspect the procedure is to start from the given portfolio and make marginal changes drawing broadly on the information arising from the evaluation procedure. Thus the procedure leaves the portfolio composition quite sticky. The incremental approach avoids large and sudden shifts in lending patterns but also implies a substantial exposure to surprises.

Individual banks, and certainly the smaller ones, will find it unprofitable if not impossible to perform their own economic and statistical evaluation. They may well produce some information but none to which senior management would attach an overriding information value. The area of country evaluation suggests a strong analogy with the standard lending business of banks. Lending procedures certainly include an evaluation of management and business prospects, but also the use of standard information sources such as Dunn & Bradstreet or other rating services. Given the large scope for economies of scale in information one wonders why there is as yet no country rating service that produces standarized, regular information which could be routinely used in lending decisions.

There is another aspect of economies of scale in information, and that concerns the world economic outlook. Certainly banks would want to consider the overriding impact that world economic interdependence has on an individual country's export prospects and macroeconomic performance. There is, however, very little useful information to which one can turn. The best evaluation of the world economy on a short-term basis is, I believe, produced by the IMF and remains, for reasons difficult to grasp, entirely confidential. It would certainly be an important improvement not only for banks' lending decisions but also for the business sector at large if these "world economic outlook" reports received the publicity that their scope and quality warrant. I would make the same case for the IMF's individual country studies — much as it is handled by the OECD — but I find that case a bit less compelling.

Risk and Return

The most important point in country risk evaluation must, in my judgment, center on the proper conceptual framework for the evaluation of risk and return. A bank in setting an analytical framework for country evaluation will implicitly or explicitly set up criteria that reflect and provide answers to the bank's business objectives. A bank cannot get around the problem of asking for a measure of the return and risk of its loan portfolio, the trade-off between risk and return, and the impact on stockholders of a change in its exposure.

These questions may largely remain implicit and rarely receive a proper formal and quantitative analysis. Nevertheless some interest remains in spelling out the main concerns. Modern finance theory provides a bit of a disappointment here in that it suggests the following. First, what matters to holders of securities is risk and return. Second, the proper measure of

risk is the correlation between a firm's earnings and the "market," i.e., some broad index such as S&P, because individual security holders can diversify their portfolios and thus eliminate firm-specific risk. What investors cannot diversify away is the correlation with the market. That is the only risk on which the market will place a price. These two considerations suggest that it does not pay a firm to diversify its sources of earnings in an effort to reduce the variability of its cash flow. The market does not pay for that diversification since stockholders can achieve it by simply diversifying their portfolios. From a strict point of view of finance theory, therefore, we have no reason for diversification considerations in bank lending. The bank should look for maximum expected return, but be unconcerned with the variability of returns on individual prospects or with the correlation between various loans in the bank's portfolio. Country risk analysis in this perspective is mainly a method for evaluating expected return, not risk.

Finance theory notwithstanding, however, banks obviously look for diversification. There is considerable justification for this, not in the least because a bank's diversification has a direct effect on its expected net earnings. A more diversified bank represents a more stable source of funds for borrowing corporations and a more stable place for depositors and holders of CDs. Accepting, then, the desirability of diversification, the issues of the appropriate trade-off between risk and return, and the method of achieving diversification remain.

From a bank's point of view it is important to assess how the various loans are related in their prospects for timely payment of interest and principal. If the loan portfolio is highly concentrated geographically or by customer-type (copper, coffee, REITs), then it must be considered very risky. By contrast if the portfolio is broadly spread across industries and trades as well as regions, then some benefits of diversification are achieved. There remains though the single most important consideration: that most bank loan prospects are affected by the world business cycle. Much as we look at the correlation of individual stocks with the market — the famous betas — we should look at a loan portfolio and ask how it correlates with world economic activity. This is likely to be the dominant source of variability in net earnings simply because the loan-specific risk is diversified away. In this perspective loans to raw material-producing countries appear as high beta positions, as do loans to very trade-dependent countries. By contrast, loans to service industries or relatively closed economies might be low beta positions. Using this perspective, a portfolio that is superficially well-balanced and diversified may well prove to be a high-risk portfolio. It might be most risky simply because it has a lot of loans (spread both geographically and by industry) that share the characteristic of being strongly affected by world aggregate demand.

Conditionality, Bonds and Banks

In concluding my remarks I would like to draw attention to the "debt problem" as a recurring one in the last 200 years. I would also note that

the conventional remedy of imposing sounder macroeconomic management, known under IMF stand-by agreements as "conditionality," is not new. The new feature in the current debt problems, arising in the aftermath of the oil shock and the unusually deep and long recession in world economic activity, is the substantial involvement of commercial banks. The problem used to be one of government default on debt that was externally held but broadly spread among foreign bond-holders. The shift to substantial external lending by commercial banks, as opposed to direct lending by bond-holders, is associated with the rise of multinational corporations that thus obtain local finance for their foreign operations. It is also associated quite unavoidably with the large intermediation requirements arising out of the petro-dollar flow to the commercial banking system in the few financial centers.

I have noted that debt problems are not new. Nor are the remedies, as is evidenced by the following quote:

> By 1927 Portugal's financial difficulties had grown so acute as to impel the Government to seek the assistance of the League of Nations in securing a new foreign loan. On the basis of a first-hand investigation in Lisbon, the Financial Committee of the League reported that a loan could be arranged but only if Portugal would agree to a program of monetary, budgetary, and fiscal reform and to the establishment in Lisbon of a foreign agent of the League to receive the revenues assigned for the service of the loan and to supervise the spending of its proceeds. . . .It was under these circumstances that Dr. Salazar became Minister of Finance. . . .Under his able leadership Portugal maintained a healthy financial economy and made economic progress without the aid of any further external loans.[1]

Conditionality has been seriously questioned mainly because of its short-run, budget-cutting orientation. While such policies do not fail to produce short-run improvements in the external balance, they have at the same time had very adverse effects on growth performance, investment, and social structure. One may seriously want to argue that these policies, on net, have actually deteriorated the balance toward large public sectors and promoted less trade-oriented, productive activity. That bias I believe arises in part from the financial aspects of conditionality and lack of attention to longer-term policy orientation. A policy that only creates a recession by cutting public sector activities without providing new, credible and financed alternatives in the traded goods sector is bound to lead to unemployment. In the medium term the public sector will come back to absorb the unemployment and take over illiquid firms, thus setting the stage for the next problem round. Thus conditionality with too short term an orientation is bound to be counterproductive. One must therefore view the current reorientation in conditionality at the IMF toward a longer horizon and structured macroeconomic and sectoral programs as one of the important aspects in international lending and country-risk evaluation.

[1]William H. Wynne, *State Insolvency and Foreign Bondholders*, Vol. III, Yale University Press, 1951, pp. 384-385.

Evaluation of Risk in International Lending: A Bank Examiner's Perspective

Harold D. Schuler*

It is indeed a pleasure to have been invited to join this distinguished group to discuss "Key Issues in International Banking." I will begin with a very brief synopsis of recent events leading to the situation as it exists today; regress in time slightly to explain some corresponding supervisory developments within the Office of the Comptroller of the Currency and, finally, offer some comments about what bankers can expect from examiners down the road.

The rapid increase in international lending by U.S. banks since the mid 1960s has proven to be a lucrative business. Losses have been few and in most of our larger banks international earnings have contributed a substantially greater share of net income than the ratio of international to domestic assets would suggest. This development has not been unhampered, however, and the long-range effects of many crucial decisions which must be made today are not as clear as most of us would hope.

The quadrupling of oil prices by the oil-exporting countries, in 1973, found the Eurocurrency markets the single means of financial intermediation between the oil rich surplus nations and rest of the borrowing world. Private banks suddenly were being called upon to finance balance-of-payments deficits and even to grant long-term development loans, both of which had been previously considered functions of the then inadequately funded IMF and World Bank.

Being the only acceptable depositories for the vast OPEC surpluses, banks continued to expand their international portfolios, offering loans to an expanding list of new borrowers and at rapidly narrowing spreads. Many less developed countries as well as a few already financially troubled industrialized countries saw private banks as anxious lenders for virtually condition-free balance-of-payments financing and optimistically budgeted long-term project loans, only some of which were export-development oriented.

A reawakening occurred during the fall of 1974 when several of the world's largest banks lost enormous sums in their foreign-exchange operations. It suddenly became apparent to everyone that the meager interest margins no longer justified the barely quantifiable credit and liquidity

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risks inherent in both the high volume foreign exchange and Euro-lending functions then being performed. Both markets contracted somewhat as exchange trading lines were reduced, second tier banks were required to pay higher costs for their Euro-funds, and country exposure limits were narrowed in recognition of mounting deficits of oil-importing countries. Inflation was high in most countries of the world and a global recession had already begun.

The reduction in market activity seemed a blessing at the beginning of 1975 as U.S. banks advantageously redirected their resources toward the development of more selective credit policies, improved operational and credit-reporting systems and increased control over foreign-exchange activities. Banks which previously had relied on their bigger brothers to judge the quality of loans to foreign public sector entities, began strengthening their own country analysis programs both for risk assessment and marketing strategy purposes. New policies reflected philosophies emphasizing "manageable" growth. This is reflected, in part, by the relatively modest growth in foreign branch assets of national banks of 11.7 percent during 1975, compared to an average annual increase of 26.9 percent for the years 1970-74.

Despite neither strong nor consistent economic recovery globally, lending and interbank activities increased significantly during 1976. Foreign branch assets of national banks grew by 20.9 percent to $135 billion. Foreign branch assets of all U.S. banks increased by 24.3 percent to $219 billion. Total international assets are now estimated at $150 billion for national banks and near $230 billion for U.S. banks in the aggregate. These figures represent 30 to 60 percent of the assets of many of our major banks, individually, and contribute in even greater proportion to their annual earnings.

Many observers contend that our banks have been excessively zealous in their desires for growth and earnings, culminating in a serious overdependence on assets due from the poorest of countries whose deficits surely will widen and whose loans will never be repaid. Doom is predicted for both the Eurocurrency markets and our private banking system.

The Office of the Comptroller of the Currency does not share these views. This is not to say that the OCC is entirely comfortable with some of the broader issues involved, e.g., the appropriate role of commercial banks relative to the IMF and the World Bank, or the numerous lending limit implications for U.S. banks. But the OCC does not consider any national bank to be "endangered" because of its international loans in general, its loans to LDCs as a group or its exposure to any single LDC. The point is, however, that the questions being asked today by the media and the public are justified by the numbers alone. It is now the responsibility of the banks and the bank regulatory authorities to provide the proper perspective for those people who presently insist upon drawing absolute conclusions from the aggregates.

Certainly, great contributions have already been made by individual

banks and by the Association of Reserve City Bankers in terms of explaining the art of "country risk" analysis. This, in itself, is of limited value, however, in monitoring the international exposure of the U.S. banking system. Significant improvements in the quality and characteristics of pertinent data are essential.

At this point, I would like to explain how the OCC views its role with regard to "country risk" analysis, and what the bank regulatory agencies are attempting to contribute in terms of "country exposure" data.

The Office of the Comptroller of the Currency does not view its primary responsibility as one of determining the relative risk involved in lending to one country vs. that of another, i.e., studying marketing alternatives and allocating credit. It does have a responsibility, on the other hand, to evaluate loans on their own merits, in order to determine the quality of the loan portfolio of each national bank. The OCC, through its examining staffs in the United States and in London, is able to utilize data generated by analytical systems employed in all national banks for purposes of monitoring global changes. Therefore, the emphasis of the OCC system, itself, centers on loans to those countries whose difficulties are pronounced or whose social, political and economic trends indicate potential debt service problems.

The OCC's Foreign Public Sector Credit Review Committee

Background

Prior to July 1974, national bank examiners were required to evaluate, independently, all credits involving country risk just as they always have been required to evaluate domestic loans. With the increase in international lending by an increasing number of national banks during the late 1960s and early 1970s it became apparent that a few examiners in various parts of the country had reached different conclusions regarding similar, and sometimes the same, loans. The banking industry justly complained about this dissimilar treatment and the OCC shared the bankers' concern. Analysis indicated that the problem centered in large, syndicated, unsecured, public sector credits. The differences were due primarily to diverse levels of examiner experience regarding country risk analysis as well as a vast difference in the quality of credit information encountered among banks. The solution to the immediate problem appeared to require the formation of a committee which, given a broader information base, could study each situation in question and render a uniform opinion to be applied to each such credit during every national bank examination. In July 1974, the responsibility for evaluating foreign public sector loans was placed with a committee comprised of the OCC's most experienced international examiners from Washington, New York, Chicago, and San Francisco. These examiners continually examine, both in the United States and overseas, our country's major multinational banks. Through their examinations, they have developed the skills necessary to evaluate properly foreign public sector loans and it is emphasized here that these major banks'

international portfolios generally contain every type of such loan. Therefore, the perspectives which the committee members develop through their examinations of these major banks are applicable to the examination of all national banks which lend internationally.

Purpose

The OCC recognizes that countries normally do not disappear as can corporate borrowers, and that, traditionally, foreign public sector loans in national banks have an excellent record of ultimate repayment. The OCC also recognizes, however, that historically national banks have not held in portfolio the increased levels of foreign public sector loans which they hold today. The primary purpose of the committee, therefore, is to evaluate these loans not only for ultimate loss potential but, more appropriately, for early identification of those large credits or blocks of credits which could become illiquid and remain in banks' portfolios in some form, long after their currently scheduled maturities. The committee evaluations result in loans being placed into one of five categories relating to the liquidity and soundness of the asset.

1) *Pass* — The loan is being repaid as structured and analysis of the loan indicates no foreseeable interruption in regular payments or eventual payout.

2) *Especially Mentioned* — The loan is being repaid as structured but analysis indicates factual inherent conditions which could lead to an interruption of regular payments.

3) *Substandard* — Orderly repayment is jeopardized or has been interrupted, resulting in a slow paying loan. Ultimate payment in full is expected.

4) *Doubtful* — There is no performance and full repayment appears tenuous.

5) *Loss* — There is no performance and no repayment is expected during the near future. The loan is not bankable, requiring its removal from the bank's assets. A loss classification does not mean that principal never will be recovered.

The committee disseminates its decisions to all national bank examiners who apply them uniformly during their examinations.

Procedures

The committee's evaluation procedures represent an extension of the traditional OCC examination process. The three committee examiners from New York, Chicago, and San Francisco, independently of each

other, continually conduct examinations of the major national banks in those cities. Examiners outside of New York, San Francisco, and Chicago often receive, through their examinations of regional financial center banks, information relevant to the committee purpose. These examiners document their findings and forward their information to OCC headquarters for use and research by the committee. Thus, all areas in the Nation have access to the committee process.

The committee's examiners begin their examinations of foreign public sector loans by determining the amounts of each borrower's liabilities due the bank under examination. The examiners also determine the structure of the loans, e.g., whether the loans are payable in the borrower's local currency or in an external currency; whether the loans are short or long term; or whether the loans are secured or unsecured. The examiners then review the borrower's financial information held by the bank as support for making the loans. The examiners next analyze the financial condition of the borrower in relation to the loans outstanding. Finally, the examiners discuss their analysis with the bank's lending officers in order to obtain information about the loans which may not yet be on file, and in order to receive the officers' opinions about the borrowers' ability to pay those loans.

The committee members meet quarterly in Washington to discuss their individual findings from examinations conducted during the quarter. The members also review data in OCC headquarters' files including that available from other U.S. government sources. The members then evaluate, as a committee, the foreign public sector loans repayable in currencies external to that of the borrowers, and assess whether the borrowers have or likely will have the external currency available to pay the national bank loans when payments are due.

Generally, the committee first looks to external economic information, e.g., balance-of-payments trends over the last few years, the expected results for the next 12 months (the short term), and the external debt structure as well as the service requirements for the same period. The committee's evaluations of loans maturing within 12 months are heavily influenced by the anticipated current account balance and current year's debt service in relation to such factors as available IMF facilities, reserve levels, official and private loan commitments, foreign investment trends and the attitude among bankers toward further lending. Generally, if a borrower appears to have the capacity to repay short-term loans and appears willing to honor the indebtedness, the committee will "pass" the loans. Should a borrower appear to face a critical short-term shortage of foreign exchange and lack availability of credit, the committee may "especially mention" the short-term loans. The committee normally does not criticize short-term trade credits unless they become delinquent or require refinancing.

The committee's evaluations of medium- and long-term loans place greater emphasis on the social/political effects of prevailing economic trends, and their impact on prospective cash flows for external debt service. The committee weighs such things as the borrower's external debt

size and structure in relation to consistency of revenues; realism in projections relative to global commodity consumption and prices; attractiveness to foreign investors; natural and human resource potential; willingness and ability to recognize economic/budgetary problems and formulate appropriate remedial or long-term plans; the anticipated social impact of remedial actions; and, finally, the feasibility of implementing such actions, given the form of government and the internal political climate.

The uncertainties involved in judging long-term risks are apparent. However, it is the degree of these uncertainties that is of concern to the committee. Generally, the committee does not criticize long-term loans which are paying as agreed and which show positive trends for continued performance. If social, political and economic trends are adversely affecting the availability of foreign exchange for debt service, long-term loans might be "especially mentioned." The committee classifies more severely loans which are not meeting scheduled payments, and/or which show trends indicating protracted repayment difficulties.

It is emphasized that the committee evaluations do not apply to foreign public sector loans denominated in the currency of the country where the borrower is located. The committee evaluations also do not apply directly to foreign private sector loans. As a practical matter, the committee is not in a position to evaluate the financial condition of every private borrower, or to determine whether a private borrower in a particular country can generate sufficient exchange outside that country to service its own obligations. Therefore, independent examiner judgment is required to determine whether private sector credits are lesser or greater quality than those loans evaluated by the committee.

Finally, the OCC's Foreign Public Sector Credit Review Committee is an in-house bank examination vehicle. It is important that the committee's determinations be recognized, not as some sort of credit allocation device nor as an order to cease lending within a particular country but as only one source of objective opinion regarding specific types of credit. The Comptroller of the Currency believes that decisions to grant or refuse loans are best left to the discretion of qualified professional lenders. For these reasons, the OCC does not distribute committee criticisms nationwide but communicates those criticisms only to bankers during the normal course of a regular bank examination.

Country Exposure

I believe the point has been sufficiently made that countries cannot be grouped into blanket categories, e.g., all industrialized countries are creditworthy and LDCs are not. Indeed, we are all aware of cases which appear to be contrary to these general assertions.

The same holds true with regard to evaluation of risk within banks' portfolios and for the U.S. banking system as a whole. More current and comprehensive aggregate data are needed. Banks need it to determine their positions relative to other creditors. Bank regulators need it to monitor the health of our banking system. International financial institutions

and the U.S. Government need it if official, bilateral and multilateral assistance is to be synchronized properly.

The OCC, in cooperation with the Federal Reserve System and the Federal Deposit Insurance Corporation, has developed a new Country Exposure Report which is designed to provide a more comprehensive view of all "credit exposure" to, or within, any country, industrialized or otherwise. The report requests 19 categories of data on the different types of credit extended, their maturities, whether to public or private sector borrowers, and whether denominated in a currency local or foreign to the country of the borrower. It will provide cross-border data as was requested by the Federal Reserve System and the Bank for International Settlements earlier this year, but will also permit reallocation of debt from the country of the primary obligor to third country parent companies or guarantors.

In summary, the Country Exposure Report will permit proper delineation (by credit type, by maturity, and by currency) of the varying degrees of risk involved in the aggregate numbers about which so many inappropriate generalizations have been made.

The report has been tested in the format attached as Appendix I. Adjustments will be made to the report based on comments solicited from bankers. Minor adjustments also will be required to iron out any remaining differences with other regulatory reports in terms of country groupings and applicable definitions.

I assure you that we are committed to consolidating existing reports as much as possible and to minimizing the reporting burden on banks as quickly as we can. In the meantime, we thank you for your cooperation and promise you a useful product in return.

Diversifying and Monitoring Global Risks

As discussed thus far, national bank examiners are responsible for the evaluation of the creditworthiness of individual borrowers and for analysis of banks' exposures in specific countries. These processes assist examiners in performing their broader assessments of risk diversification and portfolio management within individual banks. Examiners are interested in the banker's familiarity with each customer's operating environs, the bank's representation in, or frequency of visits to, each market area, and the adequacy of related communication and internal reporting systems.

Examiners must consider the quality and timeliness of statistical and qualitative data upon which country risk analysis is based. This information must be adequate to determine how credits need be, or can best be, structured within each country. Information also must be adequate to develop sound primary and optional global-marketing strategies.

I'm sure we all agree that prudent risk diversification involves a great deal more than the simple allocation of a portfolio among distinct geographic areas. Synchronization of all activities is required and in many instances this can only be done centrally. For example, national bank examiners will continue to expect bankers to be aware of all "concentrations of

credit" in the traditional application of the term, e.g., combinations of loans to parent companies and their subsidiaries, loans to principals and partners, and loans to central governments and their instrumentalities. Moving forward, however, examiners and senior-level bankers must insist upon the centralization of credit information sufficient to determine the existence of concentrations such as those within a specific industry, those reliant on a single commodity, those involving countries joined in economic or political alliances, and countries experiencing a common economic problem. Only brief mention of such things as REITs, shipping, oil and copper prices should be sufficient to establish this point. Perhaps with greater awareness and a certain degree of imagination, reoccurrence of many of our recent problems might be avoided.

It goes without saying that examiners must continue to analyze credits to single borrowers and groups of related borrowers in order to judge compliance with a bank's legal lending limit (Appendix II). Serious problems in this regard can usually be avoided if bankers are willing to assist individual borrowers in structuring their credits within any of the applicable exceptions to the limit. Lending limit complications involving groups of related borrowers, e.g., central governments and their instrumentalities, need not be troublesome provided that bankers obtain adequate credit information to determine that each borrower within a group has the financial ability, over time, to service its own debt obligations and provided further that the loan proceeds are used by the borrowing entity, not by other members of the group. Otherwise, examiners might be compelled to view the group as a single entity for legal limit purposes.

A final point of particular importance is that adequate risk diversification is not applicable only to the asset side of the balance sheet, but the liability side as well. Banks must limit their dependence on any existing sources of funds and examiners will expect bankers to have some idea of their borrowing potential without having to abuse any single funding source in times of need.

We have discussed the bank examiner's approaches to analyzing "country risk," measuring "country exposure" and monitoring overall risk diversification. It is emphasized that these approaches have evolved over several years through open communication between bankers and regulators. The OCC is confident that these procedures may constantly be improved in a manner equitable to all concerns, but in a manner which, first and foremost, is consistent with existing laws and which insures the continuing soundness of our banking system.

APPENDIX I

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

July 1, 1977

TO: THE PRESIDENT OF THE NATIONAL BANK ADDRESSED

The Office of the Comptroller of the Currencu is seeking to develop a comprehensive country exposure report in cooperation with the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation. This report is designed to provide bank supervisors with complete and accurate information which would permit the regular systematic monitoring of overseas lending by United States banks. This Office also believes that the aggregate data could be helpful to the banking industry in its lending decisions.

We recognize that no one form can suit every bank's system yet we believe that our proposed report is a reasonable attempt to develop and reflect more accurate information about country exposure. We expect that the proposed format will easily accommodate data from existing bank reporting systems.

As part of the process for developing this report, this Office initially is requesting the national banks with assets in excess of $300 million, to complete, to the best of their ability, the attached form, as of June 30, 1977. Please return the completed form to the Comptroller of the Currency, International Operations Division, Washington, D.C. 20219, by August 15, 1977.

In addition to completing the proposed form, we invite your comments about any difficulties which you encounter during its preparation. We also invite your suggestions as to possible improvements in the report and most appropriate reporting dates.

This report will be held in strictest confidence. Information which might reveal the activities of individual banks will not be disclosed. Appropriately, aggregated data for all banks may be publicly released at the end of each reporting period.

We thank you for your cooperation on this project and your continued interest in contributing to strengthening the flow of mutually beneficial information between the banking industry and the banking agencies.

Very truly yours,

H. Joe Selby
First Deputy Comptroller for Operations

Country Exposure Report

Part I — Introduction

This report is designed to provide current data on the geographic and maturity distribution of commercial bank international assets and contingent liabilities for supervisory analysis.

The Office of the Comptroller of the Currency is of the opinion that individual bank information reported in this form is exempt from public disclosure under section (b)(8) of the Freedom of Information Act (5 USC 552 (b)(8)). Accordingly, individual bank information reported in this form will be considered confidential and will not be voluntarily disclosed by the Office of the Comptroller of the Currency. Aggregate data derived from this form may be published or otherwise disclosed in a manner which will not reveal the amounts reported by any individual reporting bank.

Part II — General Information

A. Consolidation of Data.
The information is to be derived from all United States offices, foreign branches, and majority-owned domestic and foreign subsidiaries. Data should be reported on a consolidated basis, using the same consolidation procedures and test of significance as for the consolidated Domestic and Foreign Bank Report of Condition.

B. Direct Obligations and Guarantees.
This report is designed to reflect the geographic location of the borrowing recipient of direct extensions of credit (columns 1 through 4), as well as the geographic location of the ultimate source(s) of repayment (columns 9 through 12). Columns 1 through 4 will include the total direct extensions of credit granted to or within the designated country. Externally guaranteed and indirect obligations are identified and reallocated in columns 9 through 12. Letters of awareness or intent, comfort letters, and other similar documents are not considered "guarantees" for the purposes of this report.

C. Implied Guarantees.
Obligations due to the reporting bank from branches and/or wholly-owned subsidiaries of other multinational banks are assumed to contain an implied head office or parent guarantee and should be reallocated in columns 9 through 11. Wholly-owned subsidiaries of these banks are treated in the same manner as are branches, unless, in the opinion of the reporting bank, unguaranteed obligations of such subsidiaries likely would not be honored by the parent institution. Externally guaranteed claims are reallocated in columns 10 and 12.

D. Who Must Report.
All national banks with total assets of $300 million or more as of the date of the last Consolidated Report of Condition (including domestic and foreign subsidiaries).

E. Filing of Reports.
This report will be prepared semiannually, as of March 31 and September 30 and filed not later than 30 days thereafter with the Comptroller of the Currency, International Operations Division, Washington, D.C. 20219.

F. Rounding.
All data entries should be rounded to the nearest million of U.S. dollars. Due not use decimals.

Part III — Specific Instructions and Definitions

1. "United States" includes the States of the United States, the District of Columbia, the Commonwealth of Puerto Rico and the following: American Samoa, the Canal Zone, Guam, Midway Island, the Virgin Islands and Wake Island.

2. "Extensions of Credit" includes loans and discounts, overdrafts, own acceptances purchased, acceptances of other banks purchased, discounted trade bills and other accounts generally designated as LOANS and representing funds actually advanced. Also include bank placements, direct lease financing, customer's liability on acceptances outstanding, all deferred payment of letters of credit and past due or refinanced acceptances executed and outstanding. Also include Federal funds sold or extensions of credit to U.S. branches or wholly-owned subsidiaries of foreign banks.

3. "Securities" includes certificates or other evidences of ownership or participation in central banks, clearing houses, governmental entities and development banks, as well as those of private entities. This definition generally refers to either those securities required by the law of a country, to be held by branches and subsidiaries in that country, or those purchased for investment, and is *not* meant to include actual investments in subsidiaries of the reporting bank. Foreign securities holdings which bear the guarantee of the U.S. Government should also be shown in column 17.

4. "Bank Placements" include all interest or non-interest bearing deposits due from other banks whether at demand, call, or for a specified term (includes Federal Funds Sold to U.S. branches and wholly-owned subsidiaries of foreign banks).

5. "Public" includes all governments in a country, whether central, provincial or municipal, and their departments and agencies as well as banks, corporations or other entities which are majority-owned (either directly or indirectly) or deemed, by the reporting bank, to be majority-controlled by those governments. Extensions of credit to private entities which bear a foreign public entity guarantee should not be reported as public obligations. Bank Placements with branches of publicly-owned banks located outside their home country will be reported as "Public Bank Placements" (column 1) under the country in which that branch is located.

6. "Private" includes individuals, partnerships, corporations and other entities not included under "Public" above. Include private extensions of credit bearing the guarantee of foreign public entities.

7. "Maturities." Amounts reported under columns 6, 7 and 8 must reflect amortization or final maturity dates, as appropriate, rather than interest adjustments or "roll-over" dates.

8. "Commercial Letters of Credit" include those credits covering the movement of goods, whether issued or confirmed. Amounts reflected should be exclusive of deferred payment letters of credit and past due or refinanced acceptances which are reported under "Extensions of Credit" and standby letters of credit which are reported under "Other Commitments."

9. "Other Commitments" includes all fee-paid commitments to grant loans, undisbursed portions of loans contracted, standby letters of credit and guarantees issued.

10. "Portions of 5, 13, 14, 15 and 16 Guaranteed by U.S. Government Agencies" includes obligations guaranteed and/or insured by any department or agency (e.g., the Department of Defense, the Export Import Bank of the United States (including FCIA), the Commodity Credit Corporation) and shall represent only those portions actually guaranteed or insured.

11. All claims on branches and subsidiaries of foreign banks in the United States should be reported in column 9 and reallocated to the country of their head office or parent in column 11.

12. Note that local currency activities are to be reported *only* in columns 18 and 19. Claims of the foreign offices of the reporting bank on residents of the country in which they are located and denominated in the currency of that country will be reported only in column 18 and should not be included in columns 1 through 17. Local currency liabilities of those offices will be reported in column 19.

13. A work copy of the report is included for your convenience.

14. Questions as to the preparation of this report should be directed to the Office of the Comptroller of the Currency, International Operations Division, telephone (202) 447-1747.

APPENDIX II

Lending Limits

12 U.S.C. 84 — The total obligations to any national banking association of any person, copartnership, association, or corporation shall at no time exceed 10 per centum of the amount of the capital stock of such association actually paid in and unimpaired and 10 per centum of its unimpaired surplus fund. The term "obligations" shall mean the direct liability of the maker or acceptor of paper discounted with or sold to such association and the liability of the endorser, drawer, or guarantor who obtains a loan from or discounts paper with or sells paper under his guaranty to such association and shall include in the case of obligations of a copartnership or association the obligations of the several members thereof and shall include in the case of obligations of a corporation all obligations of all subsidiaries thereof in which such corporation owns or controls a majority interest. Such limitation of 10 per centum shall be subject to the following exceptions:

(1) Obligations in the form of drafts or bills of exchange drawn in good faith against actually existing values shall not be subject under this section to any limitation based upon such capital and surplus.

(2) Obligations arising out of the discount of commercial or business paper actually owned by the person, copartnership, association, or corporation negotiating the same shall not be subject under this section to any limitation based upon such capital and surplus.

(3) Obligations drawn in good faith against actually existing values and secured by goods or commodities in process of shipment shall not be subject under this section to any limitation based upon such capital and surplus.

(4) Obligations as indorser or guarantor of notes, other than commercial or business paper excepted under (2) hereof, having a maturity of not more than six months, and owned by the person, corporation, association, or copartnership indorsing and negotiating the same, shall be subject under this section to a limitation of 15 per centum of such capital and surplus in addition to such 10 per centum of such capital and surplus.

(5) Obligations in the form of banker's acceptances of other banks of the kind described in section 13 of the Federal Reserve Act shall not be subject under this section to any limitation based upon such capital and surplus.

(6) Obligations of any person, copartnership, association, or corporation, in the form of notes or drafts secured by shipping documents,

warehouse receipts, or other such documents transferring or securing title covering readily marketable nonperishable staples when such property is fully covered by insurance, if it is customary to insure such staples, shall be subject under this section to a limitation of 15 per centum of such capital and surplus in addition to such 10 per centum of such capital and surplus when the market value of such staples securing such obligation is not at any time less than 115 per centum of the face amount of such obligation, and to an additional increase of limitation of 5 per centum of such capital and surplus in addition to such 25 per centum of such capital and surplus when the market value of such staples securing such additional obligation is not at any time less than 120 per centum of the face amount of such additional obligation, and to a further additional increase of limitation of 5 per centum of such capital and surplus in addition to such 30 per centum of such capital and surplus when the market value of such staples securing such additional obligation is not at any time less than 125 per centum of the face amount of such additional obligation, and to a further additional increase of limitation of 5 per centum of such capital and surplus in addition to such 35 per centum of such capital and surplus when the market value of such staples securing such additional obligation is not at any time less than 130 per centum of the face amount of such additional obligation, and to a further additional increase of limitation of 5 per centum of such capital and surplus in addition to such 40 per centum of such capital and surplus when the market value of such staples securing such additional obligation is not at any time less than 135 per centum of the face amount of such additional obligation, and to a further additional increase of limitation of 5 per centum of such capital and surplus in addition to such 45 per centum of such capital and surplus when the market value of such staples securing such additional obligation is not at any time less than 140 per centum of the face amount of such additional obligation, but this exception shall not apply to obligations of any one person, copartnership, association, or corporation arising from the same transactions and/or secured by the identical staples for more than ten months. Obligations of any person, copartnership, association, or corporation in the form of notes or drafts secured by shipping documents, warehouse receipts, or other such documents transferring or securing title covering refrigerated or frozen readily marketable staples when such property is fully covered by insurance, shall be subject under this section to a limitation of 15 per centum of such capital and surplus in addition to such 10 per centum of such capital and surplus when the market value of such staples securing such obligation is not at any time less than 115 per centum of the face amount of such additional obligation, but this exception shall not apply to obligations of any one person, copartnership, association, or corporation arising from the same transactions and/or secured by the identical staples for more than six months.

(7) Obligations of any person, copartnership, association, or corporation in the form of notes, or drafts secured by shipping documents or instruments transferring or securing title covering livestock, or giving a lien on livestock when the market value of the livestock securing the obligation is not at any time less than 115 per centum of the face amount of the notes covered by such documents shall be subject under this section to a limitation of 15 per centum of such capital and surplus in addition to such 10 per centum of such capital and surplus. Obligations arising out of the discount by dealers in dairy cattle of paper given in payment for dairy cattle, which bear a full recourse endorsement or unconditional guarantee of the seller and are secured by the cattle being sold, shall be subject under this section to a limitation of 15 per centum of such capital and surplus in addition to such 10 per centum of such capital and surplus.

(8) Obligations of any person, copartnership, association, or corporation secured by not less than a like amount of bonds or notes of the United States issued since April 24, 1917, or certificates of indebtedness of the United States, treasury bills of the United States, or obligations fully guaranteed both as to principal and interest by the United States, shall (except to the extent permitted by rules and regulations prescribed by the Comptroller of the Currency, with the approval of the Secretary of the Treasury) be subject under this section to a limitation of 15 per centum of such capital and surplus in addition to such 10 per centum of such capital and surplus.

(9) Obligations representing loans to any national banking association or to any banking institution organized under the laws of any State, or to any receiver, conservator, or superintendent of banks, or to any other agent, in charge of the business and property of any such association or banking institution, when such loans are approved by the Comptroller of the Currency, shall not be subject under this section to any limitation based upon such capital and surplus.

(10) Obligations shall not be subject under this section to any limitation based upon such capital and surplus to the extent that such obligations are secured or covered by guaranties, or by commitments or agreements to take over or to purchase, made by any Federal Reserve Bank or by the United States or any department, bureau, board, commission, or establishment of the United States, including any corporation wholly owned directly or indirectly by the United States: *Provided*, That such guaranties, agreements, or commitments are unconditional and must be performed by payment of cash or its equivalent within sixty days after demand. The Comptroller of the Currency is hereby authorized to define the terms herein used if and when he may deem it necessary.

(11) Obligations of a local public agency (as defined in section 1460(h) of Title 42) or of a public housing agency (as defined in the United States Housing Act of 1937, as amended) which have a maturity of not more than eighteen months shall not be subject under this section to any limitation, if such obligations are secured by an agreement between the obligor agency and the Secretary of Housing and Urban Development in which the agency agrees to borrow from the Secretary, and the Secretary agrees to lend to the agency, prior to the maturity of such obligations, monies in an amount which (together with any other monies irrevocably committed to the payment of interest on such obligations) will suffice to pay the principal of such obligations with interest to maturity, which monies under the terms of said agreement are required to be used for that purpose.

(12) Obligations insured by the Secretary of Agriculture pursuant to the Bankhead-Jones Farm Tenant Act, as amended, or the Act of August 28, 1937, as amended (relating to the conservation of water resources), or sections 1471-1485 of Title 42, shall be subject under this section to a limitation of 15 per centum of such capital and surplus in addition to such 10 per centum of such capital and surplus.

(13) Obligations as endorser or guarantor of negotiable or non-negotiable installment consumer paper which carries a full recourse endorsement or unconditional guarantee by the person, copartnership, association, or corporation transferring the same, shall be subject under this section to a limitation of 15 per centum of such capital and surplus in addition to such 10 per centum of such capital and surplus: *Provided, however*, That if the bank's files or the knowledge of its officers of the financial condition of each maker of such obligations is reasonably adequate, and upon certification by an officer of the bank designated for that purpose by the board of directors of the bank, that the responsibility of each maker of such obligations has been evaluated and the bank is relying primarily upon each such maker for the payment of such obligations, the limitations of this section as to the obligations of each such maker shall be the sole applicable loan limitation: *Provided further*, That such certification shall be in writing and shall be retained as part of the records of such bank.

(14) Obligations of the Student Loan Marketing Association shall not be subject to any limitation based upon such capital and surplus.

Combining Loans to Separate Borrowers

7.1310. Loans to corporations and their subsidiaries.

(a) Law — 12 U.S.C. 84

"The total obligations to any national banking association of any person, copartnership, association, or corporation shall at no time exceed 10 per centum of the amount of capital stock of such association actually paid in and unimpaired and 10 per centum of its unimpaired surplus funds. The term 'obligations'*** shall include in the case of obligations of a copartnership or association the obligations of the several members thereof and shall include in the case of obligations of a corporation all obligations of all subsidiaries thereof in which such corporation owns or controls a majority interest.***"

(b) Purpose

The section is intended to prevent one individual, or a relatively small group, from borrowing an unduly large amount of the bank's deposits for the use of the particular business enterprises in which they are engaged. It is intended to safeguard the bank's depositors by spreading the loans among a relatively large number of persons engaged in different lines of business.

(c) General rules

(1) Obligations of a parent corporation shall be combined with obligations of all subsidiary corporations in which the parent owns or controls a majority interest.

(2) If the parent corporation is not borrowing, obligations of subsidiary corporations are generally not combined except in the following situations.

(i) Bank is looking to a single source for repayment of the loan.

(ii) One or more loans is for the accomodation of the parent corporation or other subsidiary.

(iii) The borrowing corporations are not separate concerns in reality but merely departments or divisions of a single enterprise.

(3) Obligations of a corporation must be combined with any other extension of credit the proceeds of which are used for the benefit of the corporation.

7.1320. Loans to members of a partnership or association.

(a) Under 12 U.S.C. 84 the obligations of the several members of a partnership, regardless of the purpose or the use of proceeds, are required to be combined with obligations of the partnership.

(b) In addition, where persons engaged in a common enterprise, whether in the form of a partnership, joint venture, or other association, individually borrow funds which are to be used in that enterprise, the loans must be considered as a single credit.

BANK_____ CHARTER NO._____ AS OF_____

COUNTRY EXPOSURE REPORT
(in millions of U.S. dollars)

Non-Local Currency Activities

Local Currency Activities

		Claims Outstanding												Contingent Claims						
		Extensions of Credit and Securities					Maturities			Claims on "banks" in This Country With Head Office or Parent in Another Country	Externally Guaranteed Claims from Column (5)	Claims on "banks" in Other Countries With Head Office or Parent in This Country	Claims on Borrowers in Other Countries Guaranteed by Residents of This Country	Commercial Letters of Credit		Other Commitments		Portions of (5), (13), (14), (15) and (16) Guaranteed by U.S. Government Agencies	Local Currency Claims	Local Currency Liabilities
		Bank Placements					Estimated Breakdown of Column (5) by Time Remaining to Maturity													
Code	Area and Country	Public	Private	Other Public	Other Private	Total Extensions of Direct Credit	1 year and under	Over 1 year to 5 years	5 years and over					Public	Private	Public	Private			
		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)	(17)	(18)	(19)
100	**WESTERN EUROPE**																			
101	Austria																			
103	Belgium																			
105	Denmark																			
107	Finland																			
109	France																			
111	Greece																			
113	Iceland																			
115	Ireland																			
117	Italy																			
119	Luxembourg																			
121	Norway																			
123	Netherlands																			
125	Portugal																			
127	Spain																			
129	Sweden																			
131	Switzerland																			
133	United Kingdom																			
135	West Germany																			
199	Other																			

Discussion

Herbert G. Grubel*

The historic reason for the establishment of the Office of the Comptroller of the Currency has been to protect the American public from criminals enriching themselves through fraudulent schemes involving banks. Nineteenth-century banking history abounds with examples where criminals have stripped banks of cash and invested in schemes of obviously questionable profitability or of completely fraudulent design. The development of financial disclosure regulation, greater public sophistication brought about in part by the communications revolution and self-policing among banks have made it much more difficult in today's world to defraud the public through the manipulation of banking business. The need for the services of the Office of the Comptroller of the Currency therefore is much less today than what it was originally.

However, like all bureaucratic institutions, the Office of the Comptroller of the Currency has adapted to the environment and found a modified reason for its existence. Instead of examining banks' behavior and portfolios to prevent fraud, it has now taken on the responsibility to pass qualitative judgment on the merit of banks' investment decisions. In this role, the Comptroller of the Currency faces an impossible task. In his speech, Mr. Schuler practically admitted to this fact when he stated that the Office cannot evaluate the merit of the thousands of domestic loan decisions made by U.S. banks every day. It does not take much sophistication to realize that the only operative principle in this context is to assume that bankers, putting on line their careers and wealth, are the best judges of the merit of individual and aggregate portfolio decisions.

Such an operating principle for the Comptroller of the Currency, of course, does not mean that there would never be any bank failures. They have continued to occur as men make errors of judgment. It is difficult to assess whether or not the rate of failure would have been much greater in the absence of the supervisory work by the Comptroller, but it is clear that failures could not be prevented.

The American public has not been upset by the record of performance of the Comptroller of the Currency because bank failures have lost much of the sting they had in the turbulent past of U.S. banking history. The Federal Deposit Insurance Corporation and the discounting facilities of the Federal Reserve System have prevented the development of financial panics and waves of bank failures in the wake of isolated bankruptcies.

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New Developments

While the U.S. banking community and public have learned to live with the Office of the Comptroller of the Currency and its normal activities, occasionally the development of new financial institutions and practices results in the creation of some problems. The new financial practices and institutions which have given rise to such problems are, of course, the development of international banking and the loans of U.S. banks to national governments.

Mr. Schuler in his speech and paper presented us with useful insights about how he and his staff evaluate the merit of loans made to national governments. His description sounds reasonable and I am certain that the evaluation process makes excellent use of the most current information on the financial condition of countries available from the vast resources of the Federal Government and the banking industry. Yet, as the remarks of representatives of the banking community at the Conference have shown, there is considerable dissatisfaction with the work done by Mr. Schuler's office. The official evaluation of country risk has important, direct implications for the official rating of the quality of portfolios of banks which have made loans to some countries, while the banks have no recourse to challenge the judgment of country risks made by the bureaucrats.

Thus, the Comptroller of the Currency who in practice admittedly is incapable of evaluating the merit of all private loans and largely depends on the principle of self-interest to guide its supervisory task has decided not to rely on this principle in the case of loans to foreign governments. In my view, this reaction to the development of the new loan practices of U.S. banks is not sensible. It assumes implicitly that the Comptroller is in a better position to evaluate country risk than are the banks who are putting on the line their own money. Moreover, he makes his judgments in the light of information which may have become available only after the original bank investment decisions have been made. Banks simply cannot protect themselves against the bureaucratic consequences of such second-guessing with the help of superior information and hindsight. Nor should they have to for the sake of economic efficiency or stability. I see no easy way in which the Comptroller of the Currency can circumvent the law requiring him to evaluate bank loans to foreign countries as part of his overall mandate. However, there must be some bureaucratic way of shielding banks from the consequences of such country evaluations. If this is not possible, remedial legislative action may be necessary.

Implications of the Analysis

The preceding analysis and judgments do not imply that the development of international banks and loans to governments are not a potential source of bankruptcies and economic instability. All innovations in financial markets are accompanied by such risks. What the analysis does imply is that the second-guessing of banks' investment decisions by the

Comptroller of the Currency is not the most efficient way of dealing with the problems arising from international banking and loans to governments.

The most efficient method for dealing with these problems is for the Comptroller of the Currency, or some other Federal agency, to assemble, analyze, and present information relevant for making private decisions about the risks of lending to individual countries. Such knowledge can be produced with the benefit of enormous economies of scale, especially since the Federal Government has collected the intelligence for many other purposes.

This information must be made available promptly and readily. It would be certain to increase the quality of the investment decisions made by U.S. banks and therefore reduce the risk of illiquidity and bankruptcy with accompanying social benefits in greater financial stability in the long run. The externalities of this sort are the price-theoretic justification for the public production of the knowledge.

I am pleased to note that Mr. Schuler reports on a new data survey by the Comptroller of the Currency which will do much to provide information relevant for banks lending to foreign countries. This data survey permits the publication of global data of U.S. banks' assets in different currencies, maturities and by types of borrower. I hope that these data will be published promptly and made readily available. It is unfortunate that analogous information is not collected by the same Office about the liabilities of international banks, as well as their forward exchange commitments. Such information could be used to produce quickly data on the maturity and exchange risk of U.S. international banks, in analogy with such data published by the Bank of England. Many analysts have found the British data a source of comfort because they revealed that international banks in Britain, including the U.S. banks, act more like brokers than banks and show an almost perfect match in the maturity of assets and liabilities in different currencies. Monitoring and public availability of analogous data for U.S. banks could do much to allay fears about potential problems of illiquidity and failure due to it, though the problem of default risk remains.

Some Long-Run Problems Caused by Innovators

Let me conclude my remarks with some reflections on the most worrisome problem facing all official regulatory and supervisory agencies. The recent concern over private bank lending to foreign government and quasi-public institutions, together with the innovative responses of the Comptroller of the Currency in its data collection and evaluation procedures indicates the fact that no effective mechanism exists to detect dangers from new practices of financial intermediaries until they have developed into a more or less substantial risk. Regulatory agencies are much like generals. They are equipped superbly to fight the last war. Bank

supervisors do a fine job of monitoring the potential risks emanating from traditional banking practices. But the most serious problems in war and the supervisory business tend to develop as a result of unforeseen innovations. It could be, though I doubt that it is, that the risks from international bank lending are substantial and cannot be eliminated by anything that can be done now, after the fact.

Unfortunately, there are no easy ways for generals or bank supervisors to anticipate all dangerous future innovations. Limiting financial intermediaries legally to doing business only in the traditional ways is not a viable method of control for obvious reasons. Constant vigilance, the exchange of information among government employees, the industry and academics are the only ways to minimize the risks from innovation.

Response

Harold D. Schuler*

I appreciate Mr. Grubel's observations that bank supervisors, like generals, are able to learn from past experiences and that since they possess no crystal ball, bank supervisors must rely upon "constant vigilance" in order to minimize risks from innovation. Mr. Grubel's final statement indicates some understanding of the need for bank supervisors to conduct regular examinations of banks and to provide continuous monitoring as well as feedback through published results of data reports submitted by banks. Yet, those observations are in direct conflict with statements made earlier in his critique.

Mr. Grubel's perceptions of both the reason for the establishment of the Office of the Comptroller of the Currency as well as its intended and present purpose suffer from a serious misunderstanding of historic fact. In this regard, I extend a warm welcome to Mr. Grubel to visit our offices in order that he may acquire a better understanding of OCC's role in bank supervision and I have made a note to send him a copy of a handy little history book entitled *The Comptroller and Bank Supervision.*

Mr. Grubel remarks that I practically admitted that the Comptroller of the Currency faces an impossible task in evaluating the merit of thousands of domestic loan decisions made by U.S. banks every day. What I, in fact, said (and I quote from page 141 of my paper) is that, "As a practical matter, the Committee is not in a position to evaluate the financial condition of every private borrower, or to determine whether a borrower in a particular country can generate sufficient exchange outside that country to service its own obligations. Therefore, independent examiner judgment is required to determine whether private sector credits are of lesser or greater quality than those evaluated by the Committee." He again misquotes me, in his third paragraph under the section *New Developments.*

Mr. Grubel suggests that "It does not take much sophistication to realize that the only operative principle in this context (bank supervision) is to assume that bankers, putting on line their careers and wealth, are the best judges of the merit of individual and aggregate portfolio decisions." We seem to have lost sight of depositors and their interests somewhere

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along the line. This oversight occurs, again in the third paragraph under *New Developments,* where he states:

> It assumes implicitly that the Comptroller is in a better position to evaluate country risk than are the banks who are putting on the line their own money. Moreover, he makes judgments in light of information which may become available only after the original bank investment decisions have been made. Banks simply cannot protect themselves against the bureaucratic consequences of such second-guessing with the help of superior information and hindsight. *Nor should they have to for the sake of economic efficiency or stability.*

I must say that I have never met a banker who shares Mr. Grubel's views. Bankers are all well aware that loans can go bad after they are made and responsible bankers welcome an independent appraisal of their portfolios.

Finally, I am not aware of the precise data which lead Mr. Grubel to believe that "international banks in Britain, including the U.S. banks, act more like brokers than banks and show an almost perfect match in the maturity of assets and liabilities in different currencies." I submit, however, that loans were reported not by final maturity but by interest adjustment dates or funding rollover dates for purposes of compiling such data.

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