

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

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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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¹The 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.

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

³For 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.

⁴This 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 I
Foreign Branches of U.S. Banks, Number and Total Assets, 1965-76

End of Year	U.S. banks operating foreign branches		Foreign branches		Total assets of foreign branches		
	Number ¹ (1)	Percent change from preceding year (2)	Number ¹ (3)	Percent change from preceding year (4)	Billions of current dollars (5)	Dollar amount ² (6)	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

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

²Deflated 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.

¹Caymans 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.

¹The 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.

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

³Equity 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	+21	+27	+61	+18	+28
Reported by foreign branches ²	+80	+47	+42	+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	+58	+7	+15	+21
Reported by foreign branches ⁴	+79	+42	+52	+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	+15	+21	+64	+10	+13
Reported by foreign branches ⁴	+84	+53	+29	+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	
	Domestic		International	Domestic	International			
	1970	1976	1970					
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	

^aContinental 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

	1970	1971	1972	1973	1974	1975
(Dollar amounts in millions)						
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.

¹For 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.

²Foreign operations means foreign offices.

³Data 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.

⁴Figures 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.

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

⁶The 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

⁵International 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.

⁶Note 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."

⁷Board 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

⁸Interviews 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.

⁹One 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.

¹⁰The 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

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

¹²Citicorp 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

¹Excludes 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:

<u>R²</u>	<u>A</u>	<u>I</u>	<u>Intercept</u>
0.0606	-0.0000	0.0297	0.6328
	(-0.26)	(1.52)	(1.08)

(t-ratios in parentheses)

¹³A 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.

¹⁴A 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

¹Averages 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

¹⁵On 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

¹⁶For 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.

¹⁷Interviews 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

¹⁸The 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).

¹⁹Several 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.

²⁰For 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.

²¹See 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.

²²U.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.

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

²⁴In 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 \equiv U.S. direct investment position;

G \equiv gross national product;

X + M \equiv exports plus imports;

R \equiv 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

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

²⁶With 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 (non-multinational) 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.

²⁷For 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.

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

²⁹On 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 against + 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)

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

^bThe 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, non-multinational 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

Country	End of Year									
	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. non-banking 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)

^aThe eight countries are: Belgium and Luxembourg, France, Ireland, Italy, Japan, The Netherlands, Panama and United Kingdom.

^bThe 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

	$\frac{C_F}{C_T}$	$\frac{L_F}{L_T}$	Lower of (1) or (2)	$\frac{C_F + L_F}{C_T + L_T}$	$\frac{C_{FB} + L_{FB}}{C_T + L_T}$	$\frac{C_{FN} + L_{FN}}{C_T + L_T}$
	(1)	(2)	(3)	(4)	(5)	(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

	$\frac{C_F}{C_T}$	$\frac{L_F}{L_T}$	Lower of (1) or (2)	$\frac{C_F + L_F}{C_T + L_T}$	$\frac{C_{FB} + L_{FB}}{C_T + L_T}$	$\frac{C_{FN} + L_{FN}}{C_T + L_T}$
	(1)	(2)	(3)	(4)	(5)	(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, Belgium, Greece, Hong Kong, Italy, The Netherlands, Panama, Singapore, Switzerland;

1971: Austria, Belgium, 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 = branch claims on identifiable foreign addressees.

C_T = total branch claims for which U.S. or foreign addressee is given.

L_F = branch liabilities to identifiable foreign addressees.

L_T = total branch liabilities for which U.S. or foreign addressee is given.

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

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

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

L_{FN} = 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.

³⁰A 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 Multi-national 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 seemed 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

¹It 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).

²There 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.

³See 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).