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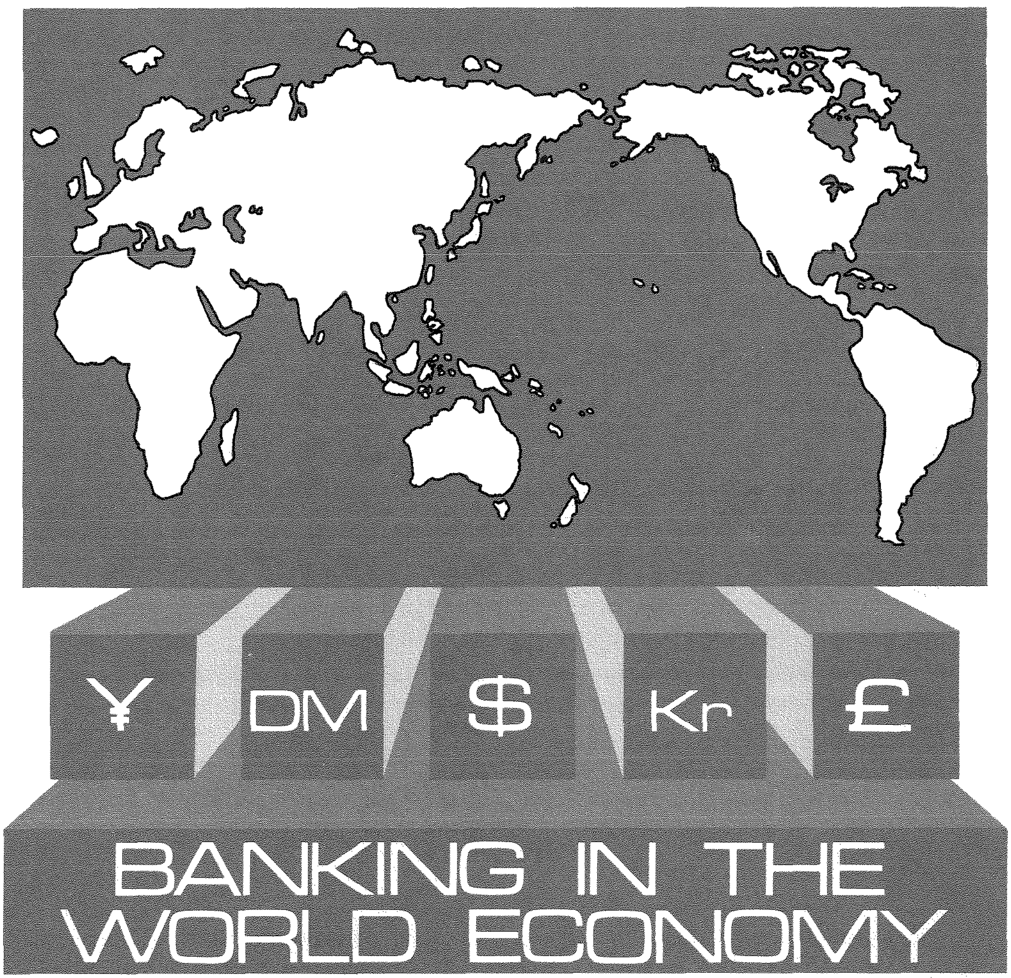

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International Banking, Risk, and U.S. Regulatory Policies

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The overseas expansion of the U.S. banking industry has produced a network of branches and subsidiaries whose assets and liabilities now exceed $200 billion, primarily on the basis of an upsurge in activity over the past decade. Despite concern about this rapid increase in overseas activity,[1] international banking has exhibited great resiliency in financing world trade in the face of the strains associated with recession and inflation. Nonetheless, the size and character of the banks' foreign assets and liabilities present special problems to regulators in supervising international banking.

This paper presents an analysis of these international regulatory problems. Section I reviews recent trends in U.S. banks' international operations, showing the increased numbers of participating banks and the growth in international credits. Section II discusses the rationale for regulation in general, and Section III examines the risks in international banking that could require regulation. The last section assesses current regulatory problems and trends in the light of the preceding analysis.

I. Growth of International Operations

As recently as 1965, U.S. foreign banking was dominated by 13 large banks with considerable experience in the field (Table 1). But then there began a rush of new banks to establish foreign offices.[2] By 1973, when the rush slowed, 125 U.S. banks were operating 737 branches overseas, with total assets of $129.9 billion. The number of branches has changed little in subsequent years, but total assets have continued to grow, reaching $222.9 billion by March 1977.[3] This figure equalled 22 percent of domestic bank assets and approximately three times U.S. banks' equity capital. Indeed, for some large banks, claims on foreigners amount to as much as one-quarter to one-half of total assets (Table 2).

The decade of the 1960's was marked by rapid growth of international trade, full convertibility of most of the major currencies, and rapid expansion overseas by major U.S. corporations. U.S. banks participated in this overseas movement not only because of a search for new opportunities, but also because of a need to expand overseas operations in order to meet the needs of their corporate customers. In this period, international trade more than quadrupled and generated additional demand for finance. A major new financial institution arose in the form of the Eurodollar market, enabling foreign branches to raise needed funds outside the United States without being subject to domestic reserve requirements and interest-rate ceilings. In addition, U.S. controls on capital flows affected international banking trends. From 1965 to 1974, U.S. banks were hampered from making foreign loans directly from their domestic offices by the so-called Voluntary Foreign Credit Restraint Program. Therefore, during much of this period, banks were encouraged to fund their overseas lending from external sources, and banks without foreign branches were at a disadvantage in competing for international business. At other times, slow domestic-business demand encouraged U.S. banks to look overseas for customers.

This period of enthusiastic overseas expansion came to an end by 1974. For one reason, the dis-

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mantling of controls on capital flows permitted more lending from home offices. But in addition, many banks by this time found that international banking required skills which they did not have, and many found that the costs were higher and the profits lower than expected.

The international-banking scene took on a new character beginning in 1974. The sharp increase in oil prices that year created massive trade surpluses for oil-exporting nations along with large deficits for the major oil-importing countries. In part, the deficits were financed indirectly by the oil-exporting countries recycling funds through the international-banking system. Commercial banks played a key role in this process by using the oil exporters' deposits to finance the imports of oil importing countries. International lending jumped 44 percent (in dollar terms) between year-end 1974 and 1976—an impressive amount even after allowing for the 12-percent rise in prices over the period (Table 1). This explains much of the increase in the assets and liabilities of U.S. foreign branches during the 1974-76 period.[4]

Despite the movement of many small U.S. banks overseas, the market remains dominated by the giant multinational banks. Just 9 of the 14,000 banks in this country account for 540 of the 737 overseas branches and 77 percent of the overseas assets. Over 70 of the 125 banks operating outside the United States have only "shell branches" in offshore money markets, such as Nassau or the Cayman Islands.[5]

In most cases, "shell branches" are more a legal fiction than a real office, yet transactions as-

Table 2
Assets of Foreign Branches of U.S. Banks
(as of December 31, 1976)

	$Billion	$Billion
1. All Foreign Countries		
a. All Currencies		
Claims on United States	8.0	
Parent bank		4.4
Other		3.6
Claims on Foreigners	204.2	
Other branches of parent bank		45.9
Other banks		83.6
Official institutions		10.6
Nonbank foreigners		64.1
Other Assets	7.0	
TOTAL	219.2	
b. Payable in U.S. dollars		
Claims on United States	7.7	
Parent bank		4.4
Other		3.3
Claims on foreigners	156.7	
Other branches of parent bank		37.8
Other bank		66.3
Official institutions		9.0
Nonbank foreigners		43.6
Other Assets	3.2	
TOTAL	167.6	
2. United Kingdom		
Total, all currencies	81.5	
Total, payable in U.S. dollars	61.6	
3. Bahamas and Cayman Islands (British West Indies)		
Total, all currencies	66.8	
Total, payable in U.S. dollars	62.7	

Source: Board of Governors of the Federal Reserve System.

Table 1
Overseas Branches Of U.S Banks
(as of year-end except June 1977)

	1960	1965	1969	1970	1971	1972	1973	1974	1975	1976	(June) 1977
Number of U.S. banks with overseas branches	8	13	53	79	91	108	122	125	126	127	130
Number of overseas branches	131	211	459	536	583	627	697	734	762	731	737
Assets of branches* ($ billion)	3.5	9.1	35.3	46.5	59.8	78.2	121.9	151.9	176.5	219.2	NA

Source: Board of Governors of the Federal Reserve System.
*Includes inter-branch funds.

signed to such branches are offshore transactions and not subject to domestic reserve requirements. Lending decisions can be made at the U.S. head office or elsewhere, and funds can be raised in London to supply loans to customers outside the United States through the books of these branches. This arrangement allows smaller banks which could not justify the high overhead expense of overseas-branch operation in such locations as London or Frankfurt to obtain offshore funds for their foreign lending. After adjusting for these shell branches, the number of banks with true foreign branches or subsidiaries is much smaller than the totals indicate.

Indeed, only a few large banks have the resources to maintain extensive branch networks and to raise the funds needed by large international borrowers. Because of their size, these banks can reduce the threat of losses by diversification and can build up the necessary staff to evaluate foreign credits properly. Smaller banks, in contrast, try to reduce their risk exposure by concentrating their efforts in the interbank Eurodollar market and in the developed countries.

II. Rationale For Banking Regulation

The rationale for banking regulation in this country is based upon the need, first, to promote economic stability and, second, to promote competition. The first goal attempts to minimize disruptions originating in the banking sector that cause fluctuations in output or employment. Because commercial banking in a modern economy is the source of the bulk of the domestic money supply and the provider of crucial financial services, public policy is always concerned with the stability of the banking system as well as the soundness of individual banks. In fact, the Federal Reserve System from its inception has had the responsibility of minimizing financial instability. The System was designed to act as lender of last resort—from which responsibility evolved its monetary-policy role—and also to act as the supervisor for state-chartered member banks. The Comptroller of the Currency, which had been the first Federal supervisory agency, has retained its responsibility for nationally-chartered banks, while the Federal Deposit Insurance Corporation since the 1930's has taken on supervisory responsibilities for state banks which are not members of the Federal Reserve System.

The second regulatory policy goal is maintenance of competition.[6] Banking is regulated to prevent undue concentration of financial resources in commercial banking, and also to preserve competition among nonbanking institutions by keeping banks out of that arena. Various Federal laws are directed to this end. Under the Glass-Steagall Act of 1932, commercial banking is separated from so-called investment banking.[7] This is in contrast to the tradition of continental Europe, where French and German banks typically combine both functions. In addition, the Bank Merger Act of 1960 established competitive standards for the approval of banking acquisitions and mergers, while the 1970 amendments to the Bank Holding Company Act set similar rules to limit the expansion of corporations controlling banks into nonbanking financial activities.

Both objectives have resulted in the expansion of government regulation over banking. The competitive goal rests upon well-known theoretical foundations: increased concentration in a market tends to reduce output and to raise market price. It follows that regulation is necessary to prevent undesirable concentration. The value of economic stability can also be readily accepted, although the theoretical case for bank regulation is less obvious in this case. The concept of financial stability—or rather instability—really concerns attitudes toward risk. Would unregulated banks build their portfolios in a way that would expose the financial sector to increased risk, and thus bring about increased (and undesirable) fluctuations in real economic activity? It may be assumed that regulation, by reducing risk, improves the functioning of the financial system by lowering the chance of destabilizing losses.

The banks themselves, as profit-making institutions, have an incentive to protect themselves against risk.[8] Risk cannot be avoided but portfolio diversification can reduce it. Banks must decide how much expected risk they are willing to trade off for an increase in expected return. They may respond to higher risk by charging higher interest rates, or by demanding increased collateral or loan guarantees. The banks themselves certainly are aware of the problem of risk. The policy question comes down to whether, in making individual risk assessments, the banks' private decisions result in risk-taking that is higher than society prefers.

It has been argued that existing institutional arrangements tend to encourage risk-taking.[9] Deposit insurance, for example, tends to increase incentives for banks to take more risk, by taking over the role traditionally filled by bank capital. Specifically, government-sponsored insurance protects depositors by making them less sensitive to a bank's capital position, and thus encourages bankers to increase their leverage and, therefore, their risk exposure.

In effect, deposit insurance tends to shift risk to the public sector. To the extent that official international-lending arrangements—through (say) the International Monetary Fund—act as a form of international deposit-insurance, banks may be tempted to increase risk exposure beyond some social optimum. While such support may result in greater overall international stability, regulation may be needed to keep individual banks' risk exposure within acceptable limits.

In addition, regulation may be justified where regulators are better qualified than the banks themselves to assess the banks' own risks. This may seem to be a strong assumption, but examiners develop considerable expertise through their constant evaluation of bank records. Banking regulation can be viewed as imposing standards based on contemporary "best-practice," with those standards shifting over time as experience confirms the safety of new practices. Regulation standards are moving averages which tend to smooth trends in banking, thereby reducing the chance of major variations in riskiness.

Poor internal procedures may induce undue risk-taking and expose a bank to unnecessary losses. Managers may gather insufficient information for assessing loan quality, or they may delegate too much loan authority, or they may concentrate their loans in too few areas. When operating overseas they may face excessive costs

Table 3
Assets Held as Claims on Foreign Countries by Head Offices and Foreign Branches of U.S. Banks[1]
(as of December 1976)

		$Billion			$Billion
Group of Ten and Switzerland		100.1	Non-Oil Developing Countries		45.2
Belgium-Luxembourg	6.1		Argentina	1.9	
France	10.0		Brazil	11.8	
Germany	8.8		Mexico	11.5	
Italy	5.8		Other Latin America	6.7	
Netherlands	2.8		Korea	3.1	
Sweden	1.3		Philippines	2.2	
Switzerland	3.0		Taiwan	2.4	
United Kingdom	41.4		Other Asia and Africa	5.6	
Canada	5.1		Eastern Europe		5.2
Japan	15.8				
			Offshore Banking Centers		23.9
Other Developed Countries		15.1	Bahamas	9.3	
			Bermuda and British West Indies	4.3	
OPEC Countries		12.7	Hong Kong	2.3	
			Singapore	4.6	
			Other Offshore	3.4	
			Miscellaneous		5.1
			TOTAL		207.3

Source: Board of Governors of the Federal Reserve System

[1]This includes claims on private individuals, businesses, and banks in foreign countries, as well as foreign governments and their agencies.

in obtaining data, or may encounter difficulties in assessing credit risk because of lack of familiarity with local customers. Yet the same problem exists domestically when a bank considers lending to customers outside its usual markets. Similar types of problems occur in assessing banking risk both internationally and domestically, and the basic process of judging creditworthiness is not fundamentally different.

The factor distinguishing international banking from domestic banking is the presence of "sovereign risk." Even if the foreign customer is financially able to repay a loan—that is, there is no "banking risk" in the sense of commercial bankruptcy—his country's government may prevent the appropriate conversion of foreign exchange to repay the bank loan. This is a default on the national level, not the private level, as will be seen from the discussion in the next section.

International lending thus presents risks similar to the normal commercial risks of domestic lending, with the one exception of sovereign risk. What role then does regulation have to play? Without regulation, commercial banks might choose a combination of risk and expected return that is unacceptable from a social viewpoint. And even if banks assess risk correctly, they may undertake activities that expose the U.S. banking system to disturbances which are unacceptable on public-policy grounds.

On the other hand, maintenance of competition is not yet a policy problem for international banking supervision. Ordinarily, the foreign operations of U.S. banks have no direct impact on domestic competition. Competitive effects inside other countries are regarded as matters for those countries to assess in terms of their own economic policy. U.S. banks are allowed to engage in many activities overseas that are not permitted for competitive reasons inside their own country—a prime example being investment banking. To forbid such activities would be to put U.S. banks at a disadvantage compared to their foreign competitors. Therefore the principal problem for international-banking regulation concerns risk, not competition. How risky, then, is international banking?

III. Risk in International Banking

Banking risk—one of the major types of risk facing international bankers—involves the assessment of borrowers' credit standing or the forecasting of deposit flows. As noted above, this is the same type of risk that bankers have to face on the domestic scene. It may be more difficult to obtain credit information abroad, but this only means that U.S. banks have less familiarity than their foreign competitors with local conditions. A similar situation exists when a domestic bank attempts to make domestic loans outside its usual markets. Yet as a practical matter, it takes time to build the expertise to interpret foreign financial practices and to develop appropriate sources of information. Consequently, many U.S. banks tend to restrict their foreign lending to major international corporations or financial institutions. This policy reflects the costs of gathering local information, and is not different in character from the basic process of making credit judgments about domestic borrowers.

When operating abroad, bankers must take into consideration many of the same economic factors that they deal with at home—government fiscal and monetary policy, bank regulatory policy, foreign exchange controls and local economic conditions generally. Although many countries tend to have unstable economies because of undue dependence on a few basic products or because of political difficulties, other countries may have greater economic stability than the United States. Moreover, most developed countries provide ample information on economic conditions that allow reasonable economic forecasting. For others, however, great uncertainty exists about their economic prospects, so banking risks may be considerably higher and sovereign risk may be a greater concern.

Actually, there are few cases where countries refuse to repay (or refuse permission for their citizens to repay) foreign loans, because borrowing countries do not want to foreclose the possibility of obtaining foreign credit again in the future. The word default is usually applied—not to outright refusal to repay—but rather to a case where loans are rescheduled or renegotiated through agreement with lenders. (This same situation arises domestically when banks change loan terms to help troubled borrowers instead of forcing insolvency.) Because countries generally attempt to avoid outright default, few cases have arisen in the last twenty years where banks experienced serious losses from sovereign risk.

Commercial banks have acted to protect themselves against this type of international risk exposure. They have built up their systems for assessing economic conditions in individual countries—in many cases, systems of considerable sophistication. In addition, they have followed policies of geographic as well as industrial diversification to reduce risk exposure (Table 3). In terms of geographic diversification, most loans are concentrated in developed countries or in interbank transactions, while loans to underdeveloped countries represent only a minor part of the total. In particular, loans to less-developed non-OPEC countries are not unduly large in terms of the relative commitment by U.S. banks and the ability of most of these countries to service their debts.[10] Loans to six countries (Argentina, Brazil, Mexico, the Philippines, Korea, and Taiwan) represent three-quarters of U.S. banks' credits in this category—but a strong case can be made for lending to these countries because of both their international reserves and their long-run growth prospects.[11]

A measure of the efficiency of U.S. banking practices is the fact that loan losses on banks' international portfolios have been smaller than on their domestic loans.[12] Recent failures of large banks cannot be attributed simply to risky international loans. Foreign-exchange losses did contribute to the failure of Franklin National Bank, but those losses reflected poor internal controls which were also typical of the bank's domestic operations.

Through diversification, improved information systems, and appropriate internal controls, banks have established a reassuring record of international operations. However, banks' collective risk assessment may still result in a banking system that is too risky from the viewpoint of society, and the function of banking supervision is to keep risk exposure within acceptable boundaries. Foreign risk, to the extent it affects the stability of the domestic banking system, makes supervision of international banking necessary.

IV. Current Regulatory Practices and Problems

Federal supervisory authority over U.S. banks' foreign operations is exercised by the Federal Reserve System and the Comptroller of the Currency.[13] The Comptroller of the Currency has the responsibility for examining national banks, which make up the majority of those banks operating overseas. The Federal Reserve System has the responsibility for examining state-chartered member banks, and for approving national banks' foreign branches and the investments of foreign subsidiaries (either directly or indirectly through Edge Act subsidiaries). Foreign acquisitions by domestic-bank holding companies also require Federal Reserve approval.

Supervisory authorities rely primarily on banks' home-office records in performing international examinations—and until recently they relied almost entirely on such records. This procedure was acceptable as long as few banks had overseas offices, since the records at hand were satisfactory for the evaluation of most loans, and the risks from foreign operations were quite small. But as the number and size of foreign assets grew, on-site examination of branches also became necessary. The Comptroller of the Currency now maintains a permanent staff in London, and both Federal agencies are increasing the frequency of their overseas examinations. These on-site examinations are used primarily to check the accuracy of head-office records and the adequacy of internal controls rather than to review the quality of local assets. Regular examination of all foreign offices would be very costly, without any assurance of a compensating increase in supervisory effectiveness.

For a time, the regulatory agencies assumed that foreign banking regulators could help monitor the activities of U.S. banks overseas. However, experience has shown that few banking authorities conduct supervision on the scale practiced in this country. Most countries' authorities emphasize regulation for purposes of monetary policy, foreign-exchange control or other economic-policy objectives. Even in countries having very extensive regulatory systems, such as Japan, the emphasis is upon checking for conformity with banking regulations rather than upon examining for the quality of credit extended by foreign branches. U.S. regulators thus must rely primarily upon their own procedures to supervise U.S. banks' foreign operations.

A particularly difficult supervisory problem in assuring adequate diversification concerns the assessment of the risks assigned to loans in particular countries—that is, country risk, which covers both "sovereign risk" and the impact on "banking risk" of local economic conditions. As noted above, banks are now developing their own systems for evaluating economic conditions in foreign countries. But regulators must also be able to judge independently whether or not a particular bank has too many resources in countries with a high level of country risk. Improved methods of assessing such risks would result in greater uniformity in the treatment of individual banks as well as a better assessment of U.S. banks' overall risk. Both the Comptroller of the Currency and the Federal Reserve System are now developing systems to measure and monitor country risk.

Other considerations must also be taken into account:

> "Bank regulators need to be sensitive to the fact that admonishments to banks can result in damage to the credit-worthiness of borrowing countries. As a possible way of dealing with this potential problem, the Federal Reserve is exploring a supervisory approach that would focus on the degree of country concentration of foreign loans in portfolios of individual banks and on the quality of information possessed by banks in assessing the degree of risk attached to their international loans."[14]

To help meet regulatory and bank information needs, a number of international agencies are now attempting to improve international financial statistics.[15] For example, the Bank for International Settlements, with the cooperation of major central banks, is now working to develop new data on external private borrowing and lending. Improved statistics of this type should reinforce the effectiveness of banks' own procedures for assessing risk, and should reduce supervisory burdens accordingly.

* * *

In conclusion, there are important differences between banking risk and sovereign risk. Banking risk is essentially the same at home and abroad. Despite greater potential difficulties in obtaining information on foreign borrowers, the credit factors involved are fundamentally the same as in domestic lending. Sovereign risk is a different matter, for which there is no domestic equivalent risk. Foreign governments can prevent the conversion of local currency into foreign currencies—which amounts to default on a national (but not private) level. There have been few cases of such default, but regulators remain concerned about the possibility.

Banks have been successful in reducing their loss exposure, judging by the relatively low losses they have experienced in their foreign operations. However, to the extent that official international lending represents a form of insurance, banks have an incentive to take greater risk, and international supervision must act to counteract that tendency. The public has an interest in ensuring that risk remains within acceptable limits, through appropriate actions by bank regulators. At the same time, this emphasis upon risk-taking should not interfere with the ability of U.S. banks to function as international lenders. Banking plays a major role in encouraging economic development through the financing of world trade and investment. Therefore, efforts to improve international banking supervision must ultimately be judged by their contribution to the world as well as the U.S. banking system.

FOOTNOTES

1. See the recent hearings by the Subcommittee on International Finance, U.S. Senate Committee on Banking, Housing and Urban Affairs, and also the staff report of that subcommittee, **International Debt, The Banks, and U.S. Foreign Policy,** August 1977.
2. In this period, overseas offices became desirable because various controls made it difficult to lend abroad from head offices. Today, however, foreign lending is conducted both from U.S. offices and foreign branches.
3. In addition, foreign subsidiaries of U.S. banks had $30 billion in assets as of December 13, 1975, the most recent date for which such information is available.
4. See article by Hang-Sheng Cheng in this issue.
5. These locations are chosen partly because of low local taxes on offshore transactions and other tax advantages, and partly because of savings in investment in staff and physical plant.
6. Of course, the U.S. cannot assure competition in foreign markets, so this consideration is less important in regulating U.S. banks' operations overseas.
7. This Act was adopted as a reaction to the investment-banking activities of commercial banks, which were thought to be a cause of the 1929 stock market crash and the ensuing depression. Although passed initially as a means of reducing financial instability, the Act has been used essentially to prevent financial concentration.
8. In a distribution of expected returns from a given investment, the standard deviation denotes the measure of risk.
9. Sam Peltzman, "Capital Investment in Commercial Banking and its Relationship to Portfolio Regulation," **Journal of Policial Economy,** January-February 1970.
10. Henry C. Wallich, Statement before Subcommittee on International Finance, U.S. Senate Committee on Banking, Housing and Urban Affairs, August 29, 1977.
11. **Ibid.**
12. Fred B. Ruckdeschel, "Risk in Foreign and Domestic Lending Activities of U.S. Banks," **Columbia Journal of World Business,** Winter 1975, pp. 50-54. Robert Morris Associates, **Domestic and International Commercial Loan Charge-Offs** (1977).
13. Few nonmember banks are engaged in international banking, and hence their supervising agency (the F.D.I.C.) has only a limited role in international-banking examination.
14. Wallich, **op. cit.**, p. 13.
15. The shortcomings of existing international-credit data are noted in **International Debt, The Banks and U.S. Foreign Policy, op. cit.**