United States General Accounting Office

GAO

Report to the Ranking Minority Member, Committee on Banking, Housing, and Urban Affairs, U.S. Senate

February 1996

FOREIGN BANKS

Assessing Their Role in the U.S. Banking System

GAO/GGD-96-26

GAO

United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-259971

February 7, 1996

The Honorable Paul S. Sarbanes
Ranking Minority Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate

Dear Senator Sarbanes:

This report examines the role of foreign banks in the United States and reviews the U.S. laws and regulations governing their operations. The former chairman of the Committee on Banking, Housing, and Urban Affairs asked us to review these laws and regulations and to evaluate whether they give foreign banks operating in the United States a significant competitive advantage over U.S. banks. This report identifies areas where U.S. laws and regulations have been adapted to meet the circumstances of foreign banks and examines the competitive impact of these adaptations on U.S. banks.

We are sending copies of this report to appropriate congressional committees, the Chairman of the Federal Reserve Board, the Chairman of the Federal Deposit Insurance Corporation, the Comptroller of the Currency, and other interested parties. We will also make copies available to others on request.

Major contributors to this report are listed in appendix II. If you have any questions, please call me at (202) 512-8678.

Sincerely yours,

James L. Bothwell
Director, Financial Institutions
and Markets Issues

Executive Summary

Purpose

Over the past 2 decades, the share of U.S. banking assets held by foreign banks has increased significantly. The Senate Committee on Banking, Housing, and Urban Affairs asked GAO to review the laws and regulations affecting foreign bank operations in the United States. The Committee was particularly interested in whether U.S. laws and regulations give foreign banks any significant advantages over U.S. banking organizations in the U.S. banking market.

This report examines the role of foreign branches and agencies in the U.S. banking system and identifies areas where U.S. laws and regulations have been adapted for foreign banks. It also examines the competitive impact of such adaptations on U.S. banks.

Background

Foreign banks operate in the United States under several organizational forms. For example, they may operate a U.S. bank as a subsidiary of their parent bank. Or they may establish branches and agencies, which are legal and operational extensions of the parent bank. As of December 1994, 82 percent of the U.S. assets of foreign banks were held in branches and agencies. Branches, which are also used by U.S. banks overseas, and agencies are the principal focus of this report. Foreign banks also service U.S. customers from locations outside the United States, including offices in their home or other countries or through what are termed shell branches—offshore operations frequently managed from U.S. offices.

The landmark federal legislation governing the activities of foreign banks in the United States was the International Banking Act (IBA) of 1978. The act brought foreign branches and agencies under federal regulation and adopted the policy of national treatment. National treatment accords foreign banks the opportunity to compete in the United States on the same basis as U.S. banks. However, national treatment does not mean identical treatment. The policy recognizes that foreign branches and agencies also operate under the regulations of their home countries, which may differ from those in the United States. Adaptations of U.S. laws and regulations were therefore needed.

In 1991, Congress passed the Foreign Bank Supervision Enhancement Act (FBSEA). This act amended the IBA and authorized the Federal Reserve to oversee all foreign bank operations in the United States. The act also established uniform standards for all U.S. offices of foreign banks, generally requiring them to meet financial, management, and operational standards equivalent to those of U.S. banking organizations.

Data limitations restricted GAO's ability to describe and analyze some aspects of foreign bank operations. For example, differences in reporting by foreign branches and agencies and U.S. banks limited comparisons by product categories. In addition, the shell branches of foreign banks did not report any data on their activities until 1993. Since 1993, shell branch data have been collected, but they are more limited than the data provided by branches and agencies in the United States and are not verifiable by U.S. bank regulators.

Results in Brief

Foreign branches and agencies operate almost exclusively in the wholesale banking markets in the United States. That is, they serve primarily their home country and U.S. corporate customers and engage in transactions with banks and other financial institutions. While many foreign banks are very large organizations and provide a full range of banking services in their home markets, in the United States most perform a narrow range of activities compared with U.S. banks.

The market share of foreign banks in the United States varies according to the assumptions made about their activities and those of U.S. banks. At the end of 1994, foreign branches and agencies held 17 percent of domestic U.S. banking assets. The addition of assets held in foreign-owned U.S. subsidiary banks increased the foreign bank market share by about 4 percentage points.

Foreign branches and agencies have attained a large share in some wholesale U.S. banking activities. For example, foreign branches and agencies held 24 percent of all U.S. commercial and industrial (C&I) loans in December 1994. By contrast, they have a negligible share of the U.S. retail banking market. For example, they held less than 1 percent of total transactions (checking) deposits in December 1994.

The previously mentioned market shares include only data on foreign branches and agencies located in the United States. Including data on the activities of shell branches increased the degree of foreign bank penetration in some segments of the U.S. banking market. For example, year-end 1994 data showed that the inclusion of shell branches increased the volume of C&I loans reported by foreign branches and agencies by about one-third. This increased the foreign branch and agency share of the C&I loan market to 29 percent. In addition, shell branches reported that they held about the same amount of total deposits from individuals and

corporations with U.S. addresses as did foreign branches and agencies in the United States.

Foreign banks have been cited as an important source of capital to the U.S. economy because they are believed to supply more funds to the United States than they raise from it. GAO could not definitively determine whether foreign branches and agencies in the United States and their shell branches were net suppliers of funds to the U.S. economy. It appeared likely that in 1994 foreign branches and agencies and their shell branches supplied more funds to the U.S. economy than they raised. However, available data did not allow GAO to determine the magnitude of foreign branch and agency funding to the U.S. economy.

GAO's review of current laws and regulations and interviews with U.S. and foreign bankers, officials at multinational and other corporations, U.S. bank regulators, and others indicated that foreign branches and agencies operating in the United States are subject to substantially the same laws and regulations as those governing U.S. banks. Under the policy of national treatment, the application of U.S. laws and regulations was designed to confer no competitive advantage to or impose no competitive disadvantage on foreign banks compared with U.S. banks. However, because foreign branches and agencies are subject to regulation in their home countries, U.S. laws and regulations cannot always be applied to foreign branches and agencies in exactly the same manner as they are applied to U.S. banks.

In areas where adaptations have been necessary, changes in U.S. laws and regulations or changes in the banking industry have reduced the possibility that foreign branches and agencies have an advantage compared with U.S. banks. In general, the bankers and others that GAO spoke with reported that laws and regulations and adaptations to them governing foreign-owned branches and agencies no longer produced any significant competitive advantages vis-a-vis U.S.-owned banks. Still, the application of the policy of national treatment remains a concern to U.S. and foreign bankers and to policymakers, especially as changes in banking legislation are considered. For example, because of structural differences in the way U.S. and foreign banks are organized (i.e., foreign banks are not generally organized under a holding company structure), legislation to repeal the Glass-Steagall Act could have a differential impact on the operations of U.S. and foreign-owned banks.

Principal Findings

Foreign Branches and Agencies Operate in Wholesale Markets

The activities of foreign branches and agencies have been concentrated in certain segments of the wholesale banking market. In 1994, two-thirds of their assets were either business loans or claims on other banks. Foreign branches and agencies also relied on wholesale markets for their funding. In 1994, over one-half their funding came from other banks, and they held 38 percent of the market for large (over $100,000) time deposits. Off-balance sheet activities have increased at foreign branches and agencies. In 1994, they accounted for between one-fifth and one-half of such products as standby letters of credit and foreign-exchange commitments.

Some U.S. bankers GAO spoke with stated that foreign branches and agencies helped to maintain funding to U.S. businesses during a recent period when U.S. banks were restricting lending in order to rebuild their capital. Between 1985 and 1992, C&I lending at U.S. banks fell by $39 billion. At the same time, C&I lending at foreign branches and agencies rose by $95 billion. This was reflected in the rise in the C&I market share of foreign banks, which peaked in 1992. Some U.S. bankers also stated that foreign branches and agencies are meeting trade financing needs not met by U.S. banks.

In GAO's interviews, U.S. bankers discounted the statistics that showed foreign banks gaining a large share of the U.S. banking market. These bankers told GAO that profitability and capital strength are the essential components of competitiveness and that U.S. banks do well by these measures.

Data on Foreign Shell Branches Indicate Increased Share In Some Markets

The role of foreign banks in the U.S. economy appeared even larger when activities at their shell branches were considered. For example, the addition of shell branch assets to those in foreign branches and agencies raised the market share of foreign branches and agencies from 17 percent to 21 percent of domestic banking assets in December 1994. A study by the Federal Reserve showed that the foreign bank share of C&I lending rose from 35 percent to 42 percent in March 1993 with the addition of shell branch data.

Foreign Branches and Agencies May Have Been Net Suppliers of Funds to the U.S. Economy

Foreign branches and agencies report data for some of their activities by the location (U.S. address or non-U.S. address) of the borrower or supplier of funds. These data showed that in 1994 foreign branches and agencies supplied $118 billion more in funds to U.S. addresses than they raised from U.S. addresses. Foreign branches and agencies also raised $150 billion more from non-U.S. addresses in 1994 than they supplied to them.

It would thus appear that foreign branches and agencies were net suppliers of funds to the U.S. economy in 1994. However, GAO cannot reach a definitive conclusion about either the magnitude or the direction of the flow of funds from foreign branches and agencies because, for a large portion of the data, it was impossible to determine precisely the location of the borrower or lender.

U.S. Laws and Regulations Do Not Appear to Create Significant Competitive Advantages for Foreign Branches and Agencies

Since 1978, changes in U.S. laws and regulations under the policy of national treatment have diminished the competitive advantages previously enjoyed by foreign branches and agencies. Changes in banking markets around the world also diminished many of the differences between foreign and U.S. banks and the advantages that foreign branches and agencies were once said to have. For example, adoption of international risk-based capital standards and market pressures for increased capital appear to have lessened concern about the amount and type of capital that foreign banks hold. Likewise, the movement towards interstate banking in the United States over the past decade reduced the advantage that a small number of foreign banks had from operating full-service interstate branch networks. Finally, improvement in the Federal Deposit Insurance Corporation's Bank Insurance Fund has led to lower deposit insurance premiums for most banks. Any advantage that foreign branches and agencies may have had from not paying these premiums has been reduced significantly.

However, areas remain where the adaptation of U.S. laws and regulations results in some differences between U.S. banks and foreign branches and agencies that could produce advantages for foreign branches and agencies. These differences include the ability to engage in transactions with nonbank subsidiaries of the parent bank and the limited supervision of shell branches by U.S. bank regulators.

Some U.S. bankers told GAO that any advantages that foreign branches and agencies have result from economic environments in the home countries of these banks and from bank management's decisions on which markets

to serve and what services to offer. In general, the U.S. bankers who GAO interviewed felt that adaptations of U.S. laws and regulations currently gave foreign branches and agencies no significant advantage over U.S. banks.

Because of differences in U.S. and foreign bank corporate structures, authorized activities, and access to insured deposits, national treatment is likely to be an important issue whenever changes are contemplated in the powers of banks or bank holding companies (BHC). For example, the House Banking and Financial Services Committee has approved legislation that would expand the powers of BHCs. Under the legislation, foreign and U.S. banks that do not take insured deposits in the United States would be subject to fewer restrictions than banks that take insured deposits. Because foreign banks would be able to raise insured deposits in their home countries, this legislation could create an advantage for them. However, the extent of this possible advantage is unknown.

Recommendations

GAO is making no recommendations in this report.

Agency Comments

GAO received written comments on a draft of this report from the Federal Reserve. In its letter, the Federal Reserve stated that the findings and conclusions concerning the activities of foreign banks in the United States are generally consistent with those of the Board's staff.

Contents

Executive Summary		2
Chapter 1 Introduction		10
	Background	10
	Growth of Foreign Banks	13
	Reasons Underlying the Growth of Foreign Banks	14
	Regulation of Foreign Bank Activities in the United States and the Concept of National Treatment	16
	Scope and Methodology	20
Chapter 2 Foreign Branches and Agencies		23
	Foreign Branches and Agencies Are Major Participants in U.S. Wholesale Markets	23
	Off-Balance Sheet Activities	31
	Shell Branches	33
	Foreign Branches and Agencies Were Likely Net Suppliers of Funds to the U.S. Economy	36
	Conclusions	38
Chapter 3 Adapting U.S. Laws and Regulations to Foreign Banks		39
	Adaptations of U.S. Laws and Regulations	39
	Views on the Competitive Position of Foreign Banks Operating in the U.S.	48
	Conclusions	55
Appendixes	Appendix I: Comments From the Federal Reserve	56
	Appendix II: Major Contributors to This Report	57
Tables	Table 1.1: Foreign Bank Organizations Operating in the United States and Shell Branches Managed by U.S. Offices, December 1994	11
	Table 2.1: Sources and Uses of Funds in Foreign Branches, Agencies, and Shell Branches, December 1994	37
Figures	Figure 1.1: Asset Growth in Foreign Branches, Agencies, and Foreign-Owned Bank Subsidiaries, 1972 to 1994	14
	Figure 2.1: Asset Distribution in Foreign Branches and Agencies, December 1994	24

Figure 2.2: Distribution of Foreign Branch and Agency Liabilities in the United States, December 1994 27
Figure 2.3: Volume of Selected OBS Activities at Foreign Branches and Agencies and U.S. Banks, December 1994 33
Figure 2.4: Asset Distribution of Foreign-Owned Shell Branches, December 1994 34
Figure 2.5: Liabilities of Foreign-Owned Shell Branches, December 1994 35

Abbreviations

BHC	Bank Holding Company
C&I	Commercial and Industrial
CRA	Community Reinvestment Act
FBSEA	Foreign Bank Supervision Enhancement Act
FSHC	Financial Services Holding Companies
FDIC	Federal Deposit Insurance Corporation
FX	Foreign Exchange
IBA	International Banking Act of 1978
IBF	International Banking Facility
IBHC	Investment Bank Holding Company
IPC	Individuals, Partnerships and Corporations
OBS	off-balance sheet
OCC	Office of the Comptroller of the Currency
SLC	Standby Letters of Credit

Introduction

This report is in response to a request from the former Chairman of the Senate Committee on Banking, Housing, and Urban Affairs to determine the reasons for the rapid growth of foreign bank operations in the United States. We were requested to assess the role of foreign banks in providing funds to the U.S. economy and to determine whether foreign banks have any significant advantages over U.S. banks because of differences in the way they are regulated.

Between 1972 and 1990, the assets of foreign banks operating in the United States increased at a faster rate than did the assets at domestic offices of U.S. banks. As a result, the market share of foreign banks grew, especially in certain wholesale banking markets where foreign banks concentrate their products and services. This report examines (1) the reasons why foreign banks have expanded so rapidly, (2) the role foreign banks play in financing the U.S. economy, and (3) whether foreign banks enjoy any significant competitive advantages in the United States over U.S. banking organizations because of regulatory differences.

Background

Capital markets have become increasingly integrated and international in character. Expansion of international trade and the growth of multinational corporations have led U.S. and foreign banks to open offices overseas to service customers of their home country and to seek new growth opportunities.

In 1994, 378 foreign banks operated 921 offices in the United States, as shown in table 1.1. Branches and agencies[1] were the most common organizational form—accounting for 61 percent of foreign bank offices and 82 percent of foreign bank assets at the end of 1994. Separately chartered U.S. bank subsidiaries were next in importance—accounting for 18 percent of foreign bank assets. The remaining forms—commercial lending companies, Edge Act Corporations, and representative offices—accounted for less than one percent of foreign bank assets in the

[1]Branches and agencies are often discussed together because they perform the same functions, with the exception that agencies cannot generally accept deposits. In this report, we will follow this convention.

United States.[2] Foreign banks also provided services to many U.S. customers through shell branches located outside the United States but managed by their U.S. branches or agencies. Because foreign branches and agencies are the dominant form of organization in the United States, this report focuses on the activities of these entities and the shell branches they manage.

Table 1.1: Foreign Bank Organizations Operating in the United States and Shell Branches Managed by U.S. Offices, December 1994

Dollars in billions

Forms of organization	Number	Assets
Branches and agencies	559	$750
Subsidiary banks	97	165
Commercial lending companies	4	1
Edge Act Corporations	11	1
Representative offices	250	0
Total, U.S. offices	921	$917
Shell branches, managed by U.S. offices	142	293[a]
Total	**1,063**	**$1,210**

Note: Numbers may not add to total because of rounding.

[a]Of the $293 billion, $113 billion represented claims on U.S. addresses other than to related depositories, $84 billion represented claims on related depositories in the United States, $12 billion represented claims on U.S. addresses denominated in currencies other than U.S. dollars, and $85 billion represented claims on non-U.S. addresses.

Source: Federal Reserve.

Like their U.S. counterparts, foreign branches and agencies are legal and operational extensions of their parent banks. Their assets and liabilities are consolidated into the accounts of their parent banks, and they operate on the consolidated equity of those banks. For example, their lending limits are based on the capital of their parent banks. Regulators in both the United States and their home country oversee their operations.

Before passage of the International Banking Act of 1978 (IBA), only states could license, supervise, and regulate the operations of foreign branches

[2]Commercial lending companies are specialized nondepository institutions authorized under state law. They may engage in borrowing and lending activities and have numerous other powers. They may maintain credit balances but may not accept deposits. To date, these companies have located in New York and are also known as New York investment companies. Edge Act Corporations allow U.S. and foreign banks to conduct international banking activities in the U.S. without the myriad of laws and regulations that apply to domestic banking activities. Representative offices are similar to the loan production offices of U.S. banks. They allow foreign banks to attract business for the parent bank and to develop correspondent relationships with local U.S. banks. They are prohibited, however, from engaging in general banking activities although they may conduct administrative functions, such as receiving checks to forward to their home office and handling the signing of loan papers.

and agencies. Some states specifically prohibited foreign branches but allowed other types of foreign bank activity. Passage of the IBA made foreign banks eligible for federal licenses and subject to federal regulation.[3]

Foreign branches and agencies may conduct a wide range of banking activities, including lending, money market services, trade financing, and other activities related to the service of home-country and U.S. clients. They can also access the U.S. payments system through the Federal Reserve and obtain other Federal Reserve services. However, they are banned from certain activities. Foreign branches have been prohibited from accepting insured deposits since the end of 1991.[4] In addition, federally licensed agencies and most state-licensed agencies cannot accept deposits.[5]

Foreign banks can charter or acquire a full-service U.S. bank subsidiary.[6] Foreign banks have exercised this option when state law prohibited them from establishing branches or when a foreign bank wanted to offer retail banking services. Foreign-owned subsidiary banks have all the powers of U.S.-owned banks, are insured by the Federal Deposit Insurance Corporation (FDIC), and are subject to all the rules and regulations governing U.S.-owned banks. However, subsidiary banks have some disadvantages compared with branches and agencies. They are more costly to operate, requiring not only separate boards of directors and managers but also their own capital base. They are also subject to the collateralization requirements and lending limits of the Federal Reserve's section 23A and 23B restrictions, which limit banks' extension of credit to their affiliates.

Foreign banks also offer services to U.S. customers through offices located outside the U.S. (offshore offices). Some offshore offices have practically no office or staff and are referred to as shell branches. Much of

[3]States, however, still determine whether foreign banks may establish branches or agencies in their jurisdiction.

[4]Those foreign branches that accepted insured deposits before the end of 1991 are still permitted to do so.

[5]Agencies may, however, accept credit balances. These balances consist of receipts from transactions and undisbursed loan balances and, in fact, serve the same purpose as transactions (checking) accounts. In some cases, states have allowed agencies limited deposit-taking capabilities. New York, for example, allows some agencies to accept large-denomination deposits, but the agency cannot accept deposits as a normal course of business (New York agencies that accept such deposits are considered branches for purposes of administering the IBA).

[6]These banks are corporate entities separate from their foreign parent bank.

their management—including funding decisions and setting lending policies—is handled elsewhere, in many instances by branches or agencies located in the United States.[7] In these cases, banking products—such as commercial and industrial (C&I) loans or deposits—are marketed to U.S. customers from U.S. offices but are held by the shell branch. Although the shell branches of U.S. banks, including foreign-owned U.S.-chartered banks, are subject to all U.S. laws and regulations, the shell branches of foreign banks are subject to U.S. regulation only for those activities that are managed within the United States.

Foreign banks can also serve U.S. customers through International Banking Facilities (IBF). Like shell branches, IBFs represent a separate set of accounts rather than an operating entity of the bank. For this reason IBFs are sometimes referred to as onshore shell branches. The Federal Reserve authorized U.S. banks and the offices of foreign banks to establish IBFs to engage in Eurocurrency lending in 1981 in response to the growth of shell branches.[8] The activities of IBFs are restricted. They can be used to take deposits from the non-U.S. offices of U.S. and foreign banks, other IBFs, IBF parent banks, and foreign governments. They can also make loans to those cited above, plus non-U.S. residents, and the foreign offices of a domestic corporation. They are free from reserve requirements, federal deposit insurance premiums, and some state income taxes. An IBF may not engage in domestic banking activities. Shell branches, by contrast, may be used to make loans to or hold deposits from any U.S. or non-U.S. customer.

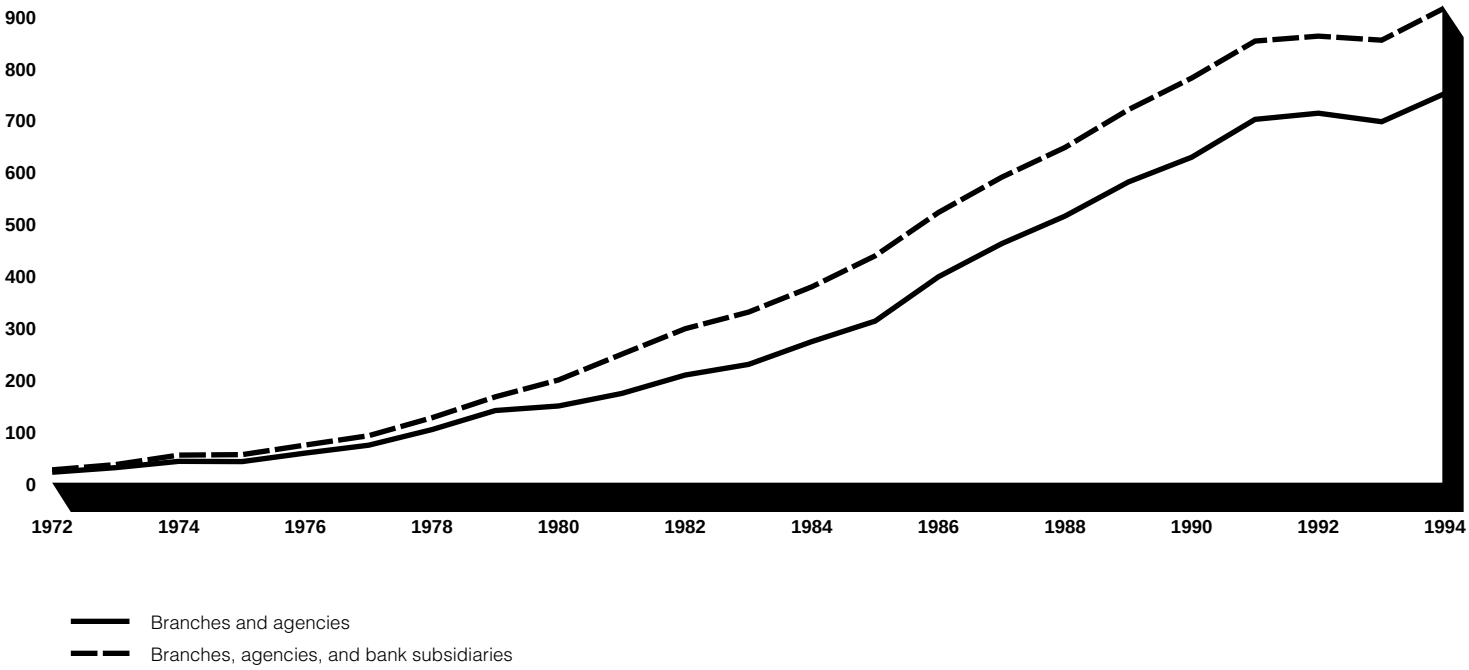
Growth of Foreign Banks

Between 1972 and 1990, the number and assets of foreign banks operating in the United States grew rapidly. The number of foreign branches and agencies increased more than sevenfold—from 77 to 600—and foreign-owned bank subsidiaries more than tripled—from 25 to 88. During this period, the average annual growth rate of branch, agency, and foreign-owned bank subsidiary assets was more than 20 percent (see figure 1.1). By December 1990, 295 foreign banks from 59 countries operated in the U.S. and held $785 billion in assets. Since 1990, the growth of assets in these banks has slowed, and the number of foreign bank offices has declined.

[7]At the end of 1994, 122 foreign banks operating in the United States reported that they managed one or more shell branches through their U.S. offices.

[8]A "Eurocurrency transaction" is a transaction conducted in a currency other than that of the country in which the bank is located. For example, loans made abroad but denominated in U.S. dollars are referred to as Eurodollar loans.

Figure 1.1: Asset Growth in Foreign Branches, Agencies, and Foreign-Owned Bank Subsidiaries, 1972 to 1994
(Dollars in billions)



Source: For 1972 to 1988, Faramarz Damanpour, The Evolution of Foreign Banking Institutions in the United States, (Quorum Books: New York, 1990). For 1989 to 1994, Board of Governors of the Federal Reserve System, Structure Data for U.S. Offices of Foreign Banks.

Forty-seven of the 50 largest banks in the world (excluding U.S.-owned banks) had commercial banking operations in the United States as of December 1993. These banks held 69 percent of foreign branch and agency assets. Of the top 20 banks, 10 had 5 percent or more of their total assets in the United States in 1993.

Reasons Underlying the Growth of Foreign Banks

Several factors have contributed to the growth of foreign branches and agencies since the 1970s.

First, expansion of foreign-owned businesses gave foreign banks a growing client base in the United States. Imports of goods and services in the United States doubled between 1970 and 1975 and again between 1975 and 1980. Since 1980, imports have continued to grow, although at a

slower pace. Between 1980 and 1994, imports doubled. As foreign business has expanded, foreign banks have entered the United States to service clients from their home countries.[9]

Second, rising federal budget deficits increased the United States' demand for capital—including foreign capital—while large trade deficits created a surplus of dollar assets abroad. Part of the dollar surplus was deposited into foreign banks. This allowed foreign banks to expand their U.S. operations because growth in their dollar-denominated deposits provided a large funding base for entering the U.S. market.[10] The recycling of dollar surpluses back into the U.S. economy helped the United States to finance its budget deficit as well as maintain economic expansion. Lending in the United States also provided foreign banks with another means of diversifying risks. For example, lending in the United States lessened foreign exchange risk by matching dollar-denominated assets to dollar deposits.

Third, as discussed later in this chapter, before passage of the IBA in 1978, foreign branches and agencies enjoyed a number of advantages in their operations compared with U.S. banks. Passage of the act, however, removed many of these advantages and brought foreign branches and agencies under federal banking laws and regulations. Some observers have said that foreign banks established branches and agencies in the United States in anticipation of receiving grandfathered privileges under this act.

Finally, the United States is a large and open economy and has a currency that plays a key role in world markets. The United States is the largest market for dollar exchange and is home to one of the world's largest financial centers. Technological advances in computers and telecommunications have also made it easier to manage overseas expansion.

[9]Traditionally, banks expanded into foreign markets to serve their domestic customers overseas. Banks have a comparative advantage in serving nonfinancial firms based in their home country. They have firsthand knowledge of the language and customs of their country. They also know their own country's legal system and their government's rules on capital flows, exchange restrictions, and taxation. Banks that want to keep their customers must offer services in the countries in which their customers do business. Establishing a presence in a foreign country also makes it easier to obtain information about that country.

[10]For example, foreign banks could use their dollar deposits to make loans to large corporations. They could also lend dollars to other banks through the Federal Funds market. Although foreign banks could recycle dollar deposits through offshore branches or through other banks, the large volume of deposits in some foreign banks made it profitable to establish offices in the United States where they could lend their funds directly.

Since 1990, foreign bank growth has slowed. Some of the slowdown may simply be due to the size and maturing of the industry. In addition, foreign banks have experienced many of the same difficulties that slowed the growth of U.S. banks in the late 1980s. Problem real estate and other loans have led foreign banks to search for less risky assets. The need to improve capital ratios has led some to seek sources of income that require little or no additional capital.

Regulation of Foreign Bank Activities in the United States and the Concept of National Treatment

The IBA of 1978 stands as the landmark federal legislation affecting foreign bank operations in the United States. In passing the IBA, the United States adopted a policy of national treatment governing the activities of foreign banks. The goal of national treatment is to allow foreign banks to operate in the United States without incurring either significant advantage or disadvantage compared with U.S. banks. To implement this policy, the IBA brought U.S. branches and agencies of foreign banks under federal banking laws and regulations. The Federal Reserve was given regulatory authority for all U.S. international banking laws, which it administers through regulation K.[11]

Before passage of the IBA, foreign branches and agencies operating in the United States enjoyed many regulatory advantages compared with U.S. banks. They were not subject to reserve requirements or deposit interest-rate ceilings, they could operate full-service branches in any state that allowed them to enter, and they could offer both commercial and investment banking services. The 1978 act was designed to eliminate these advantages and to place foreign banks on an equal footing with U.S. banks. The act required foreign banks to choose a home state and prohibited them from establishing full-service branches in states outside the home state. The IBA also limited foreign bank involvement in U.S. securities and other nonbanking markets by restricting them to those activities that could be done by U.S. bank holding companies (BHC).

The act also expanded the options of foreign banks. Prior to the IBA, only states could license foreign branches and agencies. Foreign banks were subject to the laws of the states in which they were licensed, and, in some cases, these laws were more restrictive than federal law for national banks. The act made federal licenses available to foreign banks. It also allowed foreign branches to obtain federal deposit insurance, requiring it

[11]Subpart B addresses the U.S. banking powers of foreign banks, as determined by the IBA.

for any branch with a significant amount of retail deposits.[12] The act permitted foreign banks to establish Edge Act Corporations[13] and it granted foreign branches and agencies access to the Federal Reserve's discount window.

Although the IBA eliminated many of the advantages that foreign branches and agencies had over U.S. banks, those foreign branches and agencies that were already engaged in interstate branching or securities activities were allowed to continue these activities under the grandfathering provisions of the act.[14] Restrictions, however, were applied to their growth. Foreign banks with interstate branches were only allowed to establish new full-service branches in their home state. They could not establish full-service branches in other states, even in those states where they were already located. Similarly, foreign banks with grandfathered securities activities were limited to those activities in which they were engaged (or had applied to engage) on the grandfather date. In addition, securities firms owned by foreign banks could only expand by internal growth—they were restricted from acquiring or merging with other securities firms or from expanding by hiring significant numbers of employees from other securities firms.[15] Foreign banks that acquire U.S. banks lose their grandfathered securities rights.

With the exception of the grandfathered activities, the IBA and subsequent laws and regulations brought foreign banks under the same restrictions as

[12]The act required branches that receive deposits of less than $100,000 to obtain deposit insurance, unless the FDIC or the Office of the Comptroller of the Currency (OCC) determined that the branch was not engaged in retail deposit activities. FDIC and OCC have defined a nonretail deposit as, in general, a deposit of over $100,000. However, FDIC and OCC regulations permit uninsured foreign branches to accept some deposits under $100,000. These include deposits from any business, association, or trust that engages in commercial activity for profit; any government unit or international organization; and any noncitizen or nonresident at the time of the initial deposit. In addition, any other depositor may establish a deposit account under $100,000, but only if the total amount of such deposits does not exceed 5 percent of the branch's average deposits. The branch cannot solicit these deposits.

[13]Edge Act Corporations can engage in international transactions free of U.S. restrictions. U.S. banks can also establish these offices.

[14]The practice of grandfathering activities is not unique to legislation affecting foreign banks. For example, when the Bank Holding Company Act was passed in 1956, it allowed BHCs that were operating interstate banking networks to retain them. More than 60 foreign banks had interstate branches and were grandfathered under the act. In addition, 17 foreign banks claimed grandfather rights for their securities firms.

[15]The exception to this practice has been Credit Suisse and its relationship with First Boston. Prior to 1990, First Boston was the only grandfathered securities affiliate to qualify as a "domestically controlled affiliate" under the IBA. As a result, it was not subject to the activity and growth restrictions on grandfathered securities affiliates. However, in 1990 Credit Suisse acquired additional shares of First Boston (in excess of the 45 percent restriction on "domestically controlled affiliates"). Nevertheless, the Federal Reserve determined that on the relevant grandfather date, First Boston was a major participant in the investment banking business and could continue to engage in that business.

those governing U.S. banks with some adaptations. The application of U.S. laws and regulations to foreign banks reflects the fact that structural and organizational differences exist between foreign and U.S. banks. For example, foreign banks are not generally organized under the holding company structure, as are most U.S. banks.

Because of these differences, subjecting foreign banks with branches and agencies in the United States to all U.S. laws and regulations without adaptation would likely violate the policy of national treatment. While this policy tries to ensure equal treatment of U.S. and foreign banks in the United States, it recognizes that equal treatment does not necessarily mean the same treatment. Similarly, the United States seeks to have the policy of national treatment applied to U.S. banks operating abroad.[16]

In 1991, Congress passed the Foreign Bank Supervision Enhancement Act (FBSEA). This act, which amended the IBA, authorized federal oversight of all foreign bank operations in the United States and vested this responsibility with the Federal Reserve. It also established uniform standards for all U.S. offices of foreign banks, generally requiring them to meet financial, management, and operational standards equivalent to those required of U.S. banking organizations.[17] Finally, the act prohibited foreign branches from accepting retail deposits, although it grandfathered the branches that already offered insured deposits.

FBSEA increased the Federal Reserve's supervisory and regulatory power over foreign banks by (1) requiring Federal Reserve approval for all foreign banks seeking to establish U.S. offices, whether licensed by state or federal authorities, (2) permitting the Federal Reserve to terminate the activities of a state-licensed branch or agency, or to recommend that OCC terminate the license of a federally licensed branch or agency, and (3) clarifying and strengthening the Federal Reserve's authority to ensure that foreign bank operations in the United States are examined in a comprehensive and coordinated manner.

The act required the Federal Reserve to approve all applications for entry or expansion of foreign bank activities in the United States. The Federal Reserve may not approve such applications unless it determines that the

[16]A study by the Department of the Treasury indicated that U.S. banks have not always received such treatment abroad.

[17]The act required the Federal Reserve to establish guidelines for converting data on the capital of foreign banks to the equivalent risk-based capital requirements for U.S. banks for purposes of determining whether a foreign bank's capital level is equivalent to that imposed on U.S. banks.

applicant bank engages directly in banking outside the United States and is subject to comprehensive supervision on a consolidated basis by home country authorities.[18] In coordination with OCC, FDIC, or the state bank regulator, the Federal Reserve was given authority to examine all records pertaining to the foreign bank's activities in the United States. The act required that branches and agencies be examined at least once a year. It gave the Federal Reserve the power to order a foreign bank that operates a state-licensed branch or agency in the United States to terminate its activities (1) if the Federal Reserve finds that the foreign bank is not subject to comprehensive consolidated supervision by its home country supervisor or (2) if it has reasonable cause to believe that the foreign bank or an affiliate has committed a violation of law or engaged in an unsafe or unsound banking practice in the United States. If the Federal Reserve finds these problems in a federally licensed branch or agency, it may transmit a recommendation to OCC for such action.

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 also amended the IBA and gave foreign banks the same interstate branching rights as U.S. banks were granted under the act. Under Riegle-Neal, foreign banks will be allowed to establish de novo full-service branches across state lines whenever U.S. banks are allowed to establish de novo branches across state lines. Riegle-Neal will also allow foreign banks to expand across state lines by acquiring an existing bank or branch provided that the state also allows U.S. banks to expand in such a manner.

Riegle-Neal added additional regulations for foreign banks and tightened some existing restrictions. The act provided that if a foreign bank expanded across state lines by acquiring an existing bank or branch that was subject to the Community Reinvestment Act (CRA), the new foreign branch would also be subject to CRA. This requirement contrasts with previous practice where foreign branches without insured deposits were not subject to CRA. Riegle-Neal also directed FDIC and OCC to review the definition of the types of retail deposits foreign branches can accept. The act lowered the exception to the prohibition on offering uninsured deposits of under $100,000 from any party from 5 percent to 1 percent of average branch deposits.[19] Finally, it amended the IBA to provide that a U.S. branch or agency of a foreign bank may not manage activities for a shell branch that a U.S. bank is not permitted to manage overseas.

[18]A bank is subject to comprehensive consolidated supervision if the supervisor in the bank's home country receives information on the bank's worldwide operations that the Federal Reserve considers sufficient to assess its overall financial condition and compliance with laws and regulations.

[19]See footnote 12 p. 17.

Scope and Methodology

To understand the role of foreign branches and agencies in the United States and the magnitude of their operations, we obtained data on their activities and funding sources from the Federal Reserve. We also obtained data from the Federal Reserve on shell branches managed by foreign branches and agencies in the United States. Data collected on foreign branches and agencies are similar to the call report data on domestic banks and have been collected quarterly since 1980. Data on shell branches have only been collected since March 1993. In addition, shell branch data cannot be verified because the Federal Reserve has no authority to audit the operations of a shell branch, except for those operations that are managed by a branch in the United States. We did not independently verify any of these data.

In using call report data to compare U.S.-owned banks and foreign-owned U.S. bank subsidiaries and foreign branches and agencies, it must be noted that the domestic assets and liabilities reported by these entities represent the location of the bank, branch, or agency—not the nationality of the borrower or depositor. For example, domestic loans could represent loans made to foreign-owned companies operating in the United States while foreign loans could represent loans made to the overseas offices of U.S. corporations.

To understand the relationship between foreign branches and agencies in the United States and their shell branches, we reviewed the most recent examination report of the 50 largest foreign banks with branches or agencies operating in New York. In 42 of these reports, we found that the branch or agency managed some assets for a shell operation. We also reviewed 19 other examination reports, selected at random, of branches or agencies with offices in New York, which indicated that they also managed some operations for shell branches.

To explore the reasons for foreign bank expansion in the United States, the role that foreign banks play in the U.S. economy, and whether U.S. banks face disadvantages in competing against foreign banks in U.S. markets, we interviewed officials at both U.S. banks and branches, agencies, and subsidiaries of foreign banks operating in the United States. Because we were able to speak with only a limited number of bankers and other market participants, the results are not generalizable to the entire banking industry. We also reviewed the literature on foreign bank operations in the United States. We did not attempt to assess the benefits to the U.S. economy from foreign bank participation in U.S. markets or to

undertake a study of the comparative role and treatment of U.S. banks abroad.[20]

We interviewed officials at eight foreign banks operating in the United States. The banks were chosen on a judgmental basis with consideration given to their size, location (New York City is the most common location of foreign branches and agencies), and ability to compete with U.S. banks across a number of product lines. The U.S. operations of these banks reported assets between $2 billion and $47 billion. All of the banks had branches or agencies in the United States and four owned subsidiary banks. The interviews were conducted in either the banks' New York or San Francisco offices. All of the banks had operations in more than one state, and six banks had shell branches managed by a U.S. office.

To understand how U.S. banks view their competitive position compared with foreign banks, we interviewed officials at six large U.S. banks. These banks were chosen because their size and the extent of their U.S. operations made it likely that they faced competition from foreign banks in some of their markets. Each of these banks had over $10 billion in assets and competed with foreign banks in providing loans and services to multinationals and other corporations. The banks also offered products in overseas markets, and some operated branches in foreign countries.

To gauge the impact of foreign bank activity in domestic retail markets, especially to determine whether foreign branches and agencies are competing to provide products and services to small- and medium-sized business customers, we interviewed officials at six smaller banks. These banks had assets of between $250 million to $2 billion, and none operated foreign branches. The banks were chosen because of their domestic retail orientation. The banks served smaller businesses, and they were located in areas also served by foreign branches and agencies.

We interviewed officials at various trade associations, including the (1) American Bankers Association, (2) Independent Bankers Association, (3) Institute of International Bankers, (4) Bankers Association for Foreign Trade, and (5) Bankers Roundtable to get an overall view on the extent of foreign bank competition and to determine whether their memberships expressed concern about advantages that foreign banks in the United States might have. We were also contacted by several attorneys who represented foreign banks and by officials of foreign governments.

[20]The Treasury Department assesses the treatment of U.S. banks abroad in its national treatment studies, which are updated every 4 years.

To get a perspective on how U.S. and foreign corporations use foreign and domestic bank services and meet their funding and banking-services needs worldwide, we interviewed corporate treasurers and other finance officials at nine large multinational corporations. These corporations were chosen because they have extensive operations, in the United States and abroad, and use a variety of banking services. All of the corporations raise funds in U.S. and foreign markets for their worldwide operations and have extensive cash management needs. We also spoke with officials at five smaller U.S. companies with limited, if any, overseas operations. These companies were chosen because they used a variety of banking services and did business in areas serviced by domestic and foreign banks.

We interviewed federal bank regulators at the Federal Reserve's Board of Governors and the Federal Reserve Bank of New York to determine what regulations apply to foreign banks, how foreign banks are supervised in the United States, and what role shell branches play. We spoke with officials at the New York State Banking Commission which, until 1992, regulated and supervised more foreign banks than any other U.S. regulator. We also spoke with officials at the California State Banking Department. Officials at the Federal Reserve Bank of New York and the New York State Banking Commission explained the laws and regulations governing the operations of foreign banks in the United States. They also explained their examination and supervision authority to give us a better understanding of what their roles are regarding supervision of foreign banks. We spoke with officials at the Office of the Comptroller of the Currency and reviewed the Department of the Treasury's national treatment studies done in 1990 and 1994 for information on how foreign banks are treated in the United States and how U.S. banks are treated abroad.

Our work was conducted in Washington, D.C. and San Francisco, between May 1994 and May 1995, in accordance with generally accepted government auditing standards. We obtained written comments on a draft of this report from the Federal Reserve. It said our findings and conclusions concerning the activities of foreign banks in the United States are generally consistent with those of the Board's staff. The Federal Reserve's comments are reproduced in appendix I.

Foreign Branches and Agencies

Foreign branches and agencies operate almost exclusively in selected wholesale banking markets in the United states, serving home-country and U.S.-corporate customers and engaging in transactions with banks and other financial institutions. Over the past decade, foreign branches and agencies appear to have supplied more funds to the U.S. economy than they have raised in the United States. In turn, foreign branches and agencies have gained relatively large shares of some U.S. banking markets, particularly in commercial and industrial (C&I) lending, interbank funding, foreign exchange, and loan guarantees. In this chapter we will examine (1) the role of foreign branches and agencies, (2) their funding sources, and (3) their relative position in various segments of the U.S. banking market.

Foreign Branches and Agencies Are Major Participants in U.S. Wholesale Markets

Analysis of foreign branch and agency data confirmed what regulators, U.S. bankers, and representatives of foreign banks told us—that the activities of foreign branches and agencies and their funding sources are wholesale in nature. However, even in the wholesale market, foreign branches and agencies are selective in their activities and funding sources. They tend to specialize in a few activities, such as C&I lending and interbank transactions, and most of their funding comes from other financial institutions. In some of these activities, foreign branches and agencies account for a relatively large share of the domestic market.

Foreign branches and agencies conduct little retail activity. They hold few retail deposits and make few consumer loans. Their market share in retail deposits is generally less than 1 percent and cannot be readily calculated for consumer loans. This section describes the activities and funding sources of foreign branches and agencies on the basis of data collected by the federal bank regulators. Where possible, comparisons are made with U.S. commercial banks.[1]

Assets

To understand the role of foreign branches and agencies, we grouped their assets into five categories—(1) interbank assets,[2] (2) business lending,[3]

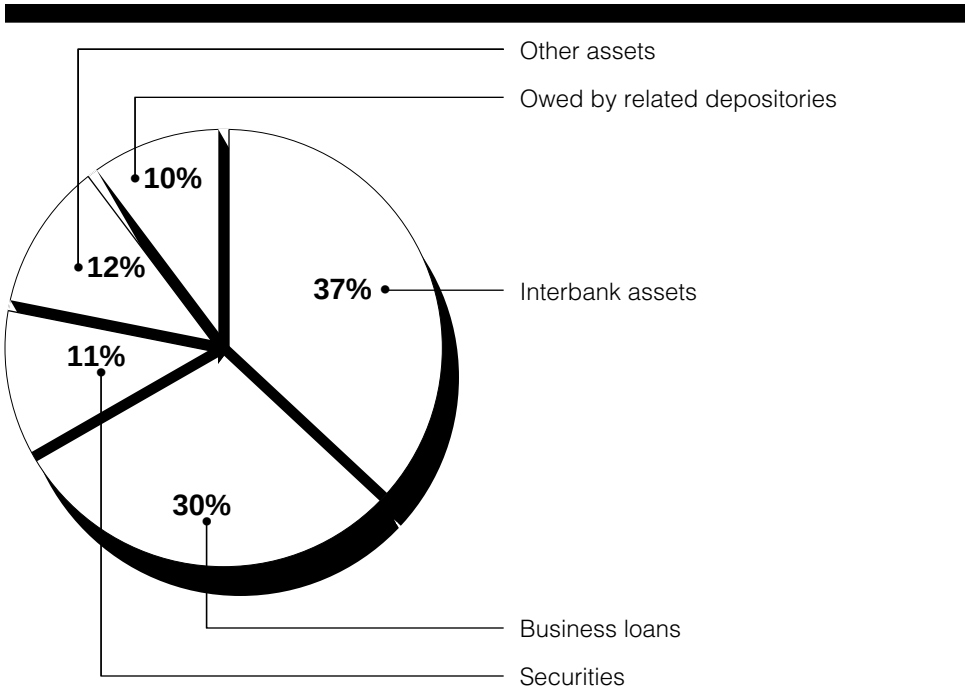
[1]Data on U.S. commercial banks include data on foreign-owned U.S. bank subsidiaries.

[2]Interbank assets include loans to other depository and financial institutions, balances due from other depository institutions, and federal funds sold and securities purchased under agreements to resell to other financial institutions.

[3]Business lending is comprised of C&I loans, trade finance, and real estate loans. Data are not available to indicate what percentage of real estate loans represent home mortgages or home equity loans. However, our review of examination reports suggest that few real estate loans are retail in nature. Therefore, we have classified these as business loans.

(3) securities holdings, (4) claims on the parent bank and related depository institutions[4] (related depositories), and (5) all other assets.[5] We looked at the amounts in each of these categories as of December 1994 and also at the growth in these categories over the period 1985 through 1994. In addition, we compared the portfolios of foreign branches and agencies to those of U.S. banks with foreign offices.[6] Among these U.S. banks, only a few would be considered wholesale institutions. This is not surprising since, in looking at the U.S. operations of foreign branches and agencies, we are considering only a portion of their parent banks' worldwide assets.

Figure 2.1: Asset Distribution in Foreign Branches and Agencies, December 1994



Source: Call report data.

[4]Claims on the parent banks and related depository institutions represents a balancing asset. It is the amount of funds transferred by the branch or agency to related depositories—either in the United States or offshore.

[5]Other assets include items such as cash, consumer loans, leases, and loans to foreign governments.

[6]At the end of 1994, 169 of the 10,453 banks in the United States had foreign offices or International Banking Facilities (IBF). About 70 percent of these 169 banks had $1 billion or more in assets.

As of December 1994, U.S. banks with foreign offices had $2.2 trillion in assets; about $500 billion was held in foreign offices. Assets in U.S. banks' IBFs totaled $42 billion.

Figure 2.1 shows the percentage of assets accounted for by each of these categories, as of December 1994. Interbank assets accounted for 37 percent of foreign branch and agency assets in 1994 and represented the largest share of foreign branch and agency assets. Over two-thirds of the interbank assets represented transactions with other foreign banks, although claims on other financial institutions, such as credit unions and savings and loans, have grown. From December 1985 through December 1994, the percentage of interbank claims on other financial institutions rose from 5 percent to 20 percent of interbank assets. In 1994, interbank assets accounted for only 12 percent of the banking assets in U.S. banks with foreign offices. Over 40 percent of these assets were held in their foreign offices.

Business lending accounted for 30 percent of foreign branch and agency assets in 1994, a decline from the 35 percent share at year-end 1991. The fall in the volume of business loans held by foreign branches and agencies since 1991 has been due to declines in real estate lending and trade financing. C&I lending has continued to grow, although modestly, since 1991. Business lending by U.S. banks with foreign offices accounted for 27 percent of total assets in December 1994.[7] From December 1990 through December 1993, the volume of business loans held by these U.S. banks also declined. However, at U.S. banks, the decline was due to a decrease in the volume of C&I loans as well as real estate loans. In 1994, the volume of business loans held by U.S. banks with foreign offices rebounded—growing over 3 times faster than at foreign branches and agencies.

Most foreign branches and agencies appeared to be lending to home countries and large businesses rather than to small or medium-sized U.S. firms. Our review of the examination reports of selected branches and agencies indicated that most foreign branch and agency business loans were either made to subsidiaries of home-country corporations or represented loans to multinationals or Fortune 500 companies. Interviews with foreign and domestic bankers and their representatives also supported this observation.

We were told by several of the people with whom we spoke that foreign branches and agencies would need to provide retail deposit services to attract the business of most retail customers (including small- and mid-sized businesses). To gauge whether foreign branches and agencies in

[7]Real estate loans on 1-to-4 family residences were excluded from this category for U.S. banks. Comparable break-out data did not exist for foreign branches and agencies.

the United States provide such services, we compared the volume of cash items in process of collection reported by foreign branches and agencies with the volume reported by U.S. banks with foreign offices.[8] In December 1994, foreign branches and agencies reported $3 billion (less than one-half of 1 percent of assets) as cash items in process of collection, compared with $63 billion (about 3 percent of assets) reported by the U.S. banks.

We also attempted to compare the extent of consumer lending in foreign branches and agencies with that in U.S. banks with foreign offices. However, foreign branches and agencies do not report consumer loans as a separate item, as do U.S. banks. In December 1994, the U.S. banks with foreign offices reported that consumer lending accounted for 9 percent of their assets.[9]

Liabilities

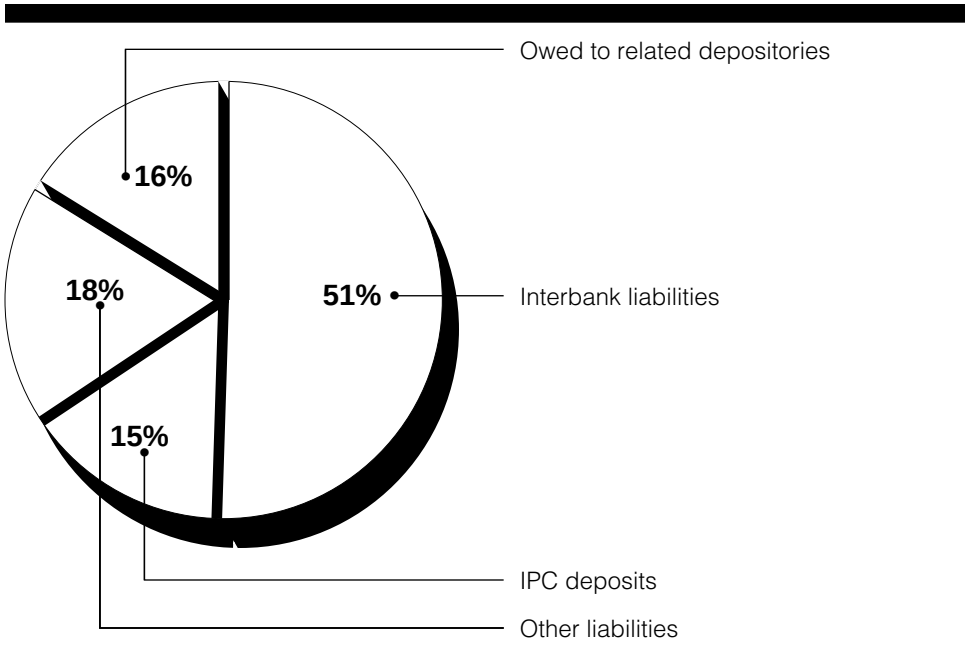
To examine how foreign branches and agencies fund themselves, we divided their funding sources into four categories—(1) interbank liabilities;[10] (2) deposits of individuals, partnerships, and corporations (IPC); (3) other liabilities; and (4) funds borrowed from related depository institutions. With the exception of IPC deposits, each of these funding sources is generally considered wholesale in nature. IPC deposits may be either wholesale or retail, although as we show in figure 2.2, most of these deposits appeared to be wholesale in foreign branches and agencies. We also looked at growth in these categories and compared their funding sources with those of U.S. banks with foreign offices. In contrast to foreign branches and agencies, which accounted for only a portion of their parent banks' worldwide liabilities, most of these U.S. banks depended on retail deposits as their primary funding source.

[8]A cash item represents any check that a bank has accepted and given immediate credit to a customer's account. While in the process of collection, it is, in effect, a short-term loan from the bank to its customer.

[9]The figure rose to 21 percent when 1-to-4 family mortgages were included.

[10]Interbank liabilities included deposits of other banks and financial institutions, federal funds purchased and securities sold under agreements to repurchase, and other money borrowed from financial institutions.

Figure 2.2: Distribution of Foreign Branch and Agency Liabilities in the United States, December 1994



Source: Call report data.

Figure 2.2 shows the relative importance of each of these funding sources. As the figure shows, foreign branches and agencies funded themselves primarily through the interbank market. In 1994, 51 percent of their liabilities represented funds owed to other financial institutions. Moreover, three-fourths of their interbank liabilities were owed to other foreign banks. From 1985 through 1994, interbank liabilities held by foreign branches and agencies doubled. However, as a funding source they actually declined in importance over that period. In 1994, U.S. banks with foreign offices held only 18 percent of their liabilities in the interbank market.[11]

Only 15 percent of foreign branch and agency funding came from the deposits of individuals or businesses (IPC deposits) in December 1994. By contrast, 59 percent of the funding in U.S. banks with foreign offices came from IPC deposits. In addition, about 28 percent of these U.S. banks' IPC deposits were in transaction accounts. By contrast, one-half of 1 percent

[11]Forty-two of the U.S. banks with foreign offices used the interbank market to fund more than 25 percent of their liabilities. Of these banks, about one-quarter were foreign-owned.

of foreign branch and agency IPC deposits represented transaction deposits.

Between December 1990 and December 1991, IPC deposits in foreign branches and agencies rose by 58 percent. This growth coincided with the Federal Reserve's move to lower reserve requirements at the end of 1990 and may represent the movement of deposits from offshore branches into U.S. branches. However, we have no data on deposits in offshore branches to verify this possibility. Since December 1992, the volume of IPC deposits in foreign branches and agencies has declined.

Market Share

Market share calculations provide a measure of the competitive impact of foreign branches and agencies in the U.S. banking market. However, these calculations are only an imperfect measure, depending on factors such as how the market is defined and finding comparable data among potential competitors. The broadest calculations of foreign branch and agency market share are based on banking assets. However, these calculations vary as different assumptions are made about which banking assets to include. For example, in December 1994, foreign branches and agencies reported total banking assets of $750 billion while U.S. commercial banks reported $4 trillion. This suggests that foreign branches and agencies had a market share of 15.7 percent.[12] However, the $4 trillion of assets in U.S. banks included about $500 billion held in foreign offices. Excluding these assets, the market share of foreign branches and agencies rose to 17.4 percent in 1994.

When evaluating the market shares of foreign branches and agencies, it must be recognized that much of their business is focused on international and interbank activities and is not related to the provision of domestic retail or business banking services. For example, IBF assets and interbank claims (excluding those recorded in IBFs) accounted for 26 percent and 15 percent, respectively, of foreign branch and agency assets in 1994.[13] Adjusting for these activities reduced the share of the U.S. banking market held by foreign branches and agencies to 11.9 percent in December 1994.

Asset Composition

Market share statistics for particular segments of the banking market give a clearer picture about the business and relative importance of foreign

[12]If we included the assets held by the U.S. bank subsidiaries of foreign banks, the market share of foreign banks in the U.S. would rise by about 3.5 percentage points.

[13]Because of the possibility of double counting between foreign-owned IBFs and foreign branches and agencies, we used only IBF assets owed by nonrelated parties in our calculations.

branches and agencies in the United States. In general, foreign branches and agencies have become a substantial presence in the C&I loan market and in interbank lending. They have almost no presence in retail markets, although precise market shares cannot be calculated.

In recent years, attention has been focused on the market share attained by foreign branches and agencies in the C&I loan market. Between December 1985 and December 1992, the volume of C&I loans held by foreign branches and agencies rose by $95 billion while they fell by $39 billion at U.S. banks. As a result, at the end of 1992, foreign branches and agencies held 24 percent of the market in C&I loans. Since then, their market share has dropped by about 1 percent as C&I loans have grown faster at U.S. banks.[14] The portion of foreign branch and agency C&I loans that goes to the U.S. subsidiaries of foreign companies is unknown.

While foreign branches and agencies are clearly an important part of the C&I loan market, their importance as originators of such loans is more limited. Foreign branches and agencies often purchase loans originated by U.S. banks through syndications and loan sales.[15] Purchases of C&I loans from U.S. banks account for a significant portion of the presence achieved by foreign banks in this market. For example, the Federal Reserve Bank of New York estimated that in 1991 foreign banks took about one-half of the loans made to U.S. corporations in syndications.

Banks that originate loans earn origination fees as well as receive interest payments from the portion of the loans they retain. Banks that buy loans receive only interest payments. While foreign banks sometimes act as agents or co-agents (i.e., the originator or co-originator) for C&I loans in the syndicated loan market, data show that the market was dominated by

[14]The C&I loan market includes loans made to U.S. and non-U.S. addresses. Calculating the C&I loan share for only U.S. addresses does not significantly change the results. In December 1994, foreign branches and agencies reported $20 billion in C&I loans made to non-U.S. addresses, while U.S. banks reported $88 billion of such loans. This gave foreign branches and agencies a 23 percent share of the market for C&I loans to U.S. addresses. Loans made to U.S. addresses represent the location of the borrower and not whether the borrower is a U.S. or foreign-owned business.

[15]Large C&I loans are often syndicated, i.e., shared among a number of banks. For example, some commercial loans are too large to be provided by a single bank and can only be made if a number of banks agree to take parts of the loan. In syndications, one or more banks take the lead by originating the loan. Other banks then participate by taking a part of the loan.

Banks also sell loans either outright or with recourse. Reasons for selling loans include diversification, avoiding lending limits, reducing capital requirements, or reducing lending costs by taking advantage of lower funding costs at other institutions. Reasons for buying loans include diversification, an ability to raise funds that exceeds the ability to generate loans directly, and an attempt to establish a banking relationship with a customer.

U.S.-owned banks. In 1993, 9 of the top 10 originators (measured by the number of deals) were U.S. banks.

The market share for the previously mentioned C&I loans only deals with one part of the market for business financing. Over the past decade, increasing numbers of nonfinancial corporations have turned to the commercial paper market as a lower-cost source of short-term funding. In addition, finance companies, which also make loans to businesses, have raised an increasing portion of their funds by issuing securities rather than obtaining bank loans.

Foreign branches and agencies provide a significant amount of funding in the interbank market, primarily by selling funds in the federal funds market and by making loans to other depositories. Since 1985, foreign branches and agencies have held an increasing share of the funds sold in the federal funds market. In 1985, they held only 7 percent of the funding in this market, and by 1994, their share had climbed to 29 percent. In addition, foreign branches and agencies have consistently held almost one-half of loans to depositories.

We were told by foreign bankers that foreign branches and agencies make few, if any, residential mortgage loans, consumer installment loans, or credit card loans. This was supported by our review of foreign branch and agency examination reports. Although data are collected separately on residential mortgage lending and consumer and credit card lending in U.S. banks, these data are only reported as part of total real estate lending and other lending, respectively, by foreign branches and agencies.

In December 1994, foreign branches and agencies held $40 billion in real estate loans. Our review of foreign branch and agency examination reports suggested that little of this was likely to represent single-family mortgage lending. By contrast, U.S. banks held $998 billion in real estate loans of which $569 billion represented loans on 1-to-4 family residential property. Other loans, which would include consumer loans, at foreign branches and agencies totaled $19 billion in 1994. For U.S. banks, consumer loans alone totaled $489 billion. Although it was not possible to calculate market shares for these activities, it is clear from the limited information that foreign branches and agencies represented a small portion of the U.S. retail banking market.

Funding Sources

Concerning funding, total deposits accounted for one-half of the liabilities of foreign branches and agencies and over three-quarters of the liabilities

of U.S. banks, in December 1994. However, the mix of deposits at foreign branches and agencies contrasted sharply with that of U.S. banks. U.S. banks depended primarily on retail deposits—represented by transaction (checking) deposits and small (less than $100,000) nontransaction deposits.[16] Foreign branches and agencies funded themselves primarily with wholesale deposits—represented by IBF deposits and large (over $100,000) time deposits.

In December 1994, foreign branches and agencies held 87 percent of all IBF deposits. They also held 38 percent of large time deposits.[17] By contrast, foreign branches and agencies had almost no presence in the retail deposit market. They held only 1 percent of total transaction deposits and less than one-half of 1 percent of nontransaction deposits of less than $100,000.

Off-Balance Sheet Activities

Changes in credit markets, the expansion of world trade, and increased volatility in foreign exchange and interest rates over the past 25 years have increased demand for off-balance sheet (OBS) products.[18] Moreover, before implementation of the risk-based capital standards, OBS products allowed banks to provide services to customers without increasing bank assets, which required regulatory capital.[19] These products have become increasingly important to U.S. and foreign banks as a way to maintain and expand their customer base and increase profitability. They represent wholesale activities.

Off-balance sheet products fall into two broad categories—(1) contingent liabilities and (2) derivative products. Contingent liabilities represent agreements by a bank to provide funds when certain conditions are met. They have been used, in part, to replace traditional loans from banks. For example, contingent liabilities allow those that borrow directly in the securities markets to protect themselves against refinancing problems, which could arise if the demand for their debt declined. Corporations,

[16]Nontransaction deposits include savings accounts and all time deposits.

[17]The foreign branch and agency share of large time deposits has increased significantly since year-end 1990, when they held just 14 percent of such deposits. Since then, the volume of these deposits at U.S. banks has dropped by over $150 billion while the volume at foreign branches and agencies has increased by over $75 billion.

[18]Off-balance sheet products represent commitments, contingencies, and other claims on the issuer and generally generate fees for these services.

[19]An important motive for expanding OBS activities was to minimize the effect of capital standards imposed by U.S. and foreign regulators. However, the implementation of risk-based capital standards, which require U.S. and foreign banks to hold capital against their OBS activities, has eliminated this motive.

state and local governments, and others receive this protection through backup lines of credit (e.g., loan commitments). Similarly, standby letters of credit (SLC) are used to enhance the credit quality of borrowers in the securities markets. They can be used to guarantee repayment when certain conditions occur.

Bank customers have also sought to protect themselves from adverse foreign exchange rate, interest rate, and commodity price movements through derivative products such as futures, forwards, options, and swaps.[20] A derivative is a security whose value depends on the value of another underlying financial product. OBS products have grown substantially in U.S. banks and foreign branches and agencies since 1985.

Market Share

The U.S. branches and agencies of foreign banks operate on the consolidated capital of their parent banks and use that relatively large base to engage in OBS activities. As U.S. banks came under capital pressures in the late 1980s and early 1990s and had their credit ratings downgraded, foreign branches and agencies gained a significant share of this market. Foreign branches and agencies have become large issuers of SLCs and loan commitments—products for which the bank's credit rating is important as an indicator of its ability to stand behind the product. For example, SLCs reported by foreign branches and agencies, net of participations—part of the SLC sold to other institutions—grew from $55 billion at the end of 1985 to $153 billion at the end of 1994.[21] At the same time, net SLCs at U.S. banks remained relatively constant at about $155 billion. Foreign branches and agencies had thus gained about one-half this market in 1994. Figure 2.3 shows the volume of selected OBS products at foreign branches and agencies and U.S. banks, as of December 1994.

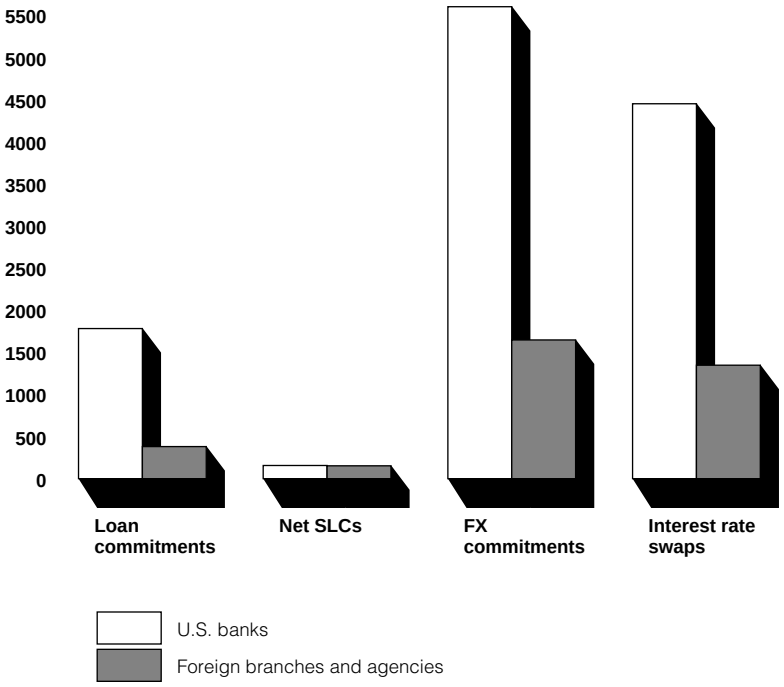
Among the derivative products, interest rate swaps and foreign exchange (FX) commitments have grown fastest at foreign branches and agencies. From $31 billion in 1985, interest rate swaps grew to $1.3 trillion at the end of 1994. Foreign branches and agencies represented 23 percent of this market at the end of 1994, up from 14 percent at the end of 1985. Foreign

[20]Forwards and futures obligate the holder to buy or sell a specific amount or value of an underlying asset or index at a specified price on a specified date. Options grant the holder the right, but not the obligation, to buy or sell a specific amount of the underlying asset at a specified price within a specified period. Swaps are agreements between counterparties to make periodic payments to each other for a specified period.

[21]Foreign branches and agencies have been especially active in support of debt issues by U.S. states and municipalities.

branches and agencies held $1.6 trillion in FX commitments in December 1994 and accounted for 23 percent of this market.[22]

Figure 2.3: Volume of Selected OBS Activities at Foreign Branches and Agencies and U.S. Banks, December 1994 (Dollars in billions)



Source: Call report data.

Shell Branches

The Federal Reserve began collecting limited data on the assets and liabilities of the shell branches of foreign banks managed or controlled by a branch or agency in the United States in March 1993.[23] Since then, the Federal Reserve has used these data to refine its estimates of foreign banks' share of the U.S. banking market. To understand the activities and impact of shell branches in the U.S. economy, we obtained these data and reviewed studies done by the Federal Reserve and the Federal Reserve Bank of New York. We also reviewed the most recent examination reports

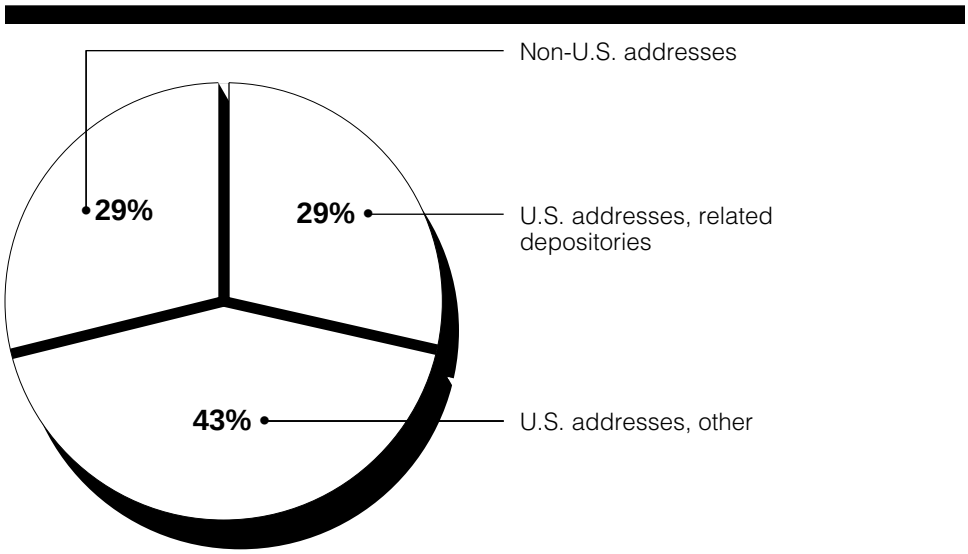
[22]A large volume of derivative products are bought and sold among financial institutions resulting in double counting for the banking industry as a whole.

[23]Some foreign banks operate offshore branches but do not have branches or agencies in the United States or do not manage their offshore branches through their U.S. offices. Therefore, data are not available that cover all banking transactions with U.S. residents.

for the 50 largest foreign banks operating in New York—most of which also have shell branches. However, the examination reports contained little information on the activities of shell branches.

The addition of assets reported by the shell branches of foreign banks raised the total assets of foreign branches and agencies operating in the United States from $750 billion to over $1 trillion in December 1994. However, as figure 2.4 shows, 29 percent of the assets in shell branches were to non-U.S. addresses, and another 29 percent represented claims on related depository institutions in the United States. Of the reported $293 billion in assets, $125 billion—or about 43 percent—represented claims on U.S. addresses other than to related depositories.

Figure 2.4: Asset Distribution of Foreign-Owned Shell Branches, December 1994



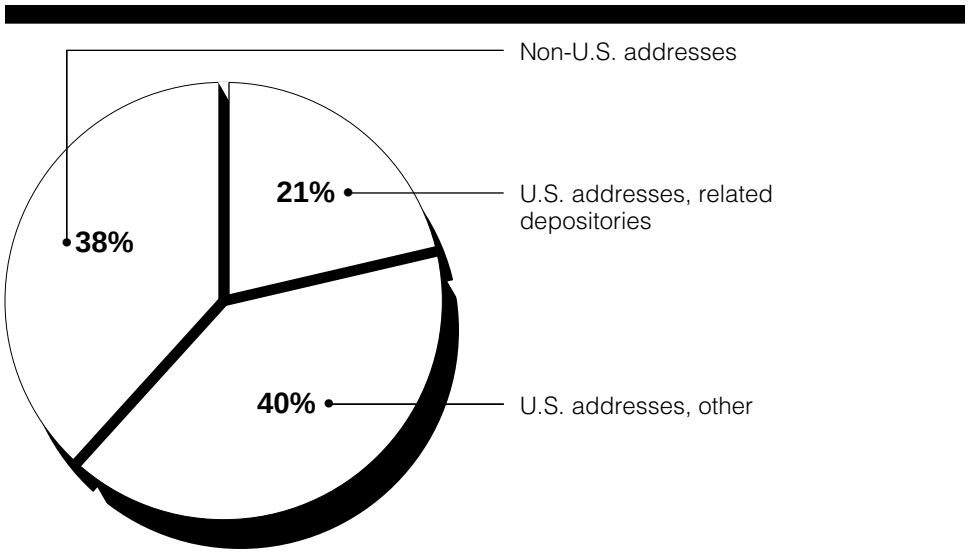
Note: Amounts may not total to 100 percent due to rounding.

Source: Federal Reserve data.

Regarding liabilities, figure 2.5 shows that 40 percent of shell branch funding ($118 billion) came from U.S. addresses not related to the branch, in December 1994. Of this amount, $86 billion was reported as liabilities to U.S. businesses and residents—about the same as the IPC deposits from

U.S. addresses reported by foreign branches and agencies in the United States. Interbank liabilities were much less important to the shell branches of foreign banks than to their branches and agencies in the United States. These liabilities accounted for only $23 billion in shell branches, as compared with $379 billion in their U.S. branches and agencies. The remainder of shell branch funding came from related depository institutions in the United States, home countries, and other addresses.

Figure 2.5: Liabilities of Foreign-Owned Shell Branches, December 1994



Note: Amounts may not total to 100 percent due to rounding.

Source: Federal Reserve data.

Impact on U.S. Market Share of Foreign Branches and Agencies

In general, the studies we reviewed found that foreign banks' share of banking assets, especially in selected markets, increased substantially when shell branch operations were included. A large portion of foreign banks' transactions with U.S. residents apparently have been booked in shell branches. We calculated the market share of foreign branches and agencies, including those assets in shell branches that were owed by U.S. addresses. Using these data, foreign branch and agency market share rose from 17 percent to 21 percent of domestic U.S. banking assets in December 1994.[24]

[24]Assets in U.S. banks exclude those in foreign offices but not IBFs.

In the commercial and industrial (C&I) loan market, the Federal Reserve estimated that the foreign bank share of lending rose from 35 percent to 42 percent in March 1993, when shell branch data were included.[25] Since then, the total volume of C&I loans reported by foreign branches and agencies and their shell branches has declined while loans held by U.S. banks have risen. For year-end 1994, foreign branches, agencies, and shell branches reported $204 billion of C&I loans to U.S. addresses ($151 billion in branches and agencies and $53 billion in shell branches). This represented 29 percent of the C&I loan market.[26]

Foreign Branches and Agencies Were Likely Net Suppliers of Funds to the U.S. Economy

Foreign branches and agencies supply funds to, and raise funds from, the U.S. market. Although it appears likely that foreign branches and agencies supplied more funds to the U.S. economy than they raised in the United States in 1994, the magnitude of this flow is uncertain. As table 2.1 shows, foreign branches and agencies supplied $118 billion more to U.S. addresses than they raised from U.S. addresses. By contrast, funds raised from non-U.S. addresses exceeded the funds used by $150 billion—more than enough to make up the difference to U.S. addresses. However, as table 2.1 shows, for a large volume of transactions the location of the parties could not be determined. Because of the magnitude of this category, we cannot definitively say that foreign branches and agencies provided more funds to the U.S. economy than they raised in 1994.

Under various scenarios, foreign branches and agencies could have supplied as much as $336 billion to the U.S. economy in 1994 or could have raised $44 billion more from the U.S. economy. To illustrate this point, if the $218 billion in funds used by unknown parties represented transactions with U.S. addresses and the $162 billion in funds raised came from transactions with non-U.S. addresses, foreign branches and agencies would have supplied $336 billion more to U.S. addresses than they raised from them in 1994. However, if the $218 billion represented transactions with non-U.S. addresses and the $162 billion represented transactions with U.S. addresses, there would have been a net outflow from U.S. addresses of $44 billion in 1994.

Although we do not know the actual magnitudes of all transactions with U.S. and non-U.S. addresses, it appears likely that foreign branches and

[25]These data include the C&I loans held by the U.S.-chartered bank subsidiaries of foreign banks. They also include C&I loans made to U.S. addresses and held in foreign offices of U.S. banks.

[26]If C&I loans to U.S. addresses held by the foreign offices of U.S. banks are excluded, the percentage of C&I loans held by foreign branches, agencies, and their shells rises to 30 percent.

agencies in the United States were net suppliers of funds to U.S. addresses in 1994. Categories that could not be identified by location included real estate lending, federal funds sold to nonbank participants, and all securities except U.S. government securities. Funds raised from unknown locations included federal funds purchased from nonbank sources and miscellaneous deposit accounts and other borrowed monies. If we assumed that all of the transactions with unknown locations occurred with U.S. addresses, then foreign branches and agencies would have supplied as much as $174 billion to the U.S. economy in 1994.

Table 2.1: Sources and Uses of Funds in Foreign Branches, Agencies, and Shell Branches, December 1994

Dollars in billions

Sources/uses of funds	Funds raised	Funds used	Difference
Transactions with customers with U.S. addresses	$357	$475	–$118
Transactions with customers with non-U.S. addresses	340	190	150
Transactions with customers whose locations are unknown	162	218	–56
Transactions with parent bank and related depositories	184	160	24

Source: Call report data.

Sources and uses of funding varied greatly between individual branches and agencies. For example, our review of examination reports showed one case in which a foreign bank funded its New York branch almost exclusively (over 95 percent) from its Cayman branch. The New York branch used the funds primarily for foreign exchange trading and to channel dollars from the parent bank's overseas offices to the Federal Funds market. In another case, a foreign bank used its New York branch as a way to raise funds to support economic development in its home country.

We also analyzed foreign branch and agency data to determine whether foreign banks made more C&I loans to U.S. addresses than they raised in deposits from individuals and corporations in the United States. For the period December 1985 through December 1994, about two-thirds of the foreign branches and agencies in the United States reported that they made more C&I loans to U.S. addresses than they raised from individuals and businesses with U.S. addresses. However, as previously mentioned,

we do not know all the sources and uses of funds by foreign branches and agencies.

Conclusions

Although their operating strategies and reasons for entering the U.S. market differ, foreign branches and agencies in the United States compete primarily in the wholesale banking market. Interbank transactions and provision of services to large corporations and home-country clients dominate their activities. Foreign branches and agencies have gained large shares in many of the market segments in which they specialize. Foreign branches and agencies accounted for 29 percent of the C&I loans in the U.S. banking market at the end of 1994,[27] and accounted for 38 percent of time deposits over $100,000.

Many of the wholesale activities of foreign branches and agencies were international in nature and were booked in their IBFs. Foreign branches and agencies use these facilities much more widely than do U.S. banks. By contrast, foreign branches and agencies held minimal shares in the retail banking market and do not appear to be competitors in this market.

[27]This market share calculation includes C&I loans to U.S. addresses reported by shell branches.

Adapting U.S. Laws and Regulations to Foreign Banks

In implementing the policy of national treatment embodied in the International Banking Act (IBA), concern has been raised that adaptations of U.S. laws and regulations have given foreign banks a competitive advantage over U.S. banks. In this chapter, we review the laws and regulations affecting the operation of foreign banks in the United States and evaluate whether such adaptations give foreign banks any significant competitive advantages over U.S. banking organizations. Our review of current laws and regulations and our interviews with U.S. and foreign bankers, executives at multinational and other corporations, U.S. bank regulators, and others indicated that differences in the legal and regulatory treatment of U.S. and foreign banks have diminished substantially since passage of the IBA. From our interviews, we found no area where adaptations of the laws and regulations were causing foreign banks to have significant competitive advantages compared with U.S. banks. However, because we were able to speak with only a limited number of bankers and other market participants, their impressions are not generalizable to the entire banking industry. National treatment will remain an important issue whenever changes in the powers of U.S. banks or bank holding companies (BHC) are contemplated because of differences in U.S. and foreign banks' corporate structures, authorized activities, and access to insured deposits.

Adaptations of U.S. Laws and Regulations

In our interviews, we found general agreement that differences in the legal and regulatory treatment of U.S. and foreign banks operating in the United States have narrowed and currently pose little concern to U.S. banks. This section reviews the adaptations of U.S. laws and regulations that are made for foreign banks operating in the United States and examines the arguments that have been made concerning the competitive impact on U.S. banks of these adaptations. The arguments have focused on seven areas: (1) capital adequacy, (2) reserve requirements, (3) retail deposit-taking and deposit insurance, (4) interstate branching, (5) consumer protection requirements, (6) nonbanking activities, and (7) supervision.

Capital Adequacy

U.S. banking regulations regarding capital adequacy apply to U.S.-chartered banks and BHCs, including those owned by foreign banks. They do not apply to branches of U.S. banks or to branches and agencies of foreign banks because these entities hold no capital of their own. However, federal and state regulators attempt to address this difference by requiring foreign branches and agencies to maintain capital equivalency deposits or asset pledge agreements as additional protection to U.S.

depositors.[1] The parent foreign banks are also responsible for meeting their home country's capital requirements and their capital levels are monitored by federal and state bank regulators.

For many years, U.S. bankers argued that differing capital requirements across countries resulted in a cost advantage for foreign branches and agencies operating in the United States. This cost advantage was attributed to capital requirements that were perceived to be higher for U.S.-chartered banks than for foreign banks and to differing restrictions on the composition of capital across countries. This cost advantage was argued to have allowed foreign branches and agencies to make C&I loans and provide other services—such as guarantees—at prices that U.S. banks could not match.[2]

In December 1992, the United States and other major industrialized countries fully implemented a set of international capital standards. These risk-based capital standards established guidelines for setting minimum capital ratios for large, internationally active banks and standardized, to a greater degree, the components of bank capital across countries.[3] The primary objectives of these standards were to strengthen the soundness and stability of the international banking system and to level the international playing field. Since their imposition, differences in bank capital requirements across countries have narrowed.[4] However, because the guidelines allow each country to vary some of the capital components and impose capital requirements beyond the minimum standards, and because the authorized activities for banking organizations vary across countries, disparities can remain. It is difficult to say whether these disparities give foreign banks an advantage. In addition, banks operate outside the United States in accordance with different regulatory and supervisory requirements, accounting principles, and asset quality standards. These differences also make it difficult to compare capital positions across countries.

[1]For example, federal branches are required to establish a capital equivalency deposit equal to the greater of 5 percent of the branch's liabilities to nonaffiliates or the minimum capitalization required of a national bank in the same location.

[2]Foreign branches and agencies have also been said to have lower costs due to cost of capital advantages and different expectations about their rates of return.

[3]See International Banking: Implementation of Risk-Based Capital Adequacy Standards, (GAO/NSIAD-91-80, January 25, 1991).

[4]It is important to note that bank regulators only set minimum capital standards. Market forces may require banks to hold greater amounts of capital.

Changes in U.S. laws and regulations have sought to diminish the potential advantage caused by differences in capital positions across countries. The Foreign Bank Supervision Enhancement Act (FBSEA) of 1991 required the Federal Reserve and Treasury to issue a Capital Equivalency Report that would contain guidelines to be used by the Federal Reserve in converting data on the capital of foreign banks to the equivalent capital requirements for U.S. banks.[5] Federal Reserve officials told us that they are to consider foreign bank capital and its equivalency to U.S. bank capital requirements when reviewing applications for the establishment or expansion of foreign bank operations in the United States.[6] The Federal Reserve has reported that it expects the parent banks of foreign branches and agencies operating in the United States to meet the same standards of financial strength (including capital equivalency), experience, and reputation as required for U.S. banks undertaking similar activities.

Reserve Requirements

Within the United States, foreign branches are required to maintain reserves in the same manner and to the same extent as U.S. Federal Reserve member banks.[7] Foreign agencies are also subject to reserve requirements on the same basis, provided that the foreign parent bank has total worldwide assets of more than $1 billion. Reserve requirements are imposed against three types of liabilities: (1) transaction deposits, (2) nonpersonal time deposits, and (3) Eurodollar activities. However, U.S. reserve requirements do not apply to offices of foreign banks outside the United States, including shell branches managed by branches or agencies in the United States.

Prior to 1991, the United States imposed a 3 percent reserve requirement on Eurodollar deposits whenever a bank's U.S. offices had net obligations to its foreign branches. A U.S.-chartered bank could not get around this requirement by booking Eurodollar-funded loans offshore because such loans were included in the bank's consolidated books. However, foreign banks could avoid the Eurodollar reserve requirement by booking Eurodollar-funded U.S. loans offshore.

Although the ability to avoid U.S. reserve requirements could confer an advantage on foreign branches and agencies, whether it did depended on

[5]The report was submitted to Congress in June 1992.

[6]The determination is to ensure that any differences in capital standards do not place U.S. banks at a competitive disadvantage.

[7]Reserve requirements determine the amount of cash and Federal Reserve deposits a bank must hold against its funding base and are costly for a bank to hold.

the cost of U.S. deposits relative to the cost of Eurodollar deposits. As long as the cost of U.S. deposits remained far enough below the cost of Eurodollar deposits to offset the cost of reserves, U.S. banks were not disadvantaged. By the mid-1980s, however, U.S. deposits were no longer inexpensive enough to offset the cost of reserves. Foreign branches and agencies appeared to have responded to this situation by booking loans in offshore offices so they could be funded without reserve requirements. The Federal Reserve Bank of New York reported that between year-end 1984 and year-end 1990 offshore claims, including those in shell branches, on U.S. nonbanks reported by foreign banks grew from $31 billion to $148 billion. In December 1990, the Federal Reserve lowered the Eurodollar reserve requirement to zero. This eliminated the potential advantage foreign banks received from booking loans offshore without reserve requirements.

Retail Deposit-Taking and Deposit Insurance

Current U.S. banking law bars foreign branches, except for 52 grandfathered branches, from accepting domestic retail deposits or obtaining deposit insurance.[8] According to Federal Reserve officials, the reason for this is to limit the exposure of the U.S. deposit insurance funds in case of failure of the branch or parent bank. However, foreign branches are permitted to take certain deposits of less than $100,000 from five categories of depositors and may accept deposits of less than $100,000 from any depositor subject to a de minimis rule.[9]

By contrast, any U.S.-chartered commercial bank may solicit retail or other deposits. Moreover, deposit insurance is required for national banks and most state banks.[10] Deposit insurance premiums are collected on all deposits, including uninsured deposits, held in offices in the United States. In recent years, the high cost of deposit insurance has led some observers to argue that foreign banks receive an advantage because they do not bear the cost of deposit insurance.

Overall, it is not clear how much of an advantage foreign branches have derived by not paying deposit insurance premiums. Although they do not bear the cost of deposit insurance, foreign branches do not have access to

[8]Under FBSEA, foreign banks must establish a separate subsidiary bank in order to take insured deposits. The 52 branches that were grandfathered under FBSEA are required to have deposit insurance.

[9]See chapter 1, p. 17.

[10]State-chartered banks that are members of the Federal Reserve System are required to obtain FDIC insurance. In addition, virtually all states require state-chartered banks to obtain FDIC insurance.

insured deposits—a stable funding source. Rather, depositors at foreign branches are expected to recognize that they must rely on the strength of the parent bank or the willingness of its government to guarantee their deposits if difficulties arise in the bank or branch. In addition, the Office of the Comptroller of the Currency (OCC) and state banking authorities can impose asset maintenance requirements on foreign branches, which require foreign branches to collateralize their liabilities. However, OCC officials said that this is not usually done unless there is a sense of trouble in the parent bank or the country, or as part of an enforcement action.

In addition, U.S. banks have substituted other funding sources for domestic deposits. For example, 38 of the 169 U.S. banks with foreign offices reported that at least 25 percent of their liabilities were foreign deposits, in December 1994.[11] Finally, the FDIC lowered deposit insurance premium rates for most U.S.-chartered banks in 1995. This should substantially reduce any advantage foreign branches and agencies have had from not paying deposit insurance premiums.

Interstate Branching

Prior to the IBA, foreign banks could establish full-service branches in any state that would permit their entry. By contrast, U.S. banks were prohibited from establishing interstate branches. Passage of the IBA ended this advantage for foreign banks by bringing them under federal regulation. However, foreign banks that had full-service interstate branches were allowed to keep them under the grandfathering provisions of the IBA. These banks were precluded from adding full-service branches except in their home state. As of December 1994, 70 foreign banks operated grandfathered branches.

Foreign banks have also been able to expand across state lines by establishing restricted branches, agencies, and Edge Act Corporations.[12] However, none of these alternatives has the range of powers of a full-service branch. Restricted branches can only accept deposits from U.S. citizens or residents in connection with foreign trade, and agencies are even more restricted in their deposit-taking abilities. Edge Act Corporations must not only restrict their deposit-taking to that resulting

[11]About one-third of the 38 banks were foreign-owned.

[12]Foreign banks can only establish restricted branches in states that specifically authorize such branches to exist. This is in contrast to establishing full-service branches, which may be established in any state that does not specifically prohibit such branches. U.S. banks may also expand across state lines by establishing Edge Act Corporations.

from foreign trade, but their lending must also be related to international activity.

In the years since passage of the IBA, any advantages afforded foreign banks from their grandfathered privileges or from their ability to expand through restricted branches or agencies have likely been eroded by subsequent changes in U.S. laws and regulations. Almost all states now allow some form of interstate banking, albeit through BHCs, and most allow nationwide entry. By June 1997, Riegle-Neal will allow U.S. and foreign banks to establish full-service branches across state lines.

Consumer Protection and the Community Reinvestment Act

Foreign branches and agencies operating in the United States are subject to the same consumer protection statutes as U.S. banks, provided that foreign branches and agencies engage in the activities targeted by each statute.[13] However, since foreign branches and agencies do not generally offer the full range of products and services typically offered by U.S. banks, they do not trigger all of the consumer protection statutes. For example, foreign branches and agencies do not generally offer mortgage loans. Therefore, they are not required to comply with consumer protection statutes that apply to mortgage lending.[14] In general, the application of consumer protection laws to U.S. banks should not place them at a disadvantage with foreign branches and agencies, since foreign branches and agencies can only avoid these laws if they do not engage in the activities that trigger them.

Specific attention has focused on the Community Reinvestment Act (CRA), which only applies to insured depositories. Since foreign branches and agencies do not generally offer insured deposits, they are not generally subject to CRA requirements.[15] However, since virtually all U.S. banks, even those that are considered wholesale banks (i.e., they do not rely on insured deposits as a funding source), must have deposit insurance, they must comply with CRA requirements. Whether foreign branches and

[13]Riegle-Neal affirmed that all consumer protection statutes apply to foreign banks in the United States. For example, foreign branches and agencies are subject to the provisions of the following federal consumer statutes: Truth in Lending Act, Fair Credit Reporting Act, Equal Credit Opportunity Act, Fair Debt Collection Practices Act, Expedited Funds Availability Act, Federal Trade Commission Act, Electronic Funds Transfer Act, Truth in Savings Act, Home Mortgage Disclosure Act, Fair Housing Act, and the Real Estate Settlement Procedures Act.

[14]Those foreign branches and agencies that do make mortgage loans, even if only to their own employees, are subject to the relevant consumer protection statutes.

[15]Those foreign branches and agencies that do offer insured deposits are subject to CRA. In addition, Riegle-Neal requires foreign banks that acquire banks that are subject to CRA to continue meeting CRA requirements.

agencies that do not offer insured deposits benefit specifically by not having to comply with CRA requirements is unknown.

Nonbanking Activities

Banks around the world differ in the products they can offer, the activities in which they may engage, and the structures under which they operate. U.S. banking laws prohibit banks from offering certain nonbanking related products and services such as insurance underwriting. Other nonbanking activities, such as selling life insurance, are allowed with limitations. Some banking-related products or services, such as corporate securities underwriting, cannot be offered by a bank but can be provided through a BHC.[16] In addition, U.S. law prohibits U.S.-chartered banks from mixing banking and commerce. By contrast, many foreign countries allow banks to operate as universal banks—offering a variety of products and conducting banking and other financial and nonfinancial activities within a single entity.[17]

Although U.S. laws governing banking activities are applied to foreign branches and agencies, in practice an attempt is made to accommodate the structural and operating differences between U.S. and foreign banks. Unlike most U.S. banks, foreign banks are not generally organized in a holding company structure. For regulatory purposes, the foreign (parent) bank is considered both a bank and a BHC. For example, the Federal Reserve treats foreign banks as BHCs for purposes of applying firewalls[18] to Section 20 companies.[19] The significance of this treatment is that foreign banks may lend to their Section 20 subsidiaries just as U.S. BHCs may lend to their Section 20 subsidiaries. However, any such loans from foreign banks must come from offices located outside the United States. Likewise, Section 20 companies affiliated with U.S. banks may borrow from foreign bank affiliates within certain limits, which are also applied to foreign banks. The U.S. branches and agencies of foreign banks may not lend to

[16]A BHC is a company that owns or controls one or more banks. The BHC structure can be used to attempt to isolate banking activities from other activities in which a bank cannot engage.

[17]U.S. banking organizations have been able to take advantage of the opportunities provided by universal banking systems in other countries. Under regulation K, and subject to host country restrictions, U.S. banks—through Edge Corporations—have been able to underwrite and deal in debt and equity securities.

[18]U.S. banking laws and regulations have established firewalls between commercial banks and their nonbank affiliates. These firewalls are intended to facilitate the conduct of activities between a bank and its affiliate(s).

[19]Section 20 companies are separately incorporated and capitalized subsidiaries of BHCs. They may underwrite and deal in debt and equity securities that banks may not, subject to revenue limitations. They are named after Section 20 of the Glass-Steagall Act, which prohibits banks from engaging in certain securities activities.

their Section 20 affiliates just as U.S. banks may not lend to their Section 20 affiliates.

In general, firewalls that are concerned with a bank's safety and soundness, such as section 23A and 23B restrictions,[20] are not applied to foreign branches and agencies. Other firewalls that are concerned with competitive advantage, such as those applied to Section 20 companies, are applied to foreign branches and agencies and their nonbank subsidiaries.

Allowing foreign banks to conduct activities through subsidiaries of the parent bank could give foreign banks a potential advantage over U.S. banks. For example, eliminating the need for a BHC structure could reduce some of the costs of operating branches or agencies and nonbank affiliates. Adopting a BHC structure is not costless—for example, a BHC requires a separate board of directors and auditors. A BHC structure may also prevent a bank from realizing economies of scope from nonbanking activities and prevent the bank from receiving profits directly from those activities as the profits accrue to the BHC parent. However, a BHC structure does limit a bank's liability for its nonbank affiliates' activities and insulates the bank from the affiliates' losses.

Under the BHC Act, foreign banks that have controlling interests in commercial or industrial firms are permitted to operate branches and agencies, own bank subsidiaries, and conduct commercial activities in the United States subject to certain conditions.[21] They cannot establish or acquire lines of business in the United States in which they are not principally engaged overseas. However, the act prohibits foreign banks with commercial banking activities in the United States from engaging in other financial activities in the United States without the Federal Reserve's approval. Officials stated that the Federal Reserve has prohibited foreign

[20]Sections 23A and 23B of the Federal Reserve Act were designed to protect banks from abuses in financial transactions with affiliates. Section 23A restricts loans and other transactions with affiliates and section 23B requires that transactions with affiliates be on an arm's length basis. The Federal Reserve stated that sections 23A and 23B do not apply to the U.S. branches and agencies of foreign banks because the United States does not regulate their safety and soundness. However, the exemption for transactions between bank affiliates of a common parent do not apply to transactions between a U.S.-chartered bank subsidiary of a foreign bank and a branch or agency of that same foreign bank.

[21]The BHC Act prohibits BHCs from engaging in a commercial or industrial activity not closely related to banking. However, the act sets forth express exemptions under which certain foreign banks (i.e., those banks that are principally engaged in banking activities outside the United States) with such affiliates can conduct their banking operations and their commercial or industrial activities in the United States. In general, these exemptions allow a foreign banking company to engage in a commercial or industrial activity in the United States only if a majority of the activity is conducted outside the United States.

banks from engaging in financial activities such as insurance underwriting.[22]

Because of differences in U.S. and foreign bank corporate structures, authorized activities, and access to insured deposits, national treatment is likely to be an important issue whenever changes are contemplated in the powers of banks or bank holding companies. For example, legislation has been approved by the House Banking and Financial Services Committee that would expand the range of BHC powers. This bill would repeal the Glass-Steagall Act and would allow companies to choose between two structures for the affiliation of banking and securities firms. Companies with an insured depository institution would have to become Financial Services Holding Companies (FSHC) while companies without an insured depository institution could become Investment Bank Holding Companies (IBHC). FSHCs would have higher firewalls because of federal deposit insurance. Under this bill, foreign banks that do not have operations that raise insured deposits in the United States could be treated as wholesale depository institutions and would be regulated as IBHCs. We do not know if this could create an advantage for foreign banks since they would be able to raise retail funds in their home country. The bill would also repeal grandfathering for those foreign banks with commercial and investment banking activities.

Supervision

Until enactment of the IBA, regulation and supervision of foreign branches and agencies operating in the United States rested solely with state banking authorities. Foreign banks wishing to establish branches or agencies obtained state licenses to operate. The IBA brought foreign branches and agencies under federal regulation and gave them the option of obtaining federal licenses.[23]

Passage of FBSEA in 1991 further expanded federal regulation of foreign banks in the United States. This legislation delegated to the Federal Reserve enhanced powers not only to examine all foreign bank operations in the United States on an annual basis, but also to approve and monitor their initial entry and subsequent expansion plans. In particular, it required

[22]One exception to this is when a bank is owned by a foreign government. Because a foreign government is not considered a company under the BHC Act, a foreign government-owned bank with a U.S. branch or agency may be affiliated with a foreign insurance company also operating in the United States without violating the BHC Act.

[23]States retained the power to prohibit foreign branches or agencies from operating within the state. However, states cannot allow state-licensed branches and agencies but exclude federally licensed branches and agencies.

the Federal Reserve to certify that foreign banks entering or expanding in the United States are subject to comprehensive consolidated supervision in their home countries.

FBSEA also required that foreign branches and agencies have annual examinations. The Federal Reserve, in coordination with OCC, FDIC, or relevant state banking authority, is responsible for these examinations. The consolidated operations of a foreign bank are regulated and examined by its home-country regulator. Like U.S. banks, foreign banks must file quarterly condition and income reports on their U.S. operations. The parent bank, as well, must file information on its condition and on that of its nonbank subsidiaries. Reports filed by branches, agencies, and their parent banks are generally less detailed than those of U.S. banks and their BHCs.

The Federal Reserve reviews the activities of shell branches that are managed by U.S. offices of foreign banks. However, U.S. bank regulators have no authority or responsibility to examine the activities of foreign banks that occur outside the United States. Review of activities in shell branches is used only as an input into assessing the quality of management in the U.S. offices of the bank. Since 1993, foreign banks that manage shell branch operations from the United States have had to file reports on the activities of their shell branches. However, because U.S. regulators do not have the authority to examine a foreign bank's operations outside the United States they cannot independently verify this information.

Views on the Competitive Position of Foreign Banks Operating in the U.S.

In preparing this report, we spoke with representatives from major money center banks, foreign banks operating in the United States, regional banks that actively participate in international markets, smaller banks in markets where foreign banks compete, multinational corporations, other corporations that have little or no international presence, and officials of state and local governments. We also spoke with officials at trade associations representing these organizations and with federal and state banking regulators. We asked these officials for their views on the competitive position of foreign and U.S. banks and whether foreign banks enjoy advantages vis-a-vis U.S. banks due to the adaptations of U.S. laws and regulations under which they operate. We also asked them to discuss the role and importance of U.S. and foreign banks in providing financial services.

U.S. and Multinational Corporations

Executives at the corporations we surveyed stated that they maintained relationships with many banks but received the majority of their banking services from a few of these banks. This subset of banks, referred to as core banks, provided the corporations' domestic cash management services as well as other domestic and international banking services.[24] Several factors were cited as important in choosing core banks. These included existing relationships with the bank, level and quality of service, price, and reputation for specialized services. Relationship, often built around the provision of cash management services, appeared to be the most important factor. The multinational corporations generally used the largest U.S. banks as their core banks. Several other companies we surveyed used these banks as well as large U.S. regional banks for their core accounts.

Multinational corporations appeared to use foreign branches and agencies primarily when their prices for particular services were lower or they believed their services were better than those of U.S. banks. This might occur because bank management had decided to specialize in certain services, such as trade financing. One official stated that a bank's competitiveness in seeking the business of growing and internationally focused companies was in part contingent on the size of the banking organization as a whole and the scope of its activities. Additionally, officials stressed the importance of a bank's international presence in providing services to growing companies. One official stated that a strong international presence and the ability to provide high-quality services worldwide were very important for businesses that were looking to grow internationally. He added that a bank that can minimize red tape and speed up the transfer of funds worldwide will have a distinct advantage over those that cannot.

Executives at several of the corporations told us that foreign branches and agencies are not able to offer any services in the United States that domestic banks cannot offer. Officials at multinational corporations said that competition varies according to the product line or specialty that each bank decides to pursue, but extensive retail networks have provided U.S. banks with an advantage in providing deposit-based services in the United States. Corporate officials also told us that when U.S. banks have a strong presence in local overseas markets and can support a corporation's needs, especially cash management, these banks will typically get their

[24]Cash management services comprise the majority of the daily banking needs of businesses. They include concentration, disbursement, and payroll services; wire transfers; and lock boxes. Other services provided by core banks include back-up lines of credit, letters of credit, foreign wire transfers, automated fund transfers, trust management services, and mortgages.

business—often because of an existing relationship. In countries where U.S. banks do not have the branch network or local presence to be able to provide cash management services, corporate officials told us they rely on foreign banks to provide such services. This can sometimes lead to the bank's supplying the company with other products and services, including some in the United States.

In interviews with officials at multinational corporations, we found that these companies typically had a group of second-tier banks that they used for specialized services or in geographic locations not served by their core banks. Often this second tier included foreign banks. Some of the corporations had 100 or more secondary or tertiary banking relationships. Some of the officials at the other firms we interviewed stated that they had fewer core bank relationships and only used other banks for cash management services in areas not served by their core banks.

State and Local Governments

State and local government officials told us they use banks in much the same way as corporations do, although they seek some different services. One official summarized municipalities' banking needs as encompassing four basic services: (1) municipalities use banks for short- and long-term financing, in particular, underwriting and selling municipal bonds; (2) banks provide cash management services; (3) banks act as trustees and paying agents for bond issues; (4) banks provide credit services such as standby letters of credit (SLC) to enhance a municipality's credit rating and lines of credit for interim borrowing.

According to state and local government officials and their representatives, the underwriting and sale of state and local government bonds is provided almost exclusively by domestic commercial and investment banks. These officials told us that foreign banks generally do not participate in this market because they do not need or benefit from holding tax-exempt bonds, and they do not have a customer base interested in purchasing such bonds. However, some officials reported that some municipalities have used foreign banks to issue bonds denominated in foreign currencies, such as Japanese yen.

Municipalities also appear to use domestic banks for cash management services for the same reasons as corporations. However, some state and local officials told us that for credit support and liquidity services foreign banks are very useful. Because many foreign banks have higher credit ratings or are willing to accept lower profit margins than U.S. banks,

foreign banks can offer guaranteed investment products and credit enhancement services at prices not available from U.S. banks.

U.S. Bankers

In our meetings with U.S. bankers, we discussed the market share statistics that show foreign banks have gained a significant share of the U.S. banking market. Two of these bankers questioned the attention given to these statistics, which suggest that foreign bank business has increased significantly in the United States. Another banker stated that asset size alone is an incomplete measure of foreign bank penetration and, more importantly, is not an accurate indicator of their competitiveness. He stated that profitability and capital strength are essential components of competitiveness, which must be taken into account, and he believed that U.S. banks do well by these measures.

Several U.S. bankers stated that foreign banks have become an integral component of the domestic financial markets. They acknowledged that some differences exist in the way U.S. laws and regulations are applied to foreign branches and agencies and U.S. banks but cited no area in which they felt that this created a significant competitive advantage for foreign banks.[25] Some U.S. bankers we spoke with stated that the risk-based capital standards and increased home-country supervision had made a difference in their ability to compete with foreign banks. One banker felt that much of the pricing advantage enjoyed by foreign banks had been eliminated. However, another banker stated that foreign banks still enjoyed some pricing advantages because of lax enforcement of the capital standards by their home countries.

Several U.S. bankers observed that foreign banks have contributed to the liquidity of the credit markets within the United States. They cited the late 1980s in particular as a time when U.S. banks were reducing their lending activities because of balance sheet constraints, and foreign banks stepped in to provide credit to U.S. corporations. Several of the bankers stated that during this period some large U.S. multinational corporations would not have survived their liquidity problems without the credit infusions provided by foreign banks.

The financial markets in the United States have undergone a dynamic evolution characterized by the fact that large U.S. corporations

[25]Concerning the application of consumer protection statutes to foreign branches and agencies, one U.S. banker stated that foreign banks are not the only competitors to whom these statutes, especially CRA, do not apply. He was particularly concerned that CRA does not apply to investment bankers, finance companies, and other municipal and local credit providers.

increasingly are bypassing commercial banks and are accessing the capital markets directly to meet their financial needs. Several U.S. bankers with whom we spoke expressed the view that Glass-Steagall restrictions were the primary cause of any eroding competitive position of U.S. banks with respect to their ability to service U.S. multinationals. These U.S. bankers stated that they felt more threatened by competition from investment banks than foreign banks in this area.

When asked about C&I lending, bankers from several of the large U.S. banks stated that they depended on foreign banks to participate in the syndicated loan market. Several bankers credited foreign banks with helping to maintain the C&I loan market in the face of increasing competition from investment banks. One banker stated that if foreign banks were not willing to participate in C&I lending, some businesses would likely issue securities such as commercial paper as substitutes for bank loans because other U.S. banks would not provide funding at prices that would be competitive with these alternatives. This banker said that the C&I loan market would be much smaller without foreign bank participation. We were told that foreign banks are more often purchasers rather than originators in this market and comprise the second tier of this market.

One U.S. banker stated that U.S. banks are at a disadvantage relative to foreign banks because foreign banks can move their operations offshore. By contrast, he stated that restrictions imposed on U.S. banks under regulation K constrain the size of their offshore securities subsidiaries, keeping them smaller than their foreign competitors. The banker stated that this puts American banks at a disadvantage when trying to underwrite securities for multinational corporations.

In general, the U.S. bankers expressed no concern about foreign bank competition in other areas. Rather, they stated that any advantage that does exist is one resulting from the economic environments in home countries and bank management's decisions as to what markets to serve and what services to offer. For example, foreign branches and agencies appear to have developed niches in areas such as trade financing, foreign exchange, and SLC. A banker from a large U.S. bank told us that his bank preferred not to offer trade financing because the bank found it to be labor intensive and costly, relative to the profits generated. He stated that regional banks and foreign banks have moved in to fill this niche. Another U.S. banker told us that foreign banks cannot compete with U.S. banks in

providing the services that U.S. corporations require domestically—i.e., cash management, lock boxes, and deposit services.

Several of the officials we interviewed at smaller U.S. banks stated that foreign banks did not compete in many of their markets, such as loans to emerging companies, cash management, or trust services. Rather, these bankers stated that most of their competition from foreign banks was in the provision of trade finance. However, several bankers stated that foreign banks are beginning to compete in the market for loans to mid-sized businesses. Although foreign banks were not generally regarded as a competitive threat, several U.S. bankers believed that foreign branches and agencies could price below most domestic banks because they received funding from their parent bank.

Foreign Bankers

Several foreign bankers told us that the mission of foreign banks in the United States is to provide global banking services to large international corporations and that most foreign banks serve customers of their home countries. An industry representative told us that only a few banks are large enough to penetrate through home country loyalties to attract other customers. However, several bankers stated that the proportion of loans to businesses from the bank's home country has diminished, although it is still significant. We were also told that any advantages their offices have in the United States derive from their relationship with their worldwide parent organization.

From our review of foreign branch and agency examination reports, it appeared that most foreign banks that try to attract U.S. customers tend to focus on Fortune 500 businesses. An industry representative stated that if foreign banks wanted to attract middle-market and small-business customers they would need to establish subsidiary banks. The representative stated that it would be difficult to attract such businesses without being able to offer them deposit services. Another foreign banker acknowledged that the definition of a nonretail deposit may be broad enough for foreign branches to offer deposit services to these businesses, but he believed federal deposit insurance would be necessary to attract them as customers.

On the basis of our interviews, it appeared that since the passage of FBSEA, foreign bankers have found the United States a difficult, and according to one banker—a hostile, environment in which to operate. One banker stated that the proposal to assess fees for Federal Reserve examinations of

foreign banks, which was mandated by FBSEA, is seen as clearly discriminatory by foreign bankers.[26] Another banker said he felt strongly that the U.S. regulatory structure has put his bank's U.S. operations at a disadvantage, relative to domestic banks. Two foreign bank officials commented that since enactment of FBSEA, paperwork processes have become time consuming and costly. Moreover, there appears to be strong sentiment that the Federal Reserve has been overly cautious in reviewing applications of foreign banks seeking to enter the United States or expand existing operations. One foreign branch official whose branch is trying to get Federal Reserve approval to acquire a small bank said he believes it could take between 1 and 2 years to get such approval. Some foreign bankers stated that completing the necessary paperwork, as well as lengthy delays in obtaining regulatory approvals for branch expansions, are costly for foreign banks. Two foreign bank officials said they felt that the application process serves as an effective barrier to foreign bank entry or expansion into the United States.

U.S. Bank Regulators

Federal Reserve officials affirmed that foreign banks operating in the United States are subject to all laws and regulations governing the activities of banks in the United States. They stated that foreign banks enjoy no significant advantages because of regulatory differences. Federal Reserve officials have acknowledged that there have been delays in processing applications for entry or expansion of activities of foreign banks in the United States. Many of the delays have been caused by requirements that the Federal Reserve evaluate each bank's comprehensive consolidated supervision and determine whether the Federal Reserve will have access to information on the bank's operations in material jurisdictions.

Federal Reserve officials stated that foreign branches and agencies have been rated on an AIM basis, i.e., asset quality, internal controls, and management capability with each office viewed as an independent entity. However, this is changing as federal bank regulators begin to focus their examinations on risk management rather than asset quality. Foreign branches and agencies are to be rated on a ROCA system, i.e., risk management, operational controls, compliance, and asset quality. The Federal Reserve also plans to conduct an annual assessment of the consolidated U.S. operations of foreign banks.

[26]Riegle-Neal has since delayed implementation of these fees.

U.S. bank regulators have no authority or responsibility to supervise activities of foreign banks that occur outside the United States, even those activities that are managed by a foreign bank's U.S. office. Rather, the supervisory responsibilities of U.S. bank regulators extend only to the safety and soundness of U.S. banking operations. To the extent that shell branches are managed by U.S. offices of foreign banks, U.S. regulators are to look at the shells as part of their overall determination of the quality of a foreign branch or agency's management. OCC and Federal Reserve officials stated that they were somewhat uncomfortable with this situation. They were concerned about who is responsible for supervising the activities of offshore branches managed in the United States. More generally, they are concerned about whether home-country regulators are able to examine banks with offices outside their home countries, especially in countries with secrecy laws. These concerns have contributed to the delays, mentioned earlier, in processing applications for entry and expansion in the United States.

Conclusions

For many years foreign banks clearly had advantages operating in the United States that U.S. banks did not have. They were not subject to federal laws and regulations and, as a result, were able to establish interstate branching networks and conduct securities as well as commercial banking activities. Although they could not offer deposit insurance, their business strategy did not depend on this source of funds. Moreover, some foreign banks attracted retail deposits even without deposit insurance.

The IBA and subsequent legislation eliminated most of the advantages that foreign banks had in the United States. Although the laws and regulations affecting U.S. and foreign banks are not exactly alike, we found general agreement among the U.S. and foreign bankers whom we interviewed that the major differences that had once existed are now gone. In general, the U.S. bankers we interviewed expressed little concern that adaptations of U.S. laws and regulations give foreign banks significant advantages compared with U.S. banks. However, as legislation moves forward that would change the activities in which banks or BHCs could engage, the structural and regulatory differences that exist between U.S. and foreign banks, if not recognized, could change the competitive environment affecting U.S. and foreign banks.

Comments From the Federal Reserve

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

November 27, 1995

Mr. James L. Bothwell
Director, Financial Institutions and Markets
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Bothwell:

We have read with interest the draft report, Foreign Banks: Assessing Their Role in the U.S. Banking System. The findings and conclusions concerning the activities of foreign banks in the United States expressed in the report are generally consistent with Board staff's own. We have no recommended changes or further comments on the draft report.

Sincerely,

William A. Ryback
Associate Director

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