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IS NATIONAL TREATMENT STILL VIABLE? U.S. POLICY IN THEORY AND PRACTICE

Sydney J. Key

ABSTRACT

National treatment, which precludes the use of rules that discriminate between foreign and domestic firms, seeks to ensure equality of competitive opportunity for foreign firms entering or operating in a host country. National treatment is a generally accepted principle for international trade in financial services. It is the basis for commitments by the twenty-four countries belonging to the Organisation for Economic Co-operation and Development (OECD) and for the current negotiations on trade in services in the Uruguay Round of the General Agreement on Tariffs and Trade (GATT). This paper provides an analysis of national treatment and alternative principles in the context of the banking sector, with the U.S. experience as an example.

The first section of the paper presents a conceptual analysis of national treatment and of principles that go beyond national treatment that have been used or proposed to govern domestic market access for foreign firms. The second section discusses the development and application of the U.S. policy of national treatment in the context of the conflicting demands created by the internationalization of banking and a host-country regulatory structure that differs significantly from that of other major industrial countries. The treatment of nonbanking activities and interstate activities of foreign banks that operate banking offices in the United States are used as examples of the U.S. approach. The final section presents the conclusions.

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Sydney J. Key*

National treatment, which precludes the use of rules that discriminate between foreign and domestic firms, seeks to ensure equality of competitive opportunity for foreign firms entering or operating in a host country. National treatment is a generally accepted principle for international trade in financial services. It is the basis for commitments by the twenty-four countries belonging to the Organisation for Economic Co-operation and Development (OECD) and for the current negotiations on trade in services in the Uruguay Round of the General Agreement on Tariffs and Trade (GATT). The banking sector provides a useful example for considering national treatment and alternative principles. Under a policy of national treatment, foreign banks are treated, as nearly as possible, like domestic banks: they have the same opportunities for establishment that domestic banks have, they can exercise the same powers in the host country, and they are subject to the same obligations.

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Difficulties in implementing national treatment arise primarily from differences in regulatory structures between the home and host countries. Some of the most difficult problems stem from the lack of agreement among the major industrial countries regarding the permissible activities of banks--for example, whether to separate commercial and investment banking. Problems also arise in trying to apply rules developed for the domestic banks of a host country to branches of foreign banks.

The increasing international integration of financial services and markets is making the difficulties in applying the policy of national treatment more acute. At the same time, however, this process of integration is also creating pressures for the convergence of national regulatory structures that would make national treatment more viable. Within the European Community, the principle of mutual recognition is being used to achieve, in interaction with market forces, a single, unified regulatory structure. Such a structure involves removing barriers created even by *nondiscriminatory* differences in national rules --that is, by differences in national rules that do not discriminate between foreign and domestic firms.

But the EC policy of mutual recognition is predicated on negotiated harmonization of essential rules and on political agreement among the member states on goals for regulatory convergence. Moreover, the policy is being developed and carried out in the context of a rather powerful supranational structure to which member states have already transferred a significant degree of sovereignty. Nowhere outside the Community is there a comparable supranational structure or, with the exception of capital-adequacy requirements for banks, comparable agreement on regulatory convergence. In their absence, one might ask whether the increasing difficulties in applying national treatment and the market pressures resulting from multinational banks operating under rules that differ significantly among countries could lead to a unification of national regulatory structures commensurate with the internationalization of financial services and markets. In other words, could these forces lead to anything like the result being sought within the Community, although perhaps over a somewhat longer time period than that acceptable within the Community?

All of this assumes that national treatment is the starting point for discussion of a country's policies toward foreign banks. A policy of national treatment applied, as in the United States, without regard to whether other countries also provide it, is based on the belief that open and competitive markets facilitate a more efficient, innovative, and financially sound banking system, and that the welfare of consumers of banking services in the host country will therefore be increased. A country may also provide national treatment in the hope that it will encourage other countries to do likewise. However, some countries, particularly some of the developing countries, still do not offer national treatment for foreign banking institutions. As a result, in addition to concern about the increasing difficulties in implementing national treatment and the interest in principles beyond national treatment, the policy of national treatment is also being criticized for its unilateral character by those who see reciprocity as a vehicle for encouraging more openness abroad.

The first section of this paper presents a conceptual analysis of national treatment and of principles that go beyond national treatment that have been used or proposed to govern domestic market access for foreign firms. The second section discusses the development and application of the U.S. policy of national treatment in the context of the conflicting demands created by the internationalization of banking and a host-country regulatory structure that differs significantly from that of other major industrial countries. The treatment of nonbanking activities and interstate activities of foreign banks that operate banking offices in the United States are used as examples of the U.S. approach. The final section presents the conclusions.

I. CONCEPTUAL FRAMEWORK

A. The Principle of National Treatment

A policy of national treatment, applied *de facto* as well as *de jure*, attempts to provide equitable treatment for entry and operation of foreign banks within a host country.[1] The OECD National Treatment Instrument defines national treatment as treatment under host country "laws, regulations, and administrative practices no less favorable than that accorded in like situations to domestic enterprises."[2] The

1. In this paper, *national treatment* refers to both entry and operation. Thus barriers to entry of foreign banks, such as quantitative restrictions, would be considered a violation of the principle of national treatment. Some use *national treatment* to refer only to operation within a host country and *market access* to refer to entry on a national-treatment basis--that is, without any discrimination against foreign firms.

2. Organisation for Economic Co-operation and Development, *Declaration by the Governments of OECD Member Countries and Decisions of the OECD Council on International Investment and Multinational Enterprises*, rev. ed. (Paris: OECD, 1984). See also Organisation for Economic Co-operation and Development, *National Treatment for Foreign-Controlled Enterprises*

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expression "no less favorable" allows for the possibility that exact national treatment cannot always be achieved and that any adjustments should favor the foreign firm. The wording is not meant to endorse a systematic policy of "better than national treatment." Instead, it emphasizes the need for national treatment to be provided on a meaningful, common-sense basis as opposed to a rigid, mechanical application of host-country rules.

National treatment has been characterized as creating "equal opportunities to achieve unequal results." The legal structure determines whether the opportunities are equal, but the market determines the results. *De facto* and *de jure* national treatment are sometimes distinguished on the basis of "effects." But here "effect" does not refer to the end result of market performance as measured, for example, by market shares. Rather, it refers to the adverse effect that rigid application of host-country rules, that is, *de jure* national treatment, might have on the *regulatory environment* for foreign institutions and thus on their ability to compete. The practical meaning of *de facto* national treatment is illustrated by the discussion of the U.S. experience in Section II below.

A conceptual difficulty with national treatment is that the appropriate market for achieving equality of competitive opportunities for multinational banking institutions may be broader than that of a single country. Because such banks compete on a global basis, barriers to international trade in banking services may also result from

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(Paris: OECD, 1985) for a discussion of the National Treatment Instrument and its application in the OECD member countries.

nondiscriminatory differences in national rules, such as differences in permissible activities for banks or differences in the types of products that may be offered.[3] National treatment, which is limited to ensuring the absence of *discriminatory* barriers, does not address the problem of practical barriers created by the lack of multinational harmonization of regulatory structures. National treatment also does not address the extent to which multinational cooperation and agreement is necessary to regulate and supervise financial activities conducted internationally.

Policies, goals, and obligations. Before considering principles that go beyond national treatment, it may be useful to identify the ways in which national treatment and other principles can be applied. First, national treatment could be a unilateral *policy* used by a host country for treatment of foreign banking organizations. As discussed below, with one exception, this is the current policy of the United States. Second, national treatment could be a *goal* set by an individual country, such as the United States, in negotiations regarding treatment of its banks abroad; such a goal could also be adopted in a multilateral agreement. Third, national treatment could be a legally binding *obligation*. Unlike a goal, such an obligation could involve sanctions.

One type of obligation is *imposed* unilaterally on another country by an individual host country as a condition of entry. For example, if a host country used national treatment as an obligation that

3. In this context, *nondiscrimination* refers to the absence of discrimination between domestic and foreign firms. By contrast, in the context of trade and capital movements, nondiscrimination usually refers to the absence of discrimination among foreign residents of different nationalities; the concept is similar to that of a most-favored nation (MFN) clause, under which benefits of any negotiated liberalization must be extended to all countries granted MFN status.

a foreign country had to fulfill in order for its banks to be granted national treatment, the host-country's policy would be *reciprocal national treatment*. As explained below, the policy of reciprocal national treatment is used in the EC's Second Banking Directive.

A second type of obligation is *undertaken* by a host country as part of its participation in a bilateral or multilateral agreement or in a supranational structure. In this situation, some type of international body or supranational authority, not an individual nation, would determine whether the obligation had been fulfilled. The OECD Codes of Liberalisation are an example of an international agreement under which national treatment is an obligation, although the Codes do not provide effective sanctions.[4] If the current Uruguay Round of GATT negotiations results in agreement on national treatment as the principle governing international trade in financial services and effective sanctions support such an agreement, national treatment could become a much stronger international obligation among a broader group of countries.

B. Principles That Go Beyond National Treatment

Various principles that go beyond national treatment, that is, principles that presuppose national treatment and seek something more, have been used or proposed as host-country policies for entry and operation of foreign banks, as goals for treatment of a country's banks abroad, or as obligations imposed by national reciprocity policies or

4. See Organisation for Economic Co-operation and Development, *Introduction to the OECD Codes of Liberalisation* (Paris: OECD, 1987) for an overview of the OECD Codes of Liberalisation of Capital Movements and Current Invisible Operations.

undertaken in connection with international agreements or a supranational structure. Principles that go beyond national treatment include *mutual recognition*, *effective market access*, and *treatment comparable to that of the home country*. These principles, which are not always precisely defined, can be most easily understood in terms of which country's rules apply to the operations of foreign banks in a host country. Specifically, national treatment and the principles that go beyond it can be analyzed in terms of three basic components: (1) *host-country rules*; (2) *home-country rules*; and (3) *harmonized rules* that apply in both countries.[5] For example, national treatment involves application of host-country rules to foreign banks on a nondiscriminatory basis.

Mutual recognition, which is the basis of the EC internal market program, involves both harmonization of essential rules and, in the absence of harmonization, acceptance by host countries of home-country rules.[6] Even if rules are harmonized, a further issue is who administers and enforces the rules. In the banking sector, this question is particularly important because harmonization of rules does not by itself guarantee the quality of supervision. The European Community is using *home-country control*, which requires acceptance of the home country's administration and enforcement of rules.

5. For an analysis of the applicability of host-country rules, home-country rules, and harmonized rules to different public policy goals and to different forms of provision of banking services internationally, see Sydney J. Key and Hal S. Scott, "A Conceptual Framework for International Trade in Banking Services" (forthcoming).

6. See Sydney J. Key, "Mutual Recognition: Integration of the Financial Sector in the European Community," *Federal Reserve Bulletin*, vol. 75, pp. 591-609 (September 1989).

Mutual recognition goes beyond national treatment in that it precludes the use of even nondiscriminatory differences in national rules to restrict access to host-country markets. Under a policy of mutual recognition, a country might be required to offer treatment more favorable than national treatment to firms from other countries.[7] Mutual recognition, however, cannot simply be decreed among a group of countries with widely divergent legal systems, statutory provisions, and regulatory and supervisory practices. Mutual recognition of rules that differ as to what a country regards as essential elements and characteristics would be politically unacceptable. As a result, a crucial aspect of mutual recognition is the harmonization of *essential* rules. Moreover, unless sufficient *de facto* harmonization already exists, it must be explicitly negotiated among countries. Within the European Community, such negotiated harmonization is far advanced and will provide the basis for mutual recognition and home-country control for financial services provided through branches and across borders beginning in 1993.

The European Community determined that national treatment (i.e., host-country rules) would not be adequate to achieve its goal of a single, unified market because even though each country's rules would have been applied on a nondiscriminatory basis, twelve separate, autonomous jurisdictions with different rules in each would still have existed. An alternative approach of complete harmonization, which the

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7. In theory, under a policy of mutual recognition it is also possible that if, for example, home-country rules did not permit a broader range of activities abroad than at home, a host country (by relying on home-country rules) might effectively offer treatment less favorable than national treatment.

Community originally used with regard to products, was abandoned as involving too much detailed legislation at the Community level and totally impractical to achieve within any reasonable period.

Within the Community, the approach of mutual recognition is being used as a pragmatic tool that, together with market forces, is expected to result in a more unified, less restrictive regulatory structure. The process is interactive: Mutual recognition requires initial harmonization, and additional harmonization results from mutual recognition. The expectation, indeed the overall strategy, is that any short-run competitive inequalities and fragmentation of markets created by mutual recognition will lead to pressures on governments for a convergence of national rules and practices that have not been harmonized at the EC level. In adopting the approach of mutual recognition in the financial area, the Community is in effect using trade in financial services to speed convergence of the regulatory policies of the member states.

Strictly speaking, unilateral recognition is the principle used as a host-country policy, and mutual recognition involves the additional step of using this principle as an obligation imposed on or undertaken by another country. Within the European Community, in certain areas each country has undertaken an obligation to recognize the validity of the laws, regulations, and administrative provisions of other member states. Supranational Community institutions determine whether a country has fulfilled its obligation and are responsible for ensuring compliance. An individual member state would not be permitted to impose unilateral sanctions on another member state.

Effective market access, another principle that goes beyond national treatment, has been used in the EC's Second Banking Directive and in the proposed Riegle bill in the United States.[8] A major difficulty with the term effective market access is that it is undefined and has therefore been used in ambiguous and contradictory ways in the context of international trade in financial services. Effective market access can be defined (a) very broadly, in terms of liberalization of a host-country's financial structure; (b) less broadly, as *de facto* national treatment; or (c) in terms of measures of performance, such as market shares.

The broad definition of effective market access involves both use of host-country rules and also harmonization of rules among nations. In this usage effective market access encompasses two elements, namely, national treatment and *progressive liberalization* of laws and regulations relating to banking and other financial services. Progressive liberalization is another term that has different meanings. In the OECD, it refers to removing discriminatory barriers over time. In the context of GATT, it was originally used with regard to developing countries to refer to overall liberalization taking place over time. Among the industrial countries, progressive liberalization could be viewed as the equivalent of an informal process of harmonization. Because the degree of liberalization in a particular industrial country would be measured against that existing in other major industrial countries, progressive liberalization would involve an attempt to bring more restrictive structures into rough conformity with more liberal structures.

8. See p. 28 below regarding the Riegle bill.

For example, suppose that a host country provides national treatment, that is, host-country rules do not discriminate between foreign and domestic firms. Nevertheless, the host-country's rules may may be so restrictive in comparison with the regulatory framework for banking services in other industrial countries that market distortions and inefficiencies may be created. The latter issue could be addressed by the concept of progressive liberalization. However, agreement among nations on the liberalization required by the broad definition of effective market access would, in effect, mean agreement on goals for regulatory convergence in areas such as the permissible activities of banks or the types of products that may be offered.

Progressive liberalization also differs from the harmonization being accomplished under the Community's approach of mutual recognition because the latter explicitly includes the harmonization of minimum prudential standards to ensure safety and soundness. As a result, progressive liberalization in the abstract, without, for example, adherence to the standards of the Basle risk-based capital accord, could lead to less regulation than might be desirable on prudential grounds. Accordingly, meaningful harmonization presupposes a consensus among nations regarding the distinction between national rules that have primarily the effect of imposing barriers to trade in services and national rules that are necessary for prudential purposes or for consumer protection. For example, a consensus exists within the European Community that permitting all forms of securities activities to be conducted in a bank or its subsidiary is a positive, liberalizing measure.

In another usage, effective market access is defined less broadly as *de facto* national treatment, that is, nondiscriminatory application of host-country rules. In this usage, effective market access is just a different label for national treatment, not a different concept. As mentioned earlier (see note 1), some use national treatment to refer only to operation within a host country and market access to refer to entry on a national treatment basis. In that case, under its less expansive definition, effective market access would mean nothing more than market access, that is, entry on a national treatment basis.[9]

A third usage of effective market access involves measuring progressive liberalization not by the regulatory frameworks of other industrial countries but by measures of market performance of foreign banks in a host-country market. This definition of effective market access cannot be analyzed in terms of host-country rules, home-country rules, or harmonized rules. The reason is that the definition is based on end results in the market rather than on the type of regulatory environment that is necessary to provide equal opportunities.

For example, figures for relative market shares are often cited as an indicator of openness of markets, that is, whether a host country provides effective market access. For example, the share of banking activity in France accounted for by U.S. banks might be compared with the share of banking activity in the United States accounted for by French banks. But such a comparison does not measure "access" to the respective

9. Whatever term is used for entry on a nondiscriminatory basis, there remains the issue of determining whether a barrier is discriminatory. For example, quotas that apply to all new entrants, whether foreign or domestic, could be considered discriminatory if foreign firms had previously been barred from the market.

banking markets because the relative shares depend on a variety of economic as well as regulatory factors. These include the size of the host-country market, the extent of international banking activity conducted in the host-country, the extent of direct investment in the host country by home-country firms, the volume of bilateral trade, the relative skills and expertise of different banks and banks from different countries, and host-country consumer preferences, which might include holding deposits at domestic banking institutions. Only differences in relative market shares that could *not* be explained by such economic factors could be interpreted as the impact of host-country barriers to entry or restrictions on the operation of foreign banks.

Treatment comparable to that of the home country also goes beyond national treatment in that it could involve reverse discrimination in favor of foreign institutions.[10] Under this principle, entry and operation of foreign banks in a host country would be governed by home-country rules. For example, under such a policy, EC banks with U.S. banking operations, would, unlike U.S. banks, be allowed to conduct securities activities in the United States without regard to the limitations imposed on domestic banks by U.S. law. If the principle of treatment comparable to that of the home country is used as an obligation, this amounts to *mirror-image reciprocity*.

Treatment comparable to that of the home country differs from mutual recognition because it does not involve harmonization of home- and host-country rules. As a result, if, for example, the European Community

10. In theory, treatment comparable to the home country could involve less favorable treatment than that provided for a host-country's domestic banks, but in that event the home country would not seek such treatment.

were to seek treatment comparable to the home country (i.e., the Community) for its banks abroad, such a goal could be viewed as the equivalent of an attempt to extend the principle of mutual recognition to countries outside the Community without having established on a more international basis the foundation for mutual recognition that exists within the Community. In the absence of agreement upon goals for regulatory convergence, systematically more favorable treatment of foreign firms resulting from the application of home-country rules in a host-country market would likely be unacceptable because of the resulting overall competitive inequality between foreign and domestic firms.

In practice, however, treatment comparable to that of the home country might be granted in certain limited areas if, for example, sufficient *de facto* harmonization already existed or the resulting competitive inequality would not be great and would be outweighed by other factors. In such cases, the *host* country might adopt and enforce rules for foreign banks that would in certain respects conform to those of the home country. By contrast, under a policy of mutual recognition, specific rules comparable to those of the home country would *not* be incorporated into the host-country's legislative framework, and enforcement would be the responsibility of the home country.

Treatment comparable to that of the home country also differs from the broad definition of effective market access, that is, national treatment plus progressive liberalization of a host country's financial structure. The latter liberalization is conducted on a national treatment basis, that is, it applies to both foreign and domestic firms. By contrast, if a host country were to grant treatment comparable to that of the home country, a foreign firm would receive better than national treatment in the host country. In other words, a country pursuing the goal of treatment comparable to that offered at home would be seeking liberalization only for its own banks within a host country, rather than for the sake of overall efficiency of markets as in the case of progressive liberalization.

The EC's Second Banking Directive, in its provisions regarding relations with non-EC countries uses three of the principles discussed above, namely, national treatment, effective market access, and treatment comparable to that of the home country. The Second Banking Directive uses national treatment and what appears to be the less expansive definition of effective market access as an obligation that non-EC countries may be required to fulfill to obtain national treatment for their banks within the Community. The Second Banking Directive also includes a principle that could be interpreted as either the broad definition of effective market access or treatment comparable to that of the home country. But this principle is used only as a negotiating goal, not as an obligation that non-EC countries may be required to fulfill. The use of the principle as an obligation would have amounted to a policy of mirror-image reciprocity.

The ambiguities in the provisions of the Second Banking Directive regarding non-EC countries arise from the Community's use of the term effective market access in two different contexts. First, effective market access is mentioned in addition to national treatment as an obligation that may be imposed on non-EC countries. The directive refers to a situation in which EC banks in a non-EC country "do not receive national treatment offering the same competitive opportunities as are available to domestic credit institutions and...the conditions of effective market access are not fulfilled." The EC Commission has stated that the standard will be "genuine national treatment," i.e., *de facto* as well as *de jure* national treatment.

Second, effective market access is used as part of the phrase "effective market access comparable to that granted by the Community" to refer to a goal for negotiations with non-EC countries. This phrase appears to refer to the principle of treatment comparable to that of the home-country (i.e., the European Community). Alternatively, it could be viewed as the broad definition of effective market access (i.e., national treatment plus progressive liberalization), with progressive liberalization defined in terms of the degree of liberalization existing within the Community.

C. <u>Treatment of Direct Branches of Foreign Banks</u>

In addition to regulatory convergence, two other issues that should be considered in relation to national treatment and the principles that go beyond it are the treatment of direct branches of foreign banks and need for increased cooperation and coordination internationally among bank supervisors.

Direct branches of foreign banks, unlike subsidiaries, are an integral part of their foreign parent banks and are not separately incorporated in the host country. Therefore, even under a policy of national treatment, host-country rules designed for separately incorporated entities cannot be literally applied to branches. Provisions recently adopted in the OECD Codes of Liberalisation regarding the establishment of agencies and branches of financial firms take such considerations into account by referring to "equivalent treatment."[11] This is defined to mean that rules different from those applicable to domestic institutions may be applied to agencies and branches but only in such a manner that the requirements are no more burdensome than those applicable to domestic enterprises. The OECD's use of the term equivalent treatment serves to emphasize the need for *de facto* national treatment for branches.

Moreover, as applied to direct branches of foreign banks, even the policy of national treatment inherently involves some reliance on home-country rules and enforcement procedures. Permitting branch entry *per se* implies some recognition of the adequacy of home-country rules and supervisory practices. In most cases this amounts to implicit unilateral recognition of only certain aspects of the home-country framework rather than an explicit policy of more general unilateral or mutual recognition of a country's laws and regulations that have not been harmonized.

The differences between subsidiaries and branches are reflected in their different treatment within the European Community. Separately incorporated subsidiaries will continue to be governed by national treatment, while services provided through branches, together with those provided across borders, are to be governed by the principle of mutual recognition and its corollary, home-country control. However, even within the Community, home-country control is not absolute. In practice, the division of responsibilities between home- and host-country authorities may be rather complicated. In general, the home country

11. Organisation for Economic Co-operation and Development, *Decision of the Council amending the Code of Liberalisation of Current Invisible Operations*, C(89)82 (May 10, 1989).

will be responsible for initial authorization and for ongoing prudential supervision. However, various aspects of the day-to day conduct of business may be subject to host-country control on a national treatment basis under, for example, consumer protection laws necessary to protect "the public interest," a rather stringent standard that has been established by the European Court of Justice. The conduct of monetary policy is an explicit exception to the principle of home-country control, and the host-country also retains responsibilities, in cooperation with the home-country, for branch liquidity.

An important issue that arises because of the special characteristics of direct branches of foreign banks involves capital requirements or what measure to use as the equivalent of capital for such branches in, for example, formulating rules for access to domestic payment systems. Within the European Community, mutual recognition requires that so-called endowment capital requirements for branches of banks authorized by any member state be abolished. By contrast, under a policy of national treatment host countries typically impose some type of branch capital requirement that is considered equivalent to the capital requirements imposed on domestic banks.

However, some countries such as the United Kingdom do not impose any endowment capital requirement on direct branches of foreign banks. Also, under provisions of the Financial Services Act, the U.K. authorities have entered into a series of "understandings" with regulatory authorities in other countries that exempt branches of firms conducting an investment business in the United Kingdom from U.K. capital requirements, subject to the sharing of supervisory and financial information by home-country regulators with U.K. authorities. These policies could be viewed as the equivalent of unilateral recognition of home-country capital requirements for U.K. branches of foreign financial firms.

A further issue involves geographic expansion by a foreign bank that wishes to establish multiple direct branches within a host country. It is clear that if a foreign bank had a subsidiary commercial bank in, for example, the United States, the domestic branches of that subsidiary should be treated in the same manner as those of a domestically owned commercial bank. But, at least with regard to limitations on geographic expansion, the appropriate parallel for a direct U.S. branch of a foreign bank is less clear. Such a branch might be regarded as the equivalent of a domestic branch of a U.S. bank or as the equivalent of the bank itself.

D. The Role of National Supervisory Authorities

The application of any principle for entry and operations of foreign banks in a host country is facilitated by the informal network of relationships among national supervisory authorities. The increasing internationalization of financial services and markets has both necessitated and facilitated greater international cooperation and coordination with regard to supervision and regulation. To some extent, this process is independent of the principle used for treatment of foreign banks in a host country. For national treatment or any of the principles that go beyond national treatment to be viable, contacts among national bank regulatory authorities are essential. Such contacts promote both harmonization of rules and supervisory practices and also trust among supervisory authorities. The latter issue is important regardless of whether rules have been harmonized. Even under the principle of national treatment, but particularly under the principles that go beyond it, a critical element is reliance by the host country on the competence of home-country supervisory authorities in other countries in administering and enforcing rules.

The international harmonization of rules governing banking that has been achieved to date has been accomplished by bank regulatory authorities in a relatively informal way. For example, the 1975 Basle Concordat, which set forth principles regarding the relative roles of home- and host-country supervisors in an effort to ensure that all banking organizations operating in international markets were supervised institutions, represented an accord reached by the bank regulatory authorities of twelve major industrial countries. It was negotiated under the auspices of the BIS Committee on Banking Regulations and Supervisory Practices, which was established in December 1974 as a mechanism for regular consultation among the banking authorities of the major industrial countries. The revised Concordat, released in 1983, incorporates the principle of home-country supervision of multinational banking institutions on a consolidated worldwide basis.

Similarly, the 1988 Basle risk-based capital framework is an accord among the banking authorities of the major industrial countries rather than a formal international agreement or treaty. Moreover, questions relating to implementation of the capital guidelines or adaptation of guidelines to changes in market practices will be dealt with as part of the continuing work of the BIS Committee. This agreement should facilitate evaluation of capital adequacy of foreign institutions seeking to enter a host country because, for countries that are a party to the agreement, home- and host-country capital requirements will be very similar once the harmonization of minimum requirements has been achieved by year-end 1992.

Under the approach of mutual recognition being used within the European Community, the role of the banking authorities is even more critical. Mutual recognition and home-country control require *inter alia* that the supervisors of other member states be recognized as capable. In addition, for mutual recognition and home-country control to be acceptable there will have to be sufficient harmonization of supervisory procedures and practices beyond the general guidelines set forth for national laws or regulations in EC directives. Cooperation and coordination among national authorities will be essential in defining and implementing a reasonable and generally accepted line between home- and host-country control. As part of a longstanding tradition of such contacts, EC bank supervisors meet formally in a *Groupe de Contact*.

II. THE U.S. POLICY OF NATIONAL TREATMENT

A. Overview

The United States provides an interesting example of the application of the policy of national treatment to international trade in banking services. The current U.S. regulatory structure is both complex and significantly different from that in other industrial countries but, at the same time, the United States is committed by policy and by statute to allow foreign banks to compete on an equal basis with domestic banks in the United States. At present, the United States uses the principle of national treatment both as a policy for treatment of foreign banking institutions and also as a goal in bilateral negotiations. However, with respect to operating as a primary dealer in the government securities market, the United States also uses national treatment as an obligation that it imposes on foreign countries, that is, it has adopted a policy of reciprocal national treatment.[12]

The U.S. policy of national treatment for foreign banking institutions was formally established in the International Banking Act of 1978 (IBA). Although this policy had not previously been established by statute, it has been the U.S. practice toward foreign direct investment in general.[13] Foreign banks operate in the United States primarily through three types of banking offices: agencies, branches, and subsidiary commercial banks.[14] Unlike subsidiary commercial banks, agencies and branches are integral parts of their foreign parent banks and are not separately incorporated entities. Both agencies and branches

12. See pp. 27-28 below. Only primary dealers, which are designated by the Federal Reserve Bank of New York, may engage in government securities transactions with the Reserve Bank of New York, which carries out the Federal Reserve System's open market operations.

13. International Banking Act of 1978, Pub. L. No. 95-369, 92 Stat. 607 (codified as amended in scattered sections of 12 U.S.C.). The term national treatment appears in the IBA only in a section dealing with reports on the denial of national treatment to U.S. banks in foreign countries. However, the term was used repeatedly in the Committee reports and hearings and in the floor debates to describe the purpose of various sections of the Act.

14. Foreign banks also operate two less common types of banking offices in the United States: so-called New York state investment companies and Edge corporations. The former, which the IBA refers to as commercial lending companies, are separately incorporated entities with powers similar to those of agencies. (The nonbanking provisions of the IBA that are discussed in this paper also apply to foreign banks operating New York investment companies.) Edge corporations are chartered by the Federal Reserve Board under the Edge Act, a 1919 amendment to the Federal Reserve Act, to engage in international banking and financial operations. An Edge corporation may be established in any state regardless of the location of its owner's other banking operations. An Edge corporation may also establish branches in any state.

may conduct full-scale lending operations, but agencies generally may not accept deposits. Prior to the IBA, U.S. agencies and branches of foreign banks were licensed and supervised only by individual states. There was no federal regulatory framework for foreign banks that operated only agencies or branches.

As a result, foreign banks enjoyed a number of advantages over their U.S. counterparts. For example, foreign banks were able to establish full-service branches in more than one state, so long as such branches were permitted by state law. Agencies and branches were not required to hold reserves with the Federal Reserve System. Moreover, only foreign banks that operated commercial bank subsidiaries in the United States were subject to the provisions of the Bank Holding Company Act (BHCA) restricting nonbanking activities.[15] As a result, many foreign banks without U.S. subsidiary banks were able to operate both securities affiliates and deposit-taking branches in the United States.

The IBA addressed the issue of parity of treatment with statutory provisions regarding federal and state licensing, interstate activities, nonbanking activities, federal reserve requirements and access to the discount window, federal deposit insurance, and ownership and powers of Edge corporations. However, because of differences in regulatory frameworks in the United States and in foreign countries, it was not always possible to achieve exact equality of treatment. The problem was to avoid applying U.S. law on an extraterritorial basis, that is, to avoid applying host-country rules to home-country activities, but

15. Section 4 of the BHCA deals with nonbanking activities of bank holding companies. Bank Holding Company Act of 1956, 12 U.S.C.A. § 1843 (West 1989).

at the same time to avoid giving foreign banks in the United States a competitive advantage over their domestic counterparts.

As a result, in enacting the IBA, Congress allowed certain deviations from national treatment that generally resulted in more favorable treatment for foreign banks. The major adjustments involved the treatment of existing and future nonbanking and interstate activities. The IBA grandfathered existing nonbanking and interstate activities of foreign banks. With regard to future nonbanking activities, the IBA applied the nonbanking provisions of the BHCA to the direct and indirect U.S. operations of foreign banks with U.S. agencies and branches.[16] However, the statute provided foreign banks an exemption from BHCA rules regarding the separation of banking and commerce for certain commercial, but not financial, activities conducted in the United States by an affiliated foreign nonbanking company. With regard to future interstate activities, the IBA limited the deposit-taking powers, but not the lending powers, of new branches established outside a foreign bank's "home state" (see below) to those permissible for Edge corporations, i.e., only deposits related to international activities.

Since enactment of the IBA, the question of what constitutes national treatment for foreign banking organizations has arisen in a number of areas. These include capital adequacy standards for foreign banks seeking to establish or to acquire banks in the United States, access to U.S. payment systems for agencies and branches of foreign banks, treatment of foreign banks under interstate banking laws enacted by the states, treatment of securities subsidiaries of foreign banking

16. An example of an "indirect" U.S. operation of a foreign bank would be a U.S. subsidiary of a foreign affiliate of the foreign bank.

organizations, and the treatment of foreign financial conglomerates. Indeed, the difficulties faced by U.S. authorities in determining the appropriate adjustment of foreign banks' reported capital to take into account differing concepts of capital was one factor leading the United States to pursue an international agreement on capital adequacy.

In enacting the IBA, Congress was also concerned about the treatment of U.S. banks in foreign countries. Although the overall policy of the IBA is national treatment for foreign banking institutions without regard to home-country treatment of U.S. banks, Congress was desirous that such an approach would promote similar attitudes on the part of foreign governments. To this end, the IBA required the Secretary of the Treasury, in conjunction with other agencies, to study and report to Congress on the extent to which U.S. banks are denied national treatment in foreign countries. The first National Treatment Study was completed in 1979, and the study has been updated twice at the request of Congress. These studies have been used as the basis for bilateral negotiations with authorities in those countries where U.S. banks see the greatest benefits from some relaxation of restraints on entry and operation of foreign banks. Under trade legislation adopted in 1988, reports on denial of national treatment for U.S. banks and securities firms will be required every four years, with the first report due by December 1990.

Although at the time it enacted the IBA Congress specifically rejected a policy of reciprocity, in recent years there has been increasing Congressional concern about the competitive position of U.S. banks both at home and abroad. Some of the issues that were originally addressed in the IBA, particularly with regard to nonbanking activities, were reopened during Congressional consideration of banking legislation in 1987. The outcome of this reexamination was, in general, to codify existing Federal Reserve rules and practices with respect to nonbanking activities of foreign banks operating in the United States. However, the Omnibus Trade and Competitiveness Act of 1988 contains an exception to the U.S. policy of national treatment by requiring reciprocal national treatment for the granting of primary dealer status to foreign firms operating in the U.S. government securities market.[17]

The primary dealer legislation requires that the Federal Reserve determine whether U.S. firms are granted "the same competitive opportunities" as are available to domestic firms in the foreign country's government debt market, i.e., whether U.S. firms are granted *de facto* national treatment. A country's failure to meet this obligation would result in a denial or revocation of primary dealer status for firms from that country in the United States.[18] In implementing this provision, the Federal Reserve made a judgment as to what constitutes *de facto* national treatment in foreign countries on much the same basis as the United States has itself defined *de facto* national treatment for foreign banks operating in the United States.[19]

17. Omnibus Trade and Competitiveness Act of 1988, 22 U.S.C. §§ 5341-42 (1988).

18. Grandfathering was provided for primary dealers designated or acquired by foreign banks prior to July 31, 1987.

19. See Federal Reserve press release, August 22, 1989, and "Primary Dealers Act of 1988," memorandum from the staff to the Board of Governors of the Federal Reserve System, August 16, 1989. See also "Switzerland and the Primary Dealers' Act," memorandum from the staff to the Board of Governors of the Federal Reserve System, November 22, 1989.

In June 1990, the Senate Banking Committee approved a bill that would change the overall U.S. policy of national treatment for foreign banking and securities firms from national treatment to reciprocal national treatment.[20] The language used in the bill would require foreign countries to grant U.S. banks and securities firms "the same competitive opportunities (including effective market access)" as are available to the country's domestic banks. The section-by-section analysis of the bill prepared by the committee in effect equates "same competitive opportunities" (the primary dealer language), "national treatment to ensure equality of competitive opportunity," "*de facto* national treatment," and "effective market access." [21] Thus effective market access appears to be used in its less expansive definition as *de facto* national treatment.

B. Nonbanking Activities

Congress found it particularly difficult to define the policy of national treatment with respect to nonbanking investments in the United States by foreign banks and their nonbanking affiliates. U.S. rules for activities that are permissible for banks and affiliated companies are established primarily by the Glass-Steagall Act and the BHCA.[22] The

20. S. 2028, as reported July 13, 1990, Senate Rep. No. 797, 101st Cong. 2d Sess. (1990).

21. U.S. Senate, Committee on Banking, Housing, and Urban Affairs, The Fair Trade in Financial Services Act of 1990, Senate Report No. 797, 101st Cong. 2d Sess. (1990).

22. Sections 16, 20, 21, and 32 of the Banking Act of 1933, 48 Stat. 162 (codified at 12 U.S.C. §§ 24, 377, 378, 78, respectively), are collectively known as the Glass-Steagall Act.

Glass-Steagall Act separated commercial and investment banking by generally prohibiting a bank or its affiliated company from underwriting or dealing in "ineligible" securities.[23] The BHCA established the further principle of separating banking and commercial activities by generally prohibiting a bank holding company from engaging directly, or indirectly through a subsidiary, in nonbanking activities and by restricting investments in nonbanking companies to not more than five percent of the voting shares.

The BHCA provides an exemption from this prohibition for activities determined by the Federal Reserve Board to be "closely related to banking," although application or prior notice to the Board is required to engage in such activities.[24] Companies whose activities are not considered closely related to banking include not only commercial enterprises but also full-service securities firms and insurance

23. "Ineligible" securities as used in this context include most debt and equity securities other than U.S. and Canadian government securities.

24. The exemption is set forth in Section 4(c)(8) of the BHCA. The activities that the Board has determined to be closely related to banking are listed in Regulation Y, Bank Holding Companies and Change in Bank Control, 12 C.F.R. § 225.25 (1990).

The U.S. statutory and regulatory structure for banks and bank holding companies is complex. The BHCA, which is implemented by the Federal Reserve Board, covers bank holding companies and their nonbank subsidiaries, but not the direct activities of banks themselves. The BHCA generally defines banks as institutions that (1) make commercial loans and accept transaction accounts, or (2) accept insured deposits.

Specific powers of banks depend on the bank's chartering authority (individual states for state-chartered banks and the Comptroller of the Currency for national, i.e., federally chartered, banks), on federal statutes such as the Federal Reserve Act and the Glass-Steagall Act, and on rules established by the bank's primary federal regulator. The Federal Reserve is the primary regulator for state-chartered member banks, the Federal Deposit Insurance Corporation for state-chartered nonmember banks, and the Comptroller of the Currency for national banks. However, the Federal Reserve also has authority over some foreign activities of national banks.

companies. Within the restrictive statutory limitations of the Glass-Steagall Act on domestic securities activities of U.S. banks and their affiliates, in 1989 the Federal Reserve Board authorized so-called Section 20 subsidiaries of bank holding companies to engage to a limited extent in underwriting and dealing in debt and equity securities on the basis that such subsidiaries are not "engaged principally" in securities activities.[25] However, with regard to insurance activities, the BHCA, as amended by the Garn-St Germain Act, specifically prohibits U.S. bank holding companies from engaging in most insurance activities in the United States and thereby precludes the Federal Reserve Board from determining that insurance activities are closely related to banking.[26]

By contrast, in many foreign countries banks may engage directly or indirectly in securities activities, and affiliations between banks and other financial or commercial enterprises are not prohibited. For example, the EC's Second Banking Directive does not place any

25. *J.P. Morgan & Co. Incorporated et al.*, 75 *Federal Reserve Bulletin* 192 (March 1989). See also Federal Reserve System, Review of Restrictions on Director and Employee Interlocks, Cross-Marketing Activities and the Purchase and Sale of U.S. Government Agency Securities, Request for Public Comment, 55 *Fed. Reg.* 28,295 (July 10, 1990). "Section 20" refers to a section of the Glass-Steagall Act that provides that member banks may not be affiliated with companies that are "engaged principally" in underwriting or public sale of ineligible securities. Although Section 20 does not technically apply to nonmember banks or to foreign banks operating only branches or agencies in the United States, the Board has used the BHCA to apply the same restrictions to affiliates of nonmember banks that are subsidiaries of bank holding companies and to affiliates of U.S. agencies and branches of foreign banks.

26. Section 4(c)(8) of the BHCA, as amended by the Garn-St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, § 601, 96 Stat. 1536. States, however, may set their own rules for powers of state-chartered banks. For example, in 1990 Delaware enacted legislation that would permit banks chartered in Delaware to conduct most insurance activities outside Delaware and limited insurance activities within Delaware (see note 38 below).

restrictions on the type of company that may own or be affiliated with a bank through a holding company structure, although it does place limitations (in terms of a percentage of bank capital) on bank investments in nonfinancial enterprises. Insurance companies are considered nonfinancial firms under EC law, but the directive permits member states to exempt insurance companies from these limitations.

The goal of achieving parity in treatment between domestic and foreign banking organizations in individual host-countries has been further recognized by U.S. law in that U.S. banking organizations operating abroad are not subject to the same restrictions that apply domestically. In order to enable U.S. banking organizations to compete more effectively with foreign banking organizations outside the United States, Congress gave the Federal Reserve Board the authority to approve certain exemptions for foreign activities that are not available for domestic activities.[27] Through bank holding companies and Edge corporations, U.S. banking organizations may engage abroad in any of the activities listed in the Board's Regulation K.[28] This list is broader than the domestic list of activities permissible for bank holding companies contained in the Board's Regulation Y. Under Regulation K, the standard for engaging in an activity abroad is whether it is "usual" in

27. Section 4(c)(13) of the BHCA and Sections 25 and 25(a) of the Federal Reserve Act, 12 U.S.C. §§ 601-632 (1988).

28. This list, established under the authority of Section 4(c)(13) of the BHCA and Sections 25 and 25(a) of the Federal Reserve Act, is set forth in Regulation K, International Banking Operations, 12 C.F.R. § 211.5(d) (1990). Additional activities may be approved by order. See also Federal Reserve System, Regulation K--International Banking Operations, Proposed Rule, 55 *Fed. Reg.* 32,424 (August 9, 1990).

connection with the business of banking or other financial operations in the host country and not inconsistent with U.S. supervisory standards.

Abroad, subsidiaries of U.S. banks and bank holding companies may engage in underwriting and dealing in debt and equity securities, subject to certain prudential limitations, such as those on the exposure to any single issuer of securities. By contrast, in the United States, underwriting and dealing in "ineligible" debt and equity securities may only be conducted in a subsidiary of the bank holding company and may not account for more than 10 percent of the subsidiary's revenues. Moreover, such a subsidiary may not be funded by its affiliated bank and is subject to numerous other prudential restrictions (so-called firewalls) designed to insulate the securities subsidiary from the bank.[29] Although branches of U.S. banks abroad are prohibited from underwriting or dealing in nongovernmental securities, they are permitted to engage in some activities that are not permitted domestically, such as issuing guarantees.

The difference between foreign and domestic powers of U.S. banks, which results from defining the powers of U.S. banking organizations operating abroad partly on the basis of activities that are permissible in the host country, enables U.S. banks to take advantage of national treatment offered by foreign countries to the extent determined

29. In January 1989, the Board determined that underwriting and dealing in both debt and equity securities would be permissible activities for Section 20 subsidiaries if conducted subject to proper controls and procedures (see note 25 above). The Board authorized debt securities activities to begin in 1989, but postponed authorization of equity securities activities, pending reviews of policies and procedures of individual companies, which, as of this writing (July 1990), have not yet been completed. In July 1990, the Board issued a proposal to relax certain of the firewalls (see note 25 above).

to be consistent with U.S. supervisory standards. This approach is consistent with the U.S. goal of obtaining national treatment for its banks abroad; without different rules for foreign and domestic operations of U.S. banking organizations, U.S. banks would not be able to compete on an equal basis in the host country. This difference is a necessary result of the internationalization of banking, divergent regulatory structures in the United States and abroad, and a governing principle that treats each country in the world as a separate playing field with national treatment accorded to foreign banks within each single host-country market.

In enacting the IBA, Congress also faced the problem of different regulatory structures in the United States and abroad. Defining *de facto* national treatment for foreign banks operating in the United States required a balancing of two potentially conflicting goals: (1) avoiding the extraterritorial application of U.S. law, that is, the application of host-country rules to home-country activities; and (2) not giving foreign banks a competitive advantage over their domestic counterparts in the conduct of nonbanking activities in the United States. Congress made different judgments as to the appropriate balancing of these factors depending upon the extent of the foreign bank's U.S. nonbanking operations, the degree of control the foreign bank exercised over foreign affiliates conducting nonbanking operations in the United States, and whether the U.S. operations involved commercial/industrial activities or securities and other nonbanking financial activities.

The situation most easily addressed arose when a foreign bank became subject to the BHCA because of its U.S. banking operations but neither the bank nor its foreign affiliates conducted nonbanking operations in the United States. Under a strict policy of national treatment, such a foreign banking organization, like domestic institutions, would need Board approval for most activities conducted abroad even if the foreign activities did not extend into the United States. Clearly, an adjustment was needed to limit the extraterritorial aspect of a literal policy of national treatment. Accordingly, the BHCA requirements for notice or approval are not applied to the non-U.S. activities of foreign banking organizations with U.S. banking offices.

The most difficult situation to address arose when a foreign bank with U.S. banking operations also engaged in activities in the United States that would not be permissible for domestic bank holding companies. If a foreign bank or its affiliate had a greater than five percent ownership interest in a U.S. company engaging in such activities, *de jure* national treatment would require that the U.S. nonbanking operations be divested, that such activities be conformed to those on the Regulation Y list of domestically permissible activities closely related to banking, or that the foreign bank refrain from operating banking offices in the United States. If this result were to be avoided, host-country (U.S.) rules would need to be modified significantly to take account of home-country rules. As discussed below, because of different levels of concern about the competitive impact on domestic markets, different solutions were adopted for commercial/industrial activities, and for securities and other nonbanking financial activities.

Prior to the IBA, the nonbanking provisions of the BHCA applied only to foreign banks with subsidiary commercial banks in the United States. A "foreign bank holding company" exemption was provided by the

Federal Reserve Board's regulations under the BHCA.[30] In the absence of this exemption a foreign bank with a subsidiary commercial bank in the United States (which was by law a bank holding company) would, like a domestic bank holding company, have been subject to Board notice or application requirements for investments and activities abroad. Although the criterion for eligibility for the exemption was quite liberal, the exemption for U.S. activities of controlled foreign affiliates (defined as an ownership interest of at least 25 percent) was quite limited.[31] Specifically, a controlled foreign affiliate could engage only in either "incidental" activities in the United States, that is, those activities permissible in the United States for an Edge corporation, or those which would be permissible under Regulation Y.[32]

Foreign banks wishing to conduct a banking business in the United States were able to avoid these limitations by operating in the United States through branches or agencies rather than subsidiaries. As a result, foreign banks were able to engage in both banking and nonbanking activities in the United States. Moreover, these nonbanking activities included both commercial/industrial activities and securities and other financial activities not permissible domestically for U.S.

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30. The exemption was granted under the authority of Sections 2(h)(2) and 4(c)(9) of the BHCA.

31. The criterion for eligibility for the exemption was that over half of a foreign bank's consolidated assets and revenues must be derived from outside the United States.

32. The U.S. activities of a *noncontrolled* foreign affiliate were not restricted, except that the affiliate was permitted to engage in the securities business in the United States only to the extent permitted to U.S. bank holding companies.

banks. This created a situation of disparity in treatment between foreign and domestic banks that was addressed in the IBA.

Commercial/industrial activities. The approach adopted by Congress involved not only bringing foreign banks whose only U.S. presence was an agency or a branch within the coverage of the nonbanking prohibitions of the BHCA but also introducing a new exemption for the U.S. activities of controlled foreign nonbanking affiliates.[33] The exemption is available under the Board's regulations for affiliates of "qualified foreign banking organizations" (QFBOs). The benefits of the QFBO exemption for U.S. activities of such an affiliate are considerably greater than those provided by the previous exemption, but the test for eligibility for the exemption is more stringent.[34] As under the former exemption, a foreign bank meeting the QFBO test may engage in foreign activities without the necessity of application or notice to the Board that would be required for a domestic bank holding company.

For U.S. activities, the QFBO exemption permits a controlled nonbanking affiliate of a foreign bank to engage in the same commercial nonbanking activities in the United States that it conducts abroad, provided more than half of the affiliate's assets and revenues are outside the United States. The test is designed to ensure that the U.S.

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33. This exemption is contained in Section 2(h)(2) of the BHCA, as amended by the IBA, and is implemented by Section 211.23(f)(5)(i)-(iii) of Regulation K. For *noncontrolled* foreign nonbanking affiliates, if the foreign banking organization meets the QFBO test, the pre-IBA exemption exemption remains applicable (see note 32 above) as long as more than half of the nonbanking affiliate's consolidated assets and revenues are outside the United States. Regulation K, § 211.23(f)(5)(i)-(ii).

34. In general, to qualify for this exemption, the bank's foreign banking activities must be greater than its consolidated nonbanking activities *and* more than half of its banking business must be located outside the United States. Regulation K, § 211.23(b).

commercial/industrial operations are a legitimate part of the foreign banking organization's customary multinational business, not a structure whose primary purpose might be to evade U.S. rules and thereby gain an unfair competitive advantage over domestic banks. As a result of this exemption, a German bank with a controlling interest in a German automobile company could conduct banking operations in the United States through agencies, branches or subsidiary commercial banks, and its affiliated automobile company could manufacture automobiles in the United States. Even if the German bank had a subsidiary bank in the United States, the German automobile company could invest in, for example, an Italian automobile company that engaged in the same line of business (i.e., the automobile business) in the United States without the prior notice or approval that would have been required in the absence of the QFBO exemption.

The solution adopted by Congress for U.S. commercial/industrial activities of foreign affiliates of foreign banks involved a modification of host-country (i.e., U.S.) rules to reflect elements of foreign banking organizations' home-country rules. This limited use of treatment comparable to that of the home country underscores the complexities of applying a policy of national treatment in a world of internationalization of banking and divergent regulatory structures.

Securities and other financial activities. Congress adopted a different solution for foreign banks seeking to conduct nonbanking financial activities in the United States. The primary reason was that, in comparison with commercial/industrial activities, U.S. securities and other nonbanking financial activities of foreign banking organizations caused a much greater concern about competitive equality between domestic and foreign banks within the U.S. market. As a result, the principle of national treatment was applied to new activities in this area without adjustments to take into account home-country structure.

Like existing commercial/industrial activities, securities activities and other nonbanking financial activities conducted in the United States prior to enactment of the IBA were grandfathered. The grandfathering of the securities activities, however, was controversial. Most of the grandfathered commercial/industrial activities would have been permissible under the exemption provided by the IBA, even without the grandfathering provision. By contrast, the IBA contained no special exemption for new securities activities or other nonbanking financial activities of foreign banks in the United States. As a result, even if a foreign bank meets the criteria for a QFBO, the rules with regard to U.S. securities activities are the same as those applicable to a U.S. bank holding company. Specifically, a foreign bank with U.S. banking offices or its foreign affiliate may not own more than five percent of the shares of a U.S. full-service securities firm.[35]

Some U.S. banks believe that the grandfathered U.S. securities subsidiaries of foreign banking organizations (which would not meet the limitations imposed on Section 20 subsidiaries) give such banks an unfair advantage over U.S. banks. Of course, U.S. banks would prefer that this

35. Regulation K, § 211.23(f)(5)(ii). This limitation applies regardless of whether the foreign bank controls its foreign affiliate because the relevant pre-IBA exemption for *noncontrolled* foreign affiliates does not apply to U.S. securities activities (see note 32 above). By contrast, for other nonbanking financial activities (such as insurance), if the foreign banking organization meets the QFBO test, its *noncontrolled* foreign affiliate is eligible for the same exemption that applies to commercial/industrial activities (see notes 32 and 33 above).

competitive disadvantage be remedied by obtaining similar powers for themselves, not by restricting the activities of foreign banks.

In 1989, as mentioned above, the Federal Reserve Board authorized so-called Section 20 subsidiaries of bank holding companies to engage to a limited extent in underwriting and dealing in debt and equity securities.[36] In so doing, the Board sought to achieve a strict separation between the Section 20 subsidiary and its affiliated banks. As a result, the Section 20 subsidiaries are subject to a framework of structural and operating limitations (so-called firewalls) that were established to avoid the potential for conflicts of interest, unsound banking practices, unfair competition, loss of public confidence in affiliate banks, and other adverse effects from the conduct of the ineligible securities underwriting and dealing activities.

In January 1990, the Board faced the issue of how to apply the U.S. policy of national treatment in approving applications by foreign banks with U.S. banking operations to establish Section 20 subsidiaries in the United States.[37] Foreign banks requested a number of modifications of the firewalls to take into account home-country rules

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36. Under the BHCA, if the Federal Reserve Board determines that an activity is closely related to banking and a proper incident thereto, the Board may approve such activities by individual order or by adding them to the list in Regulation Y. However, the Glass-Steagall Act severely limits the extent to which the Board may approve the securities activities of a company affiliated with a member bank (see notes 22 and 23 above). As a result, the Board's approval is subject to the requirement that the gross revenues from ineligible securities activities may not exceed 10 percent of the Section 20 subsidiary's total gross revenues on average over any two-year period. A subsidiary whose securities activities conform to this limitation is not "engaged principally" in ineligible securities activities in violation of the Glass-Steagall Act.

37. *Canadian Imperial Bank of Commerce, The Royal Bank of Canada, Barclays PLC*, 76 *Federal Reserve Bulletin* 158 (March 1990).

that do not require the separation of commercial and investment banking. The issue of competitive equality in the United States market was further complicated by the fact that the U.S. bank holding company structure does not exist abroad. As a result, while foreign banks are banks, they have also, as discussed above, been treated as bank holding companies under U.S. law.

In order to avoid imposing the U.S. holding company structure on foreign banks, the Board determined to treat foreign banks as holding companies for purposes of the Section 20 rules even though the result would be that a foreign bank (as a holding company) could fund its Section 20 subsidiary while a U.S. bank could not. With a few modifications, the other firewalls imposed on Section 20 subsidiaries of U.S. bank holding companies were also imposed on Section 20 subsidiaries of foreign banks but not on the non-U.S. operations of the foreign bank. A further issue involved the treatment of U.S. agencies and branches of a foreign bank. The solution was, with limited exceptions, to treat these offices as U.S. banking affiliates subject to the firewalls, not as part of the foreign parent bank in its capacity as a bank holding company.

With regard to insurance activities, as already noted, the BHCA, as amended by the Garn-St Germain Act, specifically prohibits U.S. bank holding companies (including their nonbanking subsidiaries) from engaging in most insurance activities in the United States.[38] Accordingly, under

38. However, even within the United States, there is lack of agreement between the federal and state governments regarding permissible activities for banks. For example, some states permit banks to conduct insurance activities directly. In May 1990 Delaware enacted a law that empowers state-chartered banks to engage in a full range of insurance underwriting and agency activities in a segregated department of the bank or in a subsidiary of the bank. Because of its regulatory and

(Footnote continues on next page)

the BHCA non-U.S. banks and insurance companies that operate offices in the United States and subsequently establish controlling relationships with each other outside the United States would be required to divest either existing U.S. banking or insurance operations. Although Congress has granted the Federal Reserve Board the authority to exempt non-U.S. banks from the nonbanking restrictions of the BHCA, the Board has generally used this authority to approve such activities only on a temporary basis, that is, until the activities can be conformed to those permissible under Regulation Y for U.S. bank holding companies.[39] The Board has not yet faced the situation of whether or how it might use this authority with regard to U.S. insurance activities that Congress has specifically prohibited for U.S. bank holding companies.

C. <u>Interstate Activities</u>

The issues involved in defining and applying a policy of national treatment to the U.S. nonbanking and interstate activities of foreign banks are rather different. Because interstate activities involve geographic expansion only within the United States, a policy of national treatment based on achieving a level playing field within a single host-country market can, at least in theory, be more easily

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(Footnote continued from previous page)
supervisory authority over insured banks, the FDIC could determine that the activity poses a risk to the insurance fund and therefore prohibit it. Various insurance trade associations have filed a petition asking the Federal Reserve Board to determine that conduct of the insurance activities in the bank in reality represents a violation of the nonbanking provisions of the BHCA.

39. Under Section 4(c)(9) of the BHCA, the Federal Reserve Board has discretionary authority to approve U.S. activities of foreign banks that would not be permissible domestically for U.S. bank holding companies.

defined. The problem of conflicting home- and host-country rules faced with regard to nonbanking activities is absent. However, a major complexity in defining national treatment for interstate activities of foreign banks is introduced by the U.S. federal structure and the dual banking system.

Prior to the IBA, a number of states provided "national" (i.e., state) treatment to foreign banks by permitting the establishment of agencies and branches of foreign banks. Moreover, there were no federal restrictions on the establishment of agencies and branches by foreign banks. A foreign bank was therefore able to establish agencies and branches in more than one state, even if it also had a subsidiary commercial bank in the United States. At the same time, states either could not or did not provide each other with "national" treatment. In contrast to the principle of nondiscrimination among nationalities adopted at the federal level, some states treated foreign (i.e., non-U.S.) out-of-state banks more favorably than domestic out-of-state banks.[40] As a result, from the perspective of the United States as a whole, the non-U.S. banks were receiving better than national treatment.[41]

The resulting ability of foreign banks to establish domestic deposit-taking offices in more than one state was perceived by the U.S.

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40. Some state statutes refer to any out-of-state bank, including a bank from another U.S. state, as a "foreign" bank.

41. State laws with respect to establishment of state-chartered subsidiaries of foreign banks differ. However, even if a state did not allow a foreign bank to establish a state-chartered bank, a foreign bank could, subject to the interstate restrictions of the IBA and BHCA, establish a national bank in that state. A national bank, as noted above, is a bank that is chartered by federal rather than state authorities.

Congress as a major competitive advantage for foreign banks. At the time of the IBA, domestic banks were unable to establish interstate branch networks in the United States, and this is still the case. Individual states are basically powerless to provide "national" treatment with respect to establishment of *branches* by out-of-state domestic banks because of the McFadden Act, a federal statute that effectively prohibits interstate branching regardless of state law. As a result, even if state law permitted establishment of branches by out-of-state banks, federal law would preclude national banks and state-chartered member banks from taking advantage of such a provision.[42]

In addition, at the time the IBA was under consideration, bank holding companies (both domestic and foreign) were generally unable to acquire subsidiary commercial banks outside their principal state of operations. Only in the last decade have a number of states chosen to provide "national" treatment to out-of-state bank holding companies with regard to acquisition of *subsidiaries*. In contrast to the McFadden Act, which is an outright prohibition, the federal law restricting the interstate acquisition of subsidiaries may be overcome by state laws.[43] Bank holding companies are prevented by the BHCA from acquiring subsidiary commercial banks outside their principal state of operations

42. The McFadden Act authorized national banks to branch only within their state of establishment. McFadden Act (1927), 12 U.S.C. § 36 (1988). Section 9 of the Federal Reserve Act applies the same rules to state-chartered member banks. See note 48 below regarding state-chartered nonmember banks. See note 49 below regarding proposed legislation that would repeal the interstate branching restrictions of the McFadden Act.

43. Section 3(d) of the BHCA, known as the Douglas Amendment. See note 49 below regarding proposed legislation that would repeal the Douglas Amendment.

unless host-state law explicitly permits them to do so. When the IBA was enacted (with the exception of a few institutions grandfathered by the BHCA), bank holding companies did not have banking subsidiaries in more than one state. However, as discussed below, changes in state laws beginning in the 1980s are significantly altering the geographic structure of banking in the United States.

In enacting the interstate provisions of the IBA, Congress had essentially three choices for rules governing new activities of foreign banks: (1) preserving the existing situation (i.e., not applying host-country rules at the federal level), which as explained above was considered unacceptable on the basis of competitive equality; (2) prohibiting establishment of any new interstate agencies or branches; or (3) prohibiting only those interstate activities that were the perceived source of the competitive inequality, namely, the ability to accept domestic deposits in more than one state.

The IBA used the last approach. Congress tried to achieve national treatment with respect to interstate activities of domestic and foreign banks by limiting the interstate expansion of domestic deposit-taking capabilities of foreign banks. To this end, a foreign bank with a U.S. branch or subsidiary was required to select one of the states in which it operated (including any state in which it operated only an agency) as its "home state."[44] A foreign bank may establish new agencies or branches outside its home state, but the deposit-taking powers of such branches are limited to those permissible for an Edge corporation (i.e., deposits related to international activities). No restrictions are

44. Under Regulation K, a foreign bank may change its home state one time only. Regulation K, § 211.22(c).

placed on the asset side of the branch's balance sheet. The IBA grandfathered existing deposit-taking offices of a foreign bank outside its home state.

The election of a home state by a foreign bank also affects its ability to do a banking business in the United States through a subsidiary commercial bank. A foreign bank is precluded by the IBA from acquiring a subsidiary bank outside its home state if such an acquisition would be prohibited by the BHCA for a domestic bank holding company based in that state.[45] For example, a foreign bank with an IBA home state of New York may not acquire a bank in Massachusetts unless Massachusetts law allows bank holding companies based in New York to acquire banks in Massachusetts. A foreign bank may, however, acquire a bank within its home state.[46] Prior to the IBA, only foreign banks that were bank holding companies by virtue of operating subsidiary commercial banks in the United States were covered by the BHCA limitations on interstate activities.

Some have asserted that the issue of restrictions on interstate activities of foreign banks will become moot because the United States will effectively have nationwide banking by 1991. As always under the

45. Section 3(d) of the BHCA, the so-called Douglas Amendment, effectively prohibits a bank holding company from acquiring a bank (including establishment of a *de novo* bank) outside its principal state of operations unless the other state's law expressly permits acquisition of banks in that state by out-of-state bank holding companies. The principal state of operations is the state in which total deposits of the holding company's banking subsidiaries are largest.

46. However, if a foreign bank with a U.S. subsidiary commercial bank had chosen a state other than its BHCA principal state of operations as its IBA home state, acquisition of a bank in the home state would be prohibited. In practice, foreign banks with U.S. subsidiary commercial banks have generally selected the BHCA principal state of operations as the IBA home state.

U.S. dual banking system, the situation is more complex. Beginning in the early 1980s, a number of states in the United States began to adopt regional reciprocity laws, often referred to as regional compacts. Under such laws, states permit, on a reciprocal basis, interstate acquisitions of banks by bank holding companies that operate chiefly within the region. This is, in effect, a policy of reciprocal "national" treatment among the states within a region. Some of these state laws have so-called nationwide triggers that either are already in effect or will go into effect on a certain date, that is, they will offer reciprocal "national" treatment to bank holding companies based in any of the 50 states. Moreover, some states do not have reciprocity provisions or will eliminate such provisions on a specified date and thereby provide "national" treatment to out-of-state bank holding companies.

The upshot of this process is that, under existing state laws, by January 1, 1991 (when California's nationwide trigger is scheduled to go into effect), 46 states plus the District of Columbia will permit out-of-state bank holding companies from some or all other states to acquire banks within the state.[47] Of these, 14 will have an interstate policy of more or less unrestricted "national" treatment. Another 17 states, including New York, California, and Illinois, will have an interstate policy of reciprocal "national" treatment. An additional 16

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47. As of that date, the four states without any type of interstate banking statute in effect will be Hawaii, Kansas, Montana, and North Dakota. See "Interstate Banking Legislation by State," Financial Structure Section, Board of Governors of the Federal Reserve System, July 1, 1990. See also "Trigger Dates: A Look at Laws Granting Interstate Powers to Banks," *American Banker*, vol. 155, no. 26, p. 15 (February 7, 1990). See note 49 below regarding federal legislative proposals that would permit nationwide banking, including interstate branching.

states will have a policy of reciprocal "national" treatment limited to states within their region. It is important to realize that, in general, the state interstate banking laws apply only to subsidiaries, not to branches.[48] In this context, the term "nationwide banking" has been used to refer to nationwide expansion through acquisition of subsidiaries and has not included nationwide branching.[49]

This change in the geographic structure of U.S. banking presents two different questions for the policy of national treatment for foreign banks with U.S. offices. The first issue concerns foreign banks operating subsidiary commercial banks in the United States. Under most circumstances, it appears that a foreign bank would be treated as if it were a domestic bank holding company having its principal state of operations in the state that the foreign bank has chosen as its home state. However, in some states, interstate banking laws have either expressly or implicitly excluded non-U.S. banks or their U.S. bank

48. The interstate laws in some states do provide for the establishment of branches by out-of-state banks. However, such provisions currently have little practical effect. Because of the prohibitions on interstate branching in federal law, only state-chartered banks that are not members of the Federal Reserve System may take advantage of interstate branching provisions in state law. For example, Bank of America Arizona, a nonmember bank chartered by Arizona, has established a branch licensed by Utah. (Only one bank currently has interstate branches grandfathered under the McFadden Act.)

49. In July 1990, Senator Dodd and Representative Schumer introduced legislation to permit nationwide banking, including interstate branching. S. 2922 and H. 5384, respectively, introduced July 26, 1990, 101st Cong. 2d Sess. (1990). These bills would have the effect of permitting interstate acquisitions of banks on a nationwide basis by the beginning of 1992 and establishment of *de novo* banks by the beginning of 1993; regional compacts would thereby be eliminated. The bills would also permit interstate branching by the beginning of 1994, subject to an "opt-out" provision for individual states. Banks from a state that chose to opt out of interstate branching would not be permitted to branch outside their own state.

holding company subsidiaries from taking advantage of regional acquisition opportunities. To date, Congress has not addressed this issue of possible discrimination against non-U.S. banks.

The second, more theoretical issue involves the relevance of the change in the geographic structure of U.S. banking to the restrictions imposed on establishment of new interstate branches by foreign banks. One question is whether national treatment in this context should be on the basis of function, i.e, accepting domestic deposits, or structure, i.e., branches versus subsidiaries. It could be argued that the rationale for the IBA restriction was based generally on the inability of U.S. banking organizations to establish domestic-deposit taking offices (branches *or* banks) in more than one state rather than on the inability of U.S. banks to establish interstate *branches*. Even if branching had been the crucial factor, there is still the question of how national treatment should be defined for direct branches of foreign banks. As discussed above, this involves the question of whether, for purposes of geographic restrictions, direct U.S. branches of foreign banks should be regarded as the equivalent of a domestic bank or of a domestic branch of that bank.

III. CONCLUSION

National treatment is a generally accepted principle for a country's treatment of foreign banks. Despite its federal structure, dual banking system, and a regulatory framework significantly different from that of other countries, the United States provides an example of the way *de facto* national treatment can be achieved within the jurisdiction of a host country. For nonbanking activities, however, the issues are complex and involve a balancing of often conflicting goals: ensuring equality of competitive opportunity between domestic and foreign banks in the host country and avoiding the imposition of host-country rules beyond its own borders. As the international integration of banking increases and as the problems of defining a market by national boundaries intensify, this balancing will become even more difficult.

National treatment is based on the regulatory perspective of the host country and its sovereignty over its own territory. In a world in which banks operate internationally by providing services across borders and through branches and subsidiaries located in foreign countries, the strains in applying national treatment are becoming more intense. From a global perspective, the meaning of equality of competitive opportunity is not clear when multinational banks compete throughout the world but with different powers in different jurisdictions--when, for example, U.S. banks compete in Europe with powers broader than those permitted at home, and European banks compete in the United States without certain powers permitted in their home countries.

The continued viability of national treatment as a generally accepted principle for host-country treatment of foreign banking institutions may depend on the extent to which national regulatory structures converge. But the search for viable principles beyond national treatment can be viewed as a search for a means of achieving such convergence. The principles of effective market access broadly defined and treatment comparable to that of the home country raise the question of whether convergence exists or could occur. The use of mutual recognition within the European Community must be understood in the context of a political movement to liberalize the economic relationships among a group of countries. The Community is using mutual recognition in an environment of substantial coordination and common obligations established through a supranational structure. As a result, national regulatory structures can be expected to converge.

National treatment, by contrast, does not imply explicit or implicit international harmonization. However, as has been noted above, a process of relatively informal cooperation and coordination among bank supervisory authorities has yielded an accord on international capital standards. Even in a world of host-country policies of national treatment, one can envisage a process whereby such cooperation, together with market pressures in response to the anomalies created by substantial differences in national regulatory structures, could lead to further regulatory convergence. However, without deliberate coordination, the process of convergence, particularly with regard to bank powers, is likely to be substantially slower internationally than the process that is now under way within the European Community. Nevertheless, the use of national treatment for international trade in financial services remains an essential step toward competitive and efficient markets, and it lays a strong foundation for further efforts to achieve international harmonization of regulatory and supervisory structures.

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