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SOME POLICY ASPECTS OF FOREIGN OPERATIONS OF INTERNATIONAL BANKS

by

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Some Policy Aspects of Foreign Operations of International Banks[1]

Foreign operations of major international banks -- U.S. and foreign -- expanded very substantially during the decade of the 1960's, and bankers appear to be planning for a further considerable expansion in the years ahead. This growth in foreign financing has taken the form both of an increase in the foreign claims of head offices, and of sharply increased financing by branches and subsidiaries located outside the country of domicile of the head office. The surge in Euro-dollar market activity has been the most striking evidence of the growth in international financing, but the general phenomenon is a broader one.

The expansion in international financing has been not only in size of operations but also in scope of operations. Banks have been among the principal innovators in international finance in the past decade, and their innovations have been both in the field of traditional commercial banking (e.g. development of the term loan) and in investment banking activities outside the United States (e.g. development of the variable interest bond for offshore security issues). And because of the relatively great range of activities permitted to commercial banks outside the United States -- particularly regarding use of external sources of funds for lending to non-residents -- it appears likely that banks will continue to be major innovators. The nature of the expansion has been shaped by the regulatory framework, and one would have

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1/ A paper presented at the International Finance Session of the annual meeting of the Society of Government Economists, New Orleans, December 27, 1971.

to guess that future developments and forms of innovations will also be importantly influenced by the nature of future revisions in the international financial system.

This paper identifies various major policy objectives that monetary authorities may have in establishing regulations on international banking activities, and examines the various types of measures that have been used to achieve particular objectives and their impact on other policy objectives.

A general indication of the growth and quantitative importance of international lending may be useful in putting the policy issues in perspective. Between 1960 and 1965, the foreign assets of U.S. banks' head offices more than doubled, a considerably faster rate of growth than occurred in total loans. But beginning in 1965 the Voluntary Foreign Credit Restraint program halted growth in foreign assets of U.S. offices of banks, and thereafter the expansion in international lending of U.S. banks occurred through foreign branches of banks that had -- or developed -- the capability of operating foreign branches. Beginning in 1965, the international lending of U.S. banks as a group (counting both foreign credits of U.S. offices and dollar loans of foreign branches to nonbank borrowers)1/ rose at

1/ Although an important distinction exists in present U.S. regulations between foreign claims of U.S. banks and those of the banks' foreign branches, this distinction may not be a permanent feature of U.S. international banking -- it is not an important one for many foreign banks.

about the same pace as total loans; and in both 1965 and 1971, the outstanding amount of international lending, defined in this manner, was equal to about 7 per cent of total domestic loans of all Federal Reserve member banks and equal to about 12 per cent of total domestic loans of reserve city member banks. (If one included all foreign loans of foreign branches to nonbank borrowers, rather than just those in dollars, the percentages would be slightly higher, and would have increased between 1965 and 1971.)

While international lending has been a relatively stable proportion of the total domestic loan portfolios of all member banks, it has become a rapidly growing proportion of the total business of those U.S. banks most heavily involved in the international area. For a number of large international banks international activities account for one-fourth to one-third of their gross revenues, and in at least some cases an even higher proportion of net earnings.

The international financing activities of U.S. banks as a group have grown faster than their domestic lending if one includes in international financing the <u>total</u> dollar assets of their foreign branches -- that is, includes the inter-bank placements of funds that are the hallmark of the Euro-dollar market. For U.S. banks, total international financing has grown about twice as fast as total member bank loans, or total assets, since 1965, and by mid-1971 the total foreign assets of U.S. banks (including dollar assets of foreign branches) were equal to 9 per cent of total domestic assets of all member banks.

In Europe, the growth in international financing has outpaced that in domestic by a wider margin, and accounts for a relatively greater share of total assets. In some countries (e.g. Belgium and The Netherlands) foreign assets of the commercial banks (not including assets of foreign branches) now represent one-third or more of their total assets, while in others (e.g. Germany) the ratio is more in line with that in the United States.

Thus, the size already attained by international operations of banks in many countries, and the growing importance of such operations in all major financial centers, are sufficient to ensure a substantial central bank interest in the nature and development of these operations.

Policy objectives regarding international banking operations

Broadly speaking, central banks' policies regarding international banking operations aim at achieving growth and effective stabilization, both internal and external, with efficiency in resource allocation (including the resources allocated to administration). In seeking these broad objectives, in particular internal and external stability (the policy issue most often cited in the literature), central banks have adopted specific policy objectives in three areas: the country's monetary reserve position; domestic monetary policy; and supervision of the banking structure. Although the precise significance of foreign banking operations for policy depends upon the structure of the international financial system, and of the domestic monetary system and the objectives for monetary policy, many of the specific policy objectives are broadly similar from one country to another.

1) Monetary reserves position. International banking operations affect monetary reserve positions to the extent that they involve net international capital flows. Policy actions by monetary authorities affecting international banking operations have leaned more heavily toward protecting reserves against depletion than toward preventing growth in reserves.1/

But some European surplus countries have also acted to prevent increases in reserves, particularly in times when such increases might provoke exchange market speculation on currency revaluations. Moreover, U.S. policy measures to curtail Euro-dollar borrowings by U.S. banks had as one objective lessening the reserve losses of foreign countries.

2) Domestic monetary policy objectives. The precise domestic policy objectives depend on the particular policy targets and the instruments used by the authorities. European central banks have found capital inflows troublesome because of the effect on bank reserves and bank liquidity. On the other hand, capital inflows to the United States have not generally affected the reserve base of commercial banks in a significant manner. Because of the U.S. role as a reserve currency country, the principal consequence of an inflow of private short-term funds is a reduction in U.S. liabilities to foreign monetary authorities (rather than an increase in U.S. monetary reserve assets). As the

1/ In a period when the primary U.S. policy focus was on the liquidity measure of the U.S. balance of payments, the rationale generally provided was that this measure provided the best index of flows associated with changes in potential pressures on U.S. reserve assets.

foreign investor purchases dollars from its central bank, the foreign central bank disposes of a U.S. dollar asset; the net effect of an inflow of foreign private short-term investment is the substitution of a deposit or money market investment held in the United States by a foreign private investor for a similar instrument held by a foreign monetary authority -- with no effect on the reserve base.

The inflows of foreign private funds through the large U.S. banks in the 1968-69 period of monetary restraint did tend to affect the distribution of funds within the U.S. banking system, and some policy-making officials expressed concern about this development. At the time when the Board's Regulation Q ceiling on interest payable on time deposits was putting substantial pressure on the liquidity positions of banks in general, those particular large banks with access to Euro-dollars borrowed from foreign banks were able to help offset some liquidity pressures, since funds obtained in this manner were not subject to Regulation Q ceilings. From a policy standpoint, any such differential access to funds could involve not only the issue of equity among banks, but also one of the impact of monetary restraint -- if the banks with access to international resources are also those engaged in particular types of lending that the monetary authorities desire to restrain. But this distributional aspect of capital inflows has been identified as a potential policy problem only in the United States.

3) <u>Supervisory and regulatory objectives</u>. The literature has little in the way of economic analysis on this latter aspect, except for Hyman Minsky's work. Minsky argues that central bank policy domestically should be directed toward encouraging the financing of transactions through the banking system, rather than outside it.1/ The central bank will have greater knowledge of developments that may signal an impending liquidity crisis if financing is conducted through the banking system; through the examination process, as well as through regular reports filed by banks, the central bank may become aware of changes in the financial structure that might lead to insolvency of some financial units before the market generally is aware of these developments. Moreover, if most of the financial units involved are banks, able to draw on central bank credit in emergencies, the central bank in its capacity as lender of last resort will be better able to

1/ See: Minsky, Hyman P., "Financial Instability Revisited: The Economics of Diaster," paper prepared for the Steering Committee for the Fundamental Reappraisal of the Discount Mechanism, page 47: "In particular during a euphoric expansion the central bank should resist the temptation to introduce constraining direct controls on that part of the financial system most completely under its control -- the commercial banks. The central bank should recognize that a euphoric expansion will be a period of innovation and experimentation by both bank and nonbank financial institutions. From the perspective of picking up the pieces, restoring confidence, and sustaining the economy, the portion of the financial system that the central bank most clearly protects should be as large as possible. Instead of constraining commercial banks by direct controls, the central bank should aim at sustaining the relative importance of commercial banks even during a period of euphoric expansion; in particular the commercial banks should not be unduly constrained from engaging in rate competition for resources."

prevent a cascading or cumulative liquidity problem from arising from the insolvency of a number of financial units. In meeting this sort of problem, the principal policy objective is to ensure that the chain has a large number of strong links, so that the liquidity difficulties of one unit are not transmitted widely through the financial system.

Whether or not one accepts Minsky's argument as it applies to the domestic banking system, it is worthwhile considering the applicability of a reformulation of the general proposition to international financing. The policy objective, as reformulated, might well be influencing the location of financing within the banking system -- that is, for example, encouraging foreign credits to be made from head offices rather than from foreign branches or subsidiaries. Both from the standpoint of ease of obtaining current information and from that of being able to provide emergency credit facilities under adequate supervision, the central bank might prefer to have a significant amount of international lending take place at the head office, rather than from offices abroad. But an important factor in the decision would be the relative degree of supervision of credit quality that the commercial bank could provide at different locations.

On the whole, there would be no reason to expect individual central banks to offer positive encouragement to the financing of international transactions generally by their banks, rather than through the market abroad; such a policy which might appear to be the international parallel to Minisky's domestic prescription could not be justified by reference to either a central bank's domestic or international responsibilities.

Impacts of Various Techniques

Many of the regulations by countries on the international activities of their banks have been introduced, or modified, in order to promote achievement of various short-term policy objectives, but they have also affected the longer-term structure and organization of international banking operations.

Regulations have been applied to banks' gross foreign liabilities in order to slow inflows of funds from abroad -- both for domestic and international policy reasons. Banks in France, Germany and Switzerland have been prohibited from paying interest on bank deposits of foreigners, thereby reducing the incentive for foreigners to place funds on deposit with banks, but not precluding such placements. Germany also imposed special reserve requirements on non-resident deposits (additional to those applied to all deposits) to reduce banks' readiness to accept such deposits. (At times, this requirement has operated as a restraint on the banks' net foreign position, as noted below.) The Federal Reserve also imposed reserve requirements on Euro-dollar borrowings by member banks to reduce their attractiveness at a time when banks were resorting to heavy bidding for Euro-dollars as a source of liquidity because of the restraint that Regulation Q was placing on their ability to attract (or retain) time deposits.

Regulations applied specifically to banks' gross foreign assets have been mainly a U.S. phenomenon. Other countries have restrained their banks' ability to lend abroad by regulating net foreign lending rather than gross foreign lending.

The difference is traceable to different views regarding appropriate international policy objectives. Most foreign countries have sought to protect their monetary reserves by providing that foreign credits should be made on the basis of foreign funds -- that is, by effectively separating domestic and foreign banking activities except for certain specified types of transactions (e.g. export financing).

On the other hand, the United States as a reserve currency country has over the years had objectives regarding both reserves and the growth of short-term liabilities to foreigners, since growth in these short-term liabilities generally involved a worsening of the liquidity measure of the U.S. payments position. This measure of the U.S. position, particularly in the early days of the VFCR, was given greater prominence by policy makers than has been appropriate more recently.

But given this objective, it is not sufficient to provide that a bank establish a specific net position vis a vis foreigners (however one might define that position), since the process of making foreign credits involves both an additional foreign asset (loan) and an additional foreign liability (deposit). Thus, the United States concentrated on restraining <u>gross</u> foreign assets, in order to affect <u>gross</u> foreign liabilities.

The two techniques employed by the United States to limit expansion of gross foreign assets have been (1) the Voluntary Credit Restraint guidelines, which set ceilings for foreign credits of U.S. banks, and (2) the IET, which applied a tax at first to nonbank credits with maturities of more than one year, but subsequently to banks' non-export credits as well.

Foreign countries have used rules or guidelines to affect the <u>net</u> foreign positions of their banks, and in a few instances -- notably Germany -- have employed reserve requirements.

Banks in the United Kingdom are governed by rules that effectively separate external lending from domestic lending, and provide that the former be done on the basis of external funds: banks may maintain a balanced net external position, or they may have a net liability position. In other countries, (e.g. Italy and The Netherlands) central banks have issued directives regarding the appropriate net foreign position for their banks, changing the target in the light of changes in the payments position of the country. In Germany, the reserve requirement on foreign deposits has been used as a technique for affecting the foreign position of the banks: banks have been able to avoid the requirement on foreign deposit liabilities to the extent that they acquire foreign assets.

Certain forms of regulations prevent international financing transactions from being conducted within the banking system (e.g. directives prohibiting such transactions or prohibitive taxes), while others apply some constraints (e.g. directives applied marginally, or taxes and reserve requirements that are set at less than prohibitive levels) without necessarily preventing the transactions affected.

In principle monetary authorities can seek to influence the degree of international financing through banks (1) by affecting the costs to banks (as through a tax or reserve requirement) thereby causing the banks to adjust the quantities or (2) directly affecting quantities, thereby establishing an additional implicit cost, which may vary among banks according to the alternatives available in particular cases. The former approach has a foundation in welfare economics -- which envisions the use of a tax or a subsidy to equate the marginal cost to the firm with the marginal social cost of a given activity -- but in practice the latter approach has proven markedly more popular.

In part, this state of affairs reflects the greater reliance of foreign central banks on instruments of quantitative control rather than on interest rates to conduct monetary policy generally. For the United States, it reflects in part the particular circumstances in which the VFCR was introduced.

But more generally, a preference for quantitative techniques -- rather than rate-related measures -- could also be based on a desire to avoid large shifts in quantities that might occur under a tax or reserve requirement if relative interest-rate relationships were changing more rapidly than it was feasible for the authorities to change the requirement or tax. Sizable shifts in foreign financing might complicate the tasks of monetary management as well as bank management, and such complications may well involve welfare costs. And especially if authorities take magnitudes rather than rates as policy targets, they might prefer to influence quantitites directly.

Among various methods for regulating quantities directly methods that apply to banks' net foreign positions give the banks substantially more leeway for adjustment than do methods applied to gross foreign assets and/or gross foreign liabilities separately. From a welfare standpoint, methods that affected net foreign positions are probably preferable. But a judgment between different techniques will probably be made primarily on the basis of their effectiveness for achievement of the policy objectives outlined earlier. For this purpose, we may compare the effect of restraining a given amount of foreign financing (i) by a technique that restrains gross foreign assets, or gross foreign liabilities, and (ii) by a technique that restrains the net foreign asset or liability positions.

a) The clearest difference concerns the locus of financing. Effective restraints applied to gross foreign assets (or liabilities) have the effect of requiring that the foreign financing (or investment) take place outside the banking system of the country applying the restraints. The financing may be shifted to banking systems in other countries (e.g. in the case of the VFCR, much foreign financing was shifted from U.S. head offices to foreign branches of the same banks) or completely outside any banking system (e.g. the development of a commercial paper market as a substitute for bank lending) although not necessarily outside the financial markets of the country applying the restraint.

By contrast, restraints applied to net foreign assets (or liabilities) may give banks considerable scope for retaining financing within the banking system, if they are able to meet the requirements by acquiring any of a wide range of types of foreign liabilities (or assets) in any of a wide range of maturities.

Thus, application of a restraint to banks' net foreign positions may well have advantages for internal bank supervision over foreign operations as well as for central bank supervision.

b) The effect of either technique on the international monetary reserves of a country will generally be the same so long as both have the same effect on net international capital flows involving that country. If restraints on gross positions are likely to lead to development of alternative channels of international financing within the country (with consequent effects on monetary reserves), the authorities will find it advantageous to apply restraints to net rather than gross foreign positions, and perhaps to reinforce this measure by facilitating banks' abilities to arbitrage among instruments and maturities in establishing the requisite net positions. But if alternative channels are unlikely to develop, the effect on reserves will be the same, whether the authorities control gross or net foreign positions.

c) The most obvious difference in the significance of the two types of techniques for domestic financial policy lies in the effect on total bank assets and liabilities. If the authorities control banks' net foreign positions, the banking system can be expected to have a greater volume of both foreign assets and foreign liabilities. In general, the amount of domestic resources devoted to foreign financing (or foreign resources devoted to domestic financing) would be the same under each technique, but under exceptional circumstances -- and here I mean near-crisis conditions -- banks may need to use domestic liquidity to support their international positions. The policy issue involved here has received some mention in public discussions of the stability of the Euro-dollar market: e.g. in the event that some banks' Euro-dollar loans proved uncollectable at maturity, and the Euro-dollar liquidity positions of some banks were threatened, to what extent would foreign central banks permit their banks to use domestic liquidity -- converting local currency assets into dollar assets -- in order to prevent a liquidity crisis?

I mention this case not to resurrect a spectre of hypothetical collapse of the Euro-dollar market -- from all indications that spectre has been successfully laid to rest -- but to emphasize that a full separation of domestic and international banking activities is never completely feasible. The impossibility of complete separation may be a factor in central bank evaluation of different techniques, and in the choice of the particular way in which techniques of control are applied.

Concluding comment. The foregoing should not be regarded as a brief for controls on international banking activities. What I tried to do is examine some of the inter-relationships between various types of instruments and various policy objectives. Whatever the policy conclusion regarding the advisability of special regulations on international banking operations, it is important to identify both the costs and the benefits of specific measures. As indicated, these may include not only effects on reserves, and on credit and deposit flows, but also on banking structure.

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