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Competitive Concerns of Foreign Financial Firms in Japan, the United Kingdom, and the United States

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The Honorable William Proxmire, Chairman,
The Honorable Jake Garn, Ranking Minority Member
Committee on Banking, Housing, and Urban Affairs
United States Senate

The Honorable Paul Sarbanes, Chairman
The Honorable John Heinz, Ranking Minority Member
Subcommittee on International Finance and
Monetary Policy
Committee on Banking, Housing, and Urban Affairs
United States Senate

At your request, we reviewed the regulatory treatment of U.S. banking and securities firms operating in Japan and the United Kingdom and the treatment of foreign financial firms in the United States to determine whether national treatment is being uniformly applied. This report contains the results of our work.

We believe that steady progress has been made in all three markets in reducing competitive barriers and that national treatment appears to be a reality in many areas of the international financial services industry. We found that financial firms expressed most concern about additional issues which transcend national treatment, such as the deregulation and globalization of financial markets.

Copies of this report are being sent to the Department of the Treasury, Federal Deposit Insurance Corporation, Federal Reserve, Office of the Comptroller of the Currency, Securities and Exchange Commission, and other interested parties.

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Executive Summary

Purpose

As financial firms continue to expand their international operations, two different approaches have been advanced regarding foreign access to financial markets. National treatment, i.e., equality of competitive opportunity, seeks to provide a fair and equitable competitive environment for both domestic and foreign firms within a nation's boundaries. Reciprocity, an alternative approach, would subject foreign firms to the same restrictions in the United States that U.S. firms face in their countries as well as limit U.S. firms' activities in foreign nations to those made available to the foreign nations' firms operating in the United States.

The United States has adopted the policy of national treatment for foreign financial firms operating within its borders. The Congress is concerned that national treatment also be provided U.S. financial firms in overseas markets to ensure access to these markets. Accordingly, the Senate Committee on Banking, Housing, and Urban Affairs and its Subcommittee on International Finance and Monetary Policy requested GAO to examine national treatment in three of the world's major financial markets, Japan, the United Kingdom, and the United States, to determine whether national treatment is being uniformly applied.

Because of heightened interest in Japanese financial markets, GAO issued a report in March 1988, Market Access Concerns of U.S. Financial Institutions in Japan (GAO/NSIAD-88-108BR). Relevant portions of that report are excerpted in GAO's current report.

Background

The International Banking Act of 1978 established the policy of national treatment in banking and provided that foreign banks operating in the United States be subject to regulations and requirements equivalent to those applied to U.S. banks. The principle of national treatment for securities firms has also been the practice in the administration of federal securities laws.

Current U.S. policy is based on a belief that national treatment is, both in principle and implementation, the best way to treat foreign firms in this country. This policy is based, in part, on the recognition that a policy of reciprocity would result in a matrix of regulations virtually impossible to administer and in increased barriers for U.S. firms abroad due to U.S. restrictions that apply to all financial firms, both domestic and foreign.

Efforts to provide national treatment are increasingly taking place within the context of changing regulatory environments and the globalization of financial markets. The U.S. financial regulatory environment faces possible structural changes due to the recent stock market crash and the possible repeal or amendment of the Glass-Steagall Act, which restricts banks from participating in certain securities activities. Similarly, U.S. financial institutions operating overseas face changing regulatory frameworks in foreign financial markets, particularly in the United Kingdom and Canada.

Results in Brief

U.S. financial firms report that they are generally accorded national treatment in the United Kingdom and in Japan, but they still find it difficult to do business in Japan. Foreign financial firms express overall satisfaction with the degree of competitive opportunity they are provided in the United States. In all three nations, financial firms judged remaining national treatment concerns as minor relative to general conditions.

Financial firms expressed most concern about additional issues which transcend national treatment, such as the deregulation and globalization of financial markets.

The success of national treatment in eliminating many regulatory barriers has facilitated the development of international financial markets and has enabled financial firms to engage in global business. These developments have exposed firms to the unique benefits and risks of international capital markets and highlight the need for countries to coordinate financial market oversight and regulation.

Principal Findings

Steady progress has been made in all three markets in eroding competitive barriers, and national treatment appears to be a reality in many areas of the international financial services industry.

Japan

U.S. financial institutions in Japan reported that in some areas they generally receive national treatment, but they still find Japan a difficult market in which to compete and have been frustrated by their lack of access to certain financial sectors. U.S. firms noted one remaining national treatment issue, which also affects other foreign financial firms—limited access to the Japanese government bond market. U.S. financial firms also found it difficult to introduce new financial products that they expect to be able to market successfully. This is not a national treatment issue, i.e., one caused by differences in legislative or regulatory treatment, but a market access concern which would apply to all financial market participants.

United Kingdom

The United Kingdom was cited as providing foreign firms with the greatest access to its financial markets. Since March 1986, when the United Kingdom granted foreign firms full participation in the London Stock Exchange, foreign financial firms have enjoyed almost unrestricted access to London's financial markets. The only exception noted by U.S. financial firms was the difficulty that a foreign bank could face if it wished to acquire one of the four major U.K. banks.

United States

Foreign financial firms operating in the United States believe that, for the most part, they are accorded equivalent treatment with U.S. firms; they view the exceptions as relatively minor issues. Foreign bank representatives cited as concerns (1) proposed legislation which would target foreign financial firms operating in the United States for special treatment, (2) insurance regulations in some states which serve to exclude foreign banks from participating in reinsurance activities, (3) the impact of possible regulatory changes on foreign bank entities operating in the United States, and (4) the collateralization requirement for overdrafts of foreign banks using the Fedwire, the Federal Reserve's electronic payment system.

Deregulation and Globalization

The representatives of U.S. and foreign financial firms that we interviewed expressed most concern about issues which transcend national treatment.

First, U.S. banks were concerned that the ability to be competitive in both domestic and international markets may be limited by the Glass-Steagall Act and the Federal Reserve's Regulation K, which governs the overseas operations of U.S. banks.[1] Representatives of foreign banks operating in the United States indicated similar concerns about Glass-Steagall restrictions which are applied to their U.S. operations.

[1]These are discussed in our report Issues Related to the Repeal of the Glass-Steagall Act, (GAO/GGD-88-37) Jan. 1988.

Second, U.S. financial institutions view international agreement on and implementation of bank capital adequacy standards as a key factor in placing banking institutions on the same competitive basis worldwide. Such standards should ensure that banks are adequately capitalized to meet the risks of international business and the increasingly high level of non-traditional banking business.

Regulators from different nations are working to coordinate international bank capital standards as well as other major components of financial market regulation. It is important that this coordinating work continue in view of the risks presented by interconnected financial markets and the importance of facilitating international capital flows based on business considerations rather than market barriers.

Recommendations

Because the policy of national treatment has eliminated many regulatory barriers to major foreign financial markets, GAO makes no recommendations in its report.

Agency Comments

GAO discussed its findings with officials from the Department of the Treasury, Federal Deposit Insurance Corporation, Federal Reserve, Office of the Comptroller of the Currency, and Securities and Exchange Commission and with representatives from the National Association of Insurance Commissioners. These officials provided informal comments and were in general agreement with GAO findings.

In addition to its informal comments, the Federal Reserve provided formal comments on one finding in GAO's report. The Federal Reserve suggested that since GAO had noted the difficulty a foreign bank might experience in acquiring a major U.K. bank, it should also mention that foreign banks are restricted in their ability to acquire Japanese banks. GAO included the Federal Reserve's comment in its report.

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Abbreviations

FDIC	Federal Deposit Insurance Corporation
FSA	Financial Services Act of 1986
GAO	General Accounting Office
IBA	International Banking Act of 1978
NAIC	National Association of Insurance Commissioners
RSLC	Reinsurance standby letters of credit
SEC	U.S. Securities and Exchange Commission

Introduction

Eliminating competitive barriers has become increasingly important to financial institutions as competition has burgeoned in the world's financial markets. Advancements in technology and efficiency, the increasing sophistication of markets, and growing competition have combined to put tremendous pressure on the profit margins of financial firms participating in these markets.

In this competitive environment, relatively minor barriers can have an impact on the ability of financial institutions to compete internationally. Therefore, it is not surprising that the concept of national treatment, i.e., equality of competitive opportunity, is of importance to financial firms wishing to compete in world markets. While national treatment is concerned with providing equivalent competitive opportunities to both foreign and domestic firms operating within a particular nation, an alternative approach, reciprocity, focuses on subjecting foreign firms to the same restrictions in the United States that U.S. firms face in their countries.

Current U.S. policy, however, is based on a belief that national treatment, both in principle and implementation, is the best way to treat foreign firms in this country. This policy is based partly on recognition of the disadvantages of reciprocity. A policy of reciprocity would result in a matrix of regulations virtually impossible to administer. U.S. firms would also suffer increased trade barriers abroad under reciprocity due to the Glass-Steagall Act and to state-level restrictions faced by foreign financial firms in the United States. While the potential threat of reciprocal regulatory treatment may be a useful negotiating device, the guiding principle of the U.S. regulatory framework is to accord foreign financial institutions the same competitive opportunities available to their domestic counterparts.

Background

The Congress established the policy of national treatment for banking institutions in the International Banking Act of 1978 (IBA). The IBA provided that foreign banks operating in the United States be subject to regulations and requirements equivalent to those applied to U.S. banks. Before the IBA was enacted, individual states, rather than federal regulatory authorities, exercised primary control over foreign bank operations in the United States. The principle of national treatment for securities firms has also been the practice in the administration of federal securities laws.

The Congress has been concerned that U.S. financial firms abroad should be accorded national treatment as well. Section 9 of the IBA required the Department of the Treasury to report to the Congress on the status of national treatment for U.S. banks overseas and the Department has prepared three national treatment reports; the first was issued in September 1979, and updates were released in 1984 and 1986. The 1986 update extended the review to include the treatment accorded U.S. securities firms operating overseas. In general, the reports concluded that U.S. financial firms operating in Japan and the United Kingdom are accorded national treatment.

Since passage of the IBA, Japan and the United Kingdom have made progress in addressing national treatment concerns. The elimination of many regulatory inequities has helped to facilitate the entry of financial firms into overseas markets. This ability to expand worldwide has also coincided with the increase in international financial flows, increasing the demand for firms capable of conducting international business. These two developments have played a significant role in the evolution of truly international capital markets, which have both unique benefits and risks.

Objectives, Scope, and Methodology

The Senate Committee on Banking, Housing, and Urban Affairs and its Subcommittee on International Finance and Monetary Policy asked us to review the regulatory treatment of U.S. financial institutions in Japan and the United Kingdom and the treatment of foreign financial firms in the United States to determine whether national treatment is being uniformly applied. Our review focused on legislative and regulatory barriers to national treatment of banks and securities firms rather than on market-driven differences that are part of conducting business outside of a firm's home market. We interviewed a selected group of regulatory officials, bank and securities firm representatives, trade association members, and academic experts in Japan, the United Kingdom, and the United States to obtain their views on the status of national treatment in all three markets. Interviews took place both before and after the stock market crash of October 19, 1987, to include changes in viewpoints which might have resulted from this important event. We reviewed relevant documents on the Japanese, British, and U.S. financial markets, including legislation, regulations, studies, surveys, and reports prepared by the Department of the Treasury, the Securities and Exchange Commission, the Federal Reserve Board, and various private sector organizations.

We made our review from September 1987 through January 1988 in accordance with generally accepted government auditing standards.

Views of U.S. Financial Institutions on National Treatment in Japan

U.S. financial institutions in Japan believe that in some areas they generally receive national treatment, but they still find Japan a difficult market in which to compete and have been frustrated by their lack of access to certain financial sectors. Despite the numerous steps taken to further open Japan's financial markets to foreign firms, foreign banks still have only a small share of the market and foreign securities firms continue to confront competitive barriers.

While U.S. financial institutions believe that they are generally accorded national treatment in Japan, they cited the following two problems: the first is a national treatment issue, while the second concerns market access.[1]

- U.S. and other foreign firms play a small role in the Japanese government bond market. The Japanese have taken steps recently to address this concern by increasing foreign firms' share of 10-year government bond issues, the most heavily traded bond in that market. However, these actions appear to have added little to foreign firms' share of the government bond market.
- U.S. firms have difficulty in introducing some types of new financial products in Japan, such as futures and options.[2] Although the Japanese government has introduced legislation in the parliament establishing a domestic futures market to allow comprehensive futures trading in currencies, interest rates, bonds, and stocks, some of the difficulties associated with introducing new financial products are likely to remain for the near future.

A very important past concern of foreign financial firms, access to the Tokyo Stock Exchange, appears to have been addressed to the satisfaction of most of the foreign financial firms seeking membership.[3]

[1]These issues are discussed in more detail in our report, Market Access Concerns of U.S. Financial Institutions in Japan (GAO/NSIAD-88-108BR) March 1988.

[2]Futures are contracts for future delivery of a commodity or a security. Options are contracts that give the holder the right to buy or sell a specified amount of securities at a predetermined price over a certain period of time.

[3]Tokyo Stock Exchange officials in December 1987 selected 16 additional foreign firms for membership. In 1985, 6 foreign firms had been admitted to the Exchange. The increased membership should accommodate most major foreign firms interested in and able to take advantage of membership with the exception of one qualified U.S. firm whose membership application was recently rejected.

Liberalization of Markets

The success of foreign financial firms in Japan depends, to a certain extent, on the degree of openness and deregulation of Japan's financial markets. Since the late 1970s, the Japanese government has gradually liberalized Japanese financial markets, doing so with increasing speed in the past few years. The 1984 benchmark agreement commonly known as the Yen/Dollar agreement[4] has helped to accelerate this process by promoting the (1) development of a Euroyen market, (2) liberalization of Japan's domestic capital markets, and (3) removal of barriers to foreign entry into the domestic financial services industry. Progress in liberalizing Japan's financial markets has been more successful in the international than in the domestic market, in part because domestic deregulation can be politically controversial.

The rigidities of Japan's regulated domestic markets affect U.S. firms' abilities to compete in Japan. For example, many Japanese banks, in contrast to foreign banks, have access to regulated, low-cost domestic Japanese deposits[5] through their large established retail networks.[6] Thus, foreign banks must rely on relatively high-cost money brokers for their funding in Japan; this difficulty is compounded by Japan's lack of a true interbank yen market where banking institutions borrow and lend funds among themselves.

Some U.S. banks believe they are at a competitive disadvantage because Japanese regulators impose less stringent capital requirements on Japanese banks than U.S. regulators impose on U.S. banks. The Japanese have recently taken steps to bring their capital standards more in line with those of other major industrialized countries. In 1986, Japanese bank regulators raised the minimum capital guidelines for Japanese banks and in December 1987 announced that Japanese banks would be subject to the new risk-adjusted capital standards developed by the Basle Committee[7] and the Bank of International Settlements.

[4]The Yen/Dollar agreement was developed by a working group from the U.S. Department of the Treasury and the Japanese Ministry of Finance in 1984. See our report, Implementation of the Yen/Dollar Agreement,(GAO/NSIAD-86-107) June 1986.

[5]Low-cost deposits are partly the result of interest-rate controls which still affect 60 percent of bank time deposits in Japan.

[6]U.S. banks do not view the retail networks per se as a national treatment issue or as a significant barrier, since they are not planning to enter the retail banking sector in Japan.

[7]The Basle Committee, formally the Committee on Banking Regulations and Supervisory Practices, is the principle forum for international coordination among national banking supervisors and regulators.

Japanese Government Bond Market

Japanese government bonds make up the largest portion of the Japanese bond market and are issued through one of three methods: an auction, an underwriting syndicate[8], or direct placement with official accounts, such as the Trust Fund Bureau and the Ministry of Posts and Telecommunication. In 1987, about 29 percent of these bonds were issued through an auction, 37 percent through a syndicate, and 34 percent were placed with official accounts. Seventy-eight percent of the bonds issued by syndicate were 10-year government bonds. Changes made in the government bond market in 1987 included issuing 20-year bonds through an auction instead of through syndication and relaxing foreign firms' eligibility criteria for participating in the 2, 3, and 4-year bond markets.

The most important government bond issue is the 10-year bond issue, especially in terms of secondary market trading.[9] While most other maturities are sold and priced through auctions, the Japanese government has maintained a consortium procedure for 10-year bonds.

To improve foreign firms' share of the 10-year issue, the Japanese government on April 1, 1987, increased foreign firms' share of the bonds allocated through the underwriting syndicate that is responsible for selling the 10-year issue from 0.3 to 1.5 percent and as of November 1987, introduced a limited "auction" for 20 percent of each 10-year issue. Under this process, foreign firms bid on a supplementary volume of bonds desired without knowing the issue terms. The maximum bid permitted per financial institution is one percent of the total issue; oversubscribed bonds are allocated to each bidder in proportion to its bid. This supplementary allocation system is not actually an auction, because the price of the bond is still set through negotiations between representatives of the underwriting syndicate and the Japanese government. Nevertheless, as a result of this new scheme, foreign securities dealers were able to increase their total share of a November 1987 10-year issue from the 1.5 percent share allocated under the previous formula to about 5 percent.

Despite this increase, foreign firms are still restricted to an insignificant role in the primary market for 10-year government bonds in Japan. The

[8]Underwriting is a process whereby an agent purchases a new issue of securities from an issuer and resells it. In an underwriting syndicate, portions of an issue are shared among participants. The underwriting syndicate for Japanese government bonds consists of approximately 800 financial institutions. As of April 1987, 12 U.S. banks and 12 U.S. securities firms were members of this syndicate.

[9]Secondary market trading refers to the buying and selling of previously issued securities.

U.S. Treasury and major foreign financial institutions in Japan have not succeeded in persuading the Japanese to adopt a full auction process for all government bonds in which issue terms are freely determined through open market competition. Although Ministry of Finance officials acknowledge that it is important to give foreign firms greater access to the full government bond market, their primary objective is to maintain a smooth distribution system and they believe that a full auction process would introduce an unacceptable level of uncertainty to the bond market, i.e., there would be no assurance that purchasers would fully absorb all issues regardless of market conditions. At this time, there are no plans to eliminate this syndicate allocation system.

Introducing New Products

Foreign firms in Japan sometimes have difficulties in providing the full range of products that they are able to offer in other markets, particularly new and innovative financial products such as futures and options. While not a national treatment issue, these difficulties result from existing regulations and policies governing approval of new products and the underdeveloped state of the futures and options markets in Japan. Under the Ministry of Finance's current policy, there is a general presumption of no entry for new products or services without prior Ministry approval.

A January 1988 Ministry of Finance report outlined the shape of a comprehensive financial futures market in Japan and called for broader Japanese access to overseas futures and securities options markets. The Japanese government has also submitted legislation to the parliament establishing a domestic futures market to allow comprehensive futures trading in currencies, interest rates, bonds, stocks, and various index products.[10] However, it is not expected that a full-fledged financial futures and options market will begin before late 1988. The length of time it will take to develop a full-fledged futures market in Japan has led to complaints from some U.S. firms that new financial products are allowed to be used in Japan only after Japanese firms have mastered their use in overseas markets, leaving U.S. firms in Japan with little or no competitive edge.

U.S. financial institutions told us they also have had difficulty receiving permission to sell collateralized mortgage obligations, cash management

[10]Index products reflect in a single number the market values of a list of selected securities. An equity stock index, for example, allows investors to profit from, or protect against, price movements in the stock market generally rather than in individual stocks.

accounts, mutual funds, and some types of zero coupon bonds and certificates of deposit.[11]

In its comments on a draft of this report, the Federal Reserve suggested that since we had noted the difficulty a foreign bank might experience in acquiring a major U.K. bank (see p. 16), we should also mention that foreign banks are restricted in their ability to acquire Japanese banks. Although financial institutions did not raise this with us as a concern, the Federal Reserve noted that there were significant legal restrictions on the acquisition of an existing bank in Japan, including any of the 13 city banks. (See app. I.)

[11]Collateralized mortgage obligations are securities backed by a pool of mortgages. Cash management accounts transfer funds automatically from a checking account to an investment account when the checking account exceeds a specified level. Zero coupon bonds do not pay out annual interest; the return consists of the payment of accumulated interest when the bond comes due. Mutual funds are broadly diversified investment accounts. Issuance of mutual funds in Japan is the exclusive preserve of 12 securities trust management companies.

Views of U.S. Financial Institutions on National Treatment in the United Kingdom

Of the world's three major financial markets (Japan, the United States, and the United Kingdom), the United Kingdom (U.K.) today gives foreign firms the greatest access to its financial markets. Since March 1986, when foreign firms were allowed full participation in the London Stock Exchange, foreign financial firms have enjoyed almost unrestricted access to London's financial markets.

U.S. financial institutions believe that they are given unbiased regulatory treatment and free access to U.K. financial markets. This is consistent with the ease that foreign firms have experienced in entering the U.K. financial market and participating in various financial sectors. Market share data indicate that U.S. firms are active in all U.K. markets, including the domestic market. For instance, 11 of the original 27 primary dealers[1] in the U.K. gilt market (British domestic government securities) are U.S. companies or U.S.-affiliated companies. A recent Financial Times survey rated 4 U.S.-owned investment houses among the top 12 firms in London. Further, U.S. firms, especially banks, have acquired firms that are members of the London Stock Exchange. According to the Governor of the Bank of England, at least 10 U.S. banks have bought participations in stock exchange member firms.

The only exception to national treatment mentioned by U.S. financial firms[2] was the difficulty that a foreign bank could face if it were to consider acquiring one of the four major U.K. clearing banks.[3] In addition, U.S. financial firms expressed concern over two regulatory matters that are not national treatment issues: (1) the uncertainties of the U.K.'s new regulatory structure and (2) constraints imposed by U.S. regulations.

Acquisition of U.K. Clearing Banks

U.S. financial firm representatives advised us that U.K. policy and legislation would make it unlikely that prospective foreign financial institutions would be able to acquire any one of the U.K.'s four major clearing banks: Lloyds, Midland, Barclay's, and National Westminster. Sections 21 through 23 of the Banking Act of 1987 authorize the Bank of England to block bank stock purchases when potential purchasers fail to meet various statutory criteria and section 37 requires that it be notified

[1] Primary dealers are major market makers for government securities.

[2] Only one U.S. financial firm we interviewed viewed this as a major national treatment issue.

[3] The term "clearing bank" refers to a bank which is a member of the London Bankers' Clearing House and clears its checks through this institution. The term is also used loosely in the U.K. to mean any retail commercial bank.

about purchases of 5 to 15 percent. In addition, U.K. officials have indicated that the Department of Trade and Industry can block an acquisition on the basis of public interest under the Fair Trading Act of 1973. Potential cases involving questions of national interest may be referred for consideration to the Monopolies and Mergers Commission, which in turn advises the Department of Trade and Industry on actions that should be taken regarding acquisitions.

On the policy level, the Governor of the Bank of England, in an October 13, 1987 speech, discussed the approach to the ownership and control of banks in the U.K. The Governor stated that a strong and continuing British presence in the U.K. banking system was of the highest importance and that the Bank of England has a broader duty to protect the financial system as a whole, either acting on its own initiative or as an adviser to the government.

The New U.K. Regulatory System

Some U.S. financial institutions we interviewed in London expressed concern about the new U.K. regulatory structure under the Financial Services Act (FSA) of 1986, which will affect all financial firms, both domestic and foreign. The FSA establishes a three-tier regulatory structure, eventually passing responsibility and authority for day-to-day supervision to self-regulatory organizations.[4] Initially, the FSA grants the powers to regulate and authorize the carrying on of investment business to the Secretary of State for the Department of Trade and Industry, a government agency. The Secretary of State then delegates these powers to the Securities and Investments Board, a private organization. The Board's members, who are jointly appointed by the Department of Trade and Industry and the Bank of England, are responsible for balancing industry and public interests. The Board, in turn, authorizes the self-regulatory organizations.

The U.K. implemented its new regulatory regime on April 29, 1988. As of that date, five self-regulatory organizations had received authorization from the Securities and Investments Board for recognition under the FSA. The most frequently noted concerns among U.S. firms were the tight time frames for the implementation of the regulatory structure, regulatory overlap, and increased costs of compliance.

[4]Self-regulatory organizations are practitioner-led bodies which are empowered to enforce standards of member conduct.

Short Timetable for Implementation

All financial firms had to apply to their respective self-regulatory organizations by February 1988 to be authorized to conduct business in April 1988. As the regulations were being developed, some U.S. firms expressed concern that they had to apply to their respective self-regulatory organization(s) for authorization without knowing the final rules governing operations.

Regulatory Overlap

The development of diversified and integrated financial conglomerates, erosion of traditional boundaries between financial markets, and restructuring of the U.K. securities industry has enabled single institutions to provide a full range of financial services. Consequently, many banks and other financial institutions will require authorization and supervision by more than one self-regulatory organization as well as by the Bank of England. In some cases, firms may have to apply to all of the self-regulatory organizations, paying membership fees and reporting separately to each one.

The Bank of England, the Securities and Investments Board, and the Securities Association (one of the new self-regulatory organizations) have conducted extensive negotiations to establish a "lead regulator" for the U.K. financial services industry. Broad guidelines have been established for splitting supervisory responsibilities and sharing information between regulators. The guidelines will provide the basis for determining lead responsibility for primary supervision of U.K. incorporated firms on a case-by-case basis depending on the business mix of the financial firm. The Securities and Investments Board also hopes to establish a lead regulator for firms under the supervision of multiple self-regulatory organizations.

Less progress has been made in establishing mutually agreeable domestic capital adequacy requirements. Capital adequacy standards attempt to ensure that financial firms maintain a capital base appropriate for the level of financial risk assumed. The eventual outcome of the requirements will be of particular interest to foreign bank branches, which have not yet had to adhere to any U.K. capital adequacy requirements. Preliminary discussions indicate that when the home-country regulator's supervision of the parent bank is considered adequate, as in the case of U.S. branches, capital adequacy requirements will be modified depending on the extent of the branch's involvement in investment activities.

It is important to temper all of these concerns with the overriding belief by firms that the London market is an open and fair one. Further, these firms have expressed satisfaction with their involvement in fashioning the regulatory structure. Several U.S. officials we spoke with hold top positions with the Securities and Investments Board or the Securities Association while others were consulted by the government during the drafting of the new financial legislation. All firms were allowed to comment on the draft legislation before it went into effect.

Constraints Imposed by U.S. Regulations

U.S. banks unanimously stated that U.S. regulations hurt them competitively in the U.K. market. Federal Reserve Regulation K limits the underwriting activities of U.S. banking institutions overseas[5]; while banks can conduct secondary market trading and can underwrite debt instruments[6] overseas based on a percentage of capital, they cannot underwrite more than $2 million per equity[7] underwriting issue per subsidiary of the bank. Bank officials complained that this places them at a competitive disadvantage with U.S. investment houses and foreign universal banks, which are able to underwrite significantly larger issues.

The bank officials we contacted explained several ways of partially circumventing the $2 million equity underwriting limit[8]. However, bank officials insisted that this circumvention created costs and inefficiencies their competitors do not encounter.

According to bank officials, two methods are used to partially circumvent the equity underwriting limits of Regulation K. The first is a consortium approach, whereby the bank owns up to the maximum allowable 5 percent in a consortium of financial firms that distribute equity underwriting and assume the associated underwriting risk. The

[5]Regulation K sets forth regulations for U.S. banking institutions operating abroad and foreign banking organizations operating in the United States. The Board of Governors of the Federal Reserve System issued Regulation K in 1920, and modified it periodically, including in 1979 following passage of the International Banking Act of 1978. Regulation K was issued under the authority of the Federal Reserve Act of 1913, Bank Holding Company Act of 1956, International Banking Act of 1978, Bank Export Services Act, and the International Lending Supervision Act of 1983.

[6]Debt instruments are certificates that evidence a loan between a borrower and a lender.

[7]Equity represents ownership in a corporation; it is also commonly known as stock.

[8]According to a Federal Reserve official, the intent of Regulation K was to minimize U.S. banks' overseas risk by limiting equity underwriting to $2 million per issue. Some bank representatives, however, have interpreted Regulation K as allowing for underwriting of up to $15 million per issue with $2 million underwritten in each subsidiary. Federal Reserve officials have stated that while such an interpretation is a technically correct legal interpretation of Regulation K, it does not have the endorsement of the Federal Reserve.

second method involves the bank spreading an underwriting placement, up to $2 million per subsidiary, around its international subsidiaries to a maximum of $15 million per issue.

Views of Foreign Financial Institutions on National Treatment in the United States

Most of the foreign financial industry representatives and U.S. regulatory authorities we interviewed in the United States believed that, for the most part, foreign and U.S. financial firms operating in the United States enjoy equal regulatory treatment. However, a number of minor national treatment concerns remain.

Foreign bank representatives felt that restrictions under the Glass-Steagall Act, which limit the scope of securities business that U.S. and foreign banks may conduct in the United States, were far more important than any remaining inequities in national treatment. Some bank executives from countries which permit their banks to engage in securities activities, such as the United Kingdom, Switzerland, and Germany, believe it is unfair that U.S. banks can engage in securities activities in their countries while they are prohibited from engaging in securities operations in the United States.

Furthermore, foreign representatives believe that some U.S. regulations and legislation are exceptions, although relatively minor ones, to the general provision of national treatment.[1]

National treatment issues of continuing concern to foreign banks include (1) proposed legislative provisions which would target foreign financial firms in the United States for special treatment, (2) insurance regulations in some states which serve to exclude foreign banks from a segment of the insurance market, (3) the impact of possible U.S. regulatory changes on foreign bank entities operating in the United States, and (4) the collateralization requirement for foreign banks using daylight overdrafts on the Fedwire.[2]

Foreign securities firm executives generally agreed that they are receiving equitable treatment. Their major concerns centered on issues other than national treatment, such as the level of detailed disclosure of financial information required by the Securities and Exchange Commission (SEC) and how the differences between SEC regulatory standards and

[1]Foreign financial firms are not unanimous in their view of the importance of these national treatment issues. The relative importance ascribed to these differences depends, to a large extent, on the standpoint of the particular firm in question. Cultural differences, corporate personality, area of specialization, and other factors all influence a firm's opinion of the relative importance of any one national treatment issue.

[2]The Fedwire is one of two large dollar payment electronic transfer systems which enables depository institutions to send payment messages to each other through communication links with their Federal Reserve banks. Temporary overdrafts occur frequently during any given day, because it is not possible for debit and credit payment entries to be in perfect balance, given the speed of transactions on the FedWire.

those of other countries complicate stock issues involving underwriters from two or more countries. A number of the firms stated that U.S. securities requirements were sometimes at odds with their home-country regulations and that the complexity of U.S. regulations bore down more heavily on foreign firms unfamiliar with the U.S. legal and regulatory environment. A case in point involves Swiss firms which must balance the SEC's thorough disclosure requirements with Switzerland's strict secrecy laws.

Proposed Legislation Affecting Foreign Firms

Some foreign financial firms expressed concern about several legislative proposals during the 100th Congress which would target them for discriminatory treatment if enacted into law. For example, sections 909 and 910 of the Proxmire Financial Modernization Act of 1988 would enable U.S. regulatory bodies to deny foreign firms' applications to establish banks and broker/dealers[3] and sections 3501 and 3502 of the Omnibus Trade and Competitiveness Act of 1988 would require the regulators to deny applications to establish primary dealers if the foreign country does not accord similar competitive opportunities to U.S. firms. Foreign firms were concerned that such proposals would undermine the U.S. policy of national treatment, even if the proposals were not enacted.

Foreign banks, for example, believed that a tax proposal contained in the original version of the Technical Corrections Act of 1987 would have targeted them unfairly. The Act makes technical corrections to the Tax Reform Act of 1986. Initial drafts of the legislation included a provision to override tax treaties between the United States and other countries to the extent those treaties protected foreign banks from the branch profits tax[4] and the branch-level interest tax[5] legislated in the 1986 Act. Although the version of the bill that was enacted into law did not contain the treaty override, foreign banks were alarmed that Congress would consider overriding existing treaties and that such provisions might be considered again.

[3]Brokers serve as intermediaries between buyers and sellers. Dealers purchase or sell securities for their firm's own account.

[4]The branch profits tax is a 30 percent tax on the after-tax profits remitted by a foreign bank's U.S. branch to offices of the foreign parent and is levied in addition to the U.S. corporate income tax.

[5]The branch level interest tax includes (1) a 30-percent withholding tax on interest actually paid to foreign persons by the U.S. branches of a foreign bank and (2) the so-called "excess interest tax," which is a 30 percent tax on the amount by which a foreign bank's interest deduction for U.S. tax purposes exceeds the foreign bank's actual U.S. book interest expense. The rates at which all of these taxes are imposed may be reduced or eliminated by treaty.

Reinsurance Standby Letters of Credit

Foreign bank representatives have encountered problems from state insurance regulators in issuing or confirming reinsurance standby letters of credit (RSLC).[6] These RSLCs differ from traditional trade-related letters of credit because they involve (1) an insurance company, (2) a foreign reinsurance company, and (3) a bank. When a U.S. insurance company reinsures through a foreign reinsurer (i.e., purchases insurance from a foreign reinsurer for portions of its risk portfolio), the obligation of the foreign reinsurer to the insurance company must be secured by collateral that is acceptable to the appropriate state insurance department. The most popular form of collateral is a standby letter of credit issued by a bank on behalf of the foreign reinsurer in favor of the U.S. insurance company.

The U.S. insurance industry is regulated on the state rather than the federal level. Standards and guidelines for the industry are developed by the National Association of Insurance Commissioners (NAIC), a voluntary professional organization. Individual state regulatory authorities are free to accept or reject these guidelines. Foreign banks had been prevented from becoming active in this market for RSLCs because many state insurance regulators adopted regulatory guidelines previously issued by the NAIC. These guidelines recommended that only Federal Reserve System member banks be permitted to issue or confirm RSLCs in the belief that membership was an important indication of bank credit quality. However, some Federal Reserve member banks are weaker in credit quality than highly rated banks which are not members. While the adoption of the guidelines prevented those U.S. banks that are not Federal Reserve members from participation in this business, foreign banks were affected most heavily because foreign branches are not members of the Federal Reserve System (only subsidiaries can qualify).

Following substantial lobbying by the foreign bank community, the NAIC recently amended its guidelines to recognize that Federal Reserve membership was not necessarily an indication of bank creditworthiness. Individual states, however, had the option of accepting or rejecting these new guidelines. On December 31, 1987, the New York State Insurance Department adopted the new NAIC guidelines, which base approval of foreign banks' involvement in RSLCs primarily on the credit-ratings of

[6]Reinsurance is acceptance by one insurer of all or part of the risk of loss of another insurer. With a standby letter of credit, a bank guarantees payment to a third party should the holder of the letter fail to meet his financial obligations or perform according to contract.

these banks.[7] The foreign bank community is concerned however, that other important states, such as California and Illinois, have yet to amend their regulations. Foreign banks are concerned that until they are able to issue or confirm RSLCs throughout the United States, U.S. insurance companies will tend to choose U.S. banks over foreign banks for this line of business. U.S. insurance companies typically conduct business in many states and, therefore, seek banks which are able to issue or confirm RSLCs in those states.

In their informal comments on a draft of this report, officials of one agency noted that the regulation of RSLCs is a matter for state insurance regulators and thus is not properly a national treatment issue. While regulation in this area is a state matter, it can be regarded as a national treatment concern since disparate treatment of foreign banks continues to exist in those states which have chosen not to adopt the new NAIC guidelines.

Impact of Possible U.S. Regulatory Changes on Foreign Banks

Foreign bankers have expressed concern that a restructured financial system following possible repeal or amendment of the Glass-Steagall Act might result in greater required capital levels for foreign banks in the United States. A bank holding company structure has been proposed to allow banks to engage in securities activities. Foreign banks which do not currently operate under a bank holding company structure might have to establish such a structure in order to compete in a post Glass-Steagall financial system in the United States. This would involve capitalizing the new bank holding company in order to comply with capital requirements.

A number of foreign banks are also concerned about financial regulations under continuing discussion which would limit the amount of country exposure[8] permitted each U.S branch of a foreign bank. The Federal Deposit Insurance Corporation (FDIC) has issued regulations which would limit the amount of foreign loans that a foreign bank could make from its U.S. branch, based on the assets held by the branch rather than on the bank's worldwide consolidated assets.

[7] In the spring and fall of 1987, the Department of Treasury wrote to the NAIC and the State Insurance Departments of New York and California to indicate its support for the NAIC's new guidelines.

[8] Country exposure generally refers to the amount of debt outstanding by a particular bank to a particular country.

Access to Fedwire Overdraft Capacity

A number of foreign banks have complained that the limited daylight overdraft capacity they are permitted on the Fedwire is not in accordance with national treatment. U.S. banks' access to Fedwire overdraft capacity is based on their worldwide capital, but foreign banks' access is generally limited to 5 percent of their third-party liabilities in the United States unless their overdrafts are fully collateralized. Thus, a foreign bank would be allowed only a portion of the uncollateralized overdrafts on the Fedwire permitted a U.S. bank of equivalent size.

The Federal Reserve limits the uncollateralized daylight overdrafts that foreign banks may have on the Fedwire because of the risk that foreign institutions might be unable to meet their obligations for payment messages they have sent over the Fedwire. This is done for prudential reasons to protect the funds of the U.S. government. As the ultimate guarantor of all transactions made on the Fedwire, the Federal Reserve must cover all payments for institutions unable to do so. However, it believes that it does not have sufficient information on foreign bank parent organizations to monitor their credit quality and has therefore determined that the best way to limit risk is to place a greater limit on foreign banks' overdrafts which are not collateralized.

Emerging Issues in International Financial Regulation

A number of problems continue to demand attention, but national treatment is no longer a major concern for U.S. financial firms in the United Kingdom or Japan, or for foreign firms conducting business in the United States. In general, national treatment is a reality in these markets, and the competitiveness of U.S. financial firms is not substantially limited by foreign regulations. Some issues of limited market access remain to be resolved within the area of national treatment, but a denial of national treatment is not a major impediment to international financial markets or to the competitive opportunities of U.S. financial institutions operating in the United Kingdom and Japan. Therefore, we believe that there is no reason to pursue a policy alternative to national treatment, such as reciprocity.

During our review, we examined reciprocity in financial markets as an alternative to national treatment. The relative disadvantages of a regulatory policy of reciprocity that led to congressional adoption of national treatment in 1978 have not changed. A number of these disadvantages were highlighted in the Treasury Department's September 1984 testimony before the Senate Committee on Banking, Housing, and Urban Affairs, which stated that a policy of reciprocity would

> " require a burgeoning regulatory bureaucracy and could lead to administrative chaos. If strictly applied, reciprocity would reduce U.S. policy to a lowest common denominator basis, removing flexibility, and work against building and developing the United States as a major international financial center."[1]

Reciprocity would result in an uneven and unpredictable array of regulations that would be constantly changed to match foreign regulations. Furthermore, it would be difficult to apply reciprocal regulations, geared to match the regulations of a foreign nation, to a multinational firm whose ownership and operations are international. While reciprocity can be useful as a negotiating tool in certain circumstances, its use entails an inherent risk of countermoves that would remove currently available U.S. access to foreign financial markets.

With substantial progress made on national treatment, concern has shifted to the implications of internationalization for financial market regulation. The challenge for national regulation of financial markets is to ensure safety and soundness without unnecessarily impeding the free flow of capital. National regulators need to continue to work together to

[1] This testimony was included in the Department of the Treasury's National Treatment Study: Report to Congress on Foreign Government Treatment of U.S. Commercial Banking and Securities Organizations, 1986 Update, page 18.

coordinate regulations so they can be effective in an era of international capital markets, while at the same time ensuring that the benefits of international capital markets are realized.

Remaining Concerns of Financial Institutions

The primary concerns expressed by multinational financial firms, including those that are primarily U.S. firms, relate to the internationalization of financial markets rather than to remaining problems in applying the national treatment principle to national regulations.

For example, some U.S. laws and regulations may hinder the competitiveness of U.S. firms in global markets. Most notably, many U.S. banks believe that current limitations on their ability to move from traditional lines of commercial banking (such as lending) into the potentially more profitable securities business severely limit their ability to compete in both domestic and international markets against foreign and U.S. competitors. These restrictions, imposed under the Glass-Steagall Act of 1933, are now under review, and the decision to retain, revise, or repeal the Act should include consideration of the international character of financial markets as well as the need to ensure the safety and soundness of the international financial system. As we noted in our January 1988 report, Issues Related to the Repeal of the Glass-Steagall Act (GAO/GGD-88-37), we believe that coming to grips with the question of Glass-Steagall repeal represents an opportunity to systematically address changes in legal and regulatory structures that are needed to better reflect the realities of the financial marketplace.

Regulatory Challenges of Internationalization

The success of national treatment in eliminating many regulatory inequities has helped to facilitate the entry of financial firms into overseas markets. This ability to expand worldwide has coincided with the increase in international financial flows, increasing the demand for firms capable of conducting international business. These two factors have led to the development of truly international capital markets, which have unique benefits and risks.

Some problems confronting international financial markets are beyond the ability or authority of any one nation's regulators to dictate rules and standards. Thus, banking regulators of major nations have been working to coordinate their supervisory oversight of multinational banking institutions.[2] The goal of this coordination has been to ensure that regulatory practices of individual nations respond to the risks to the safety and soundness of the financial system caused by internationalization without conferring unfair competitive advantages on firms from any one nation.

International Capital Standards

International regulatory coordination has been a particularly prominent issue in recent months in the area of international standards for bank capital adequacy. Different national standards for capital adequacy have been seen as an important source of competitive inequality among banks operating internationally or facing foreign competition in their home markets, since banks that have lower capital standards are able to operate at lower cost and thus offer lower priced loans and services than banks from nations with higher capital standards. Although not technically a national treatment issue, U.S. banks operating in Japan and the United Kingdom stressed the importance of uniform international bank capital requirements.

Japanese capital standards, particularly, have been cited as unfairly low compared with the levels that other nations deem as essential to maintain the safety and soundness of the banking system. While it is difficult to make direct comparisons among the capital standards of different nations, some U.S. banks believe they are at a competitive disadvantage in Japan because Japanese regulators impose less stringent capital requirements on Japanese banks than U.S. regulators impose on U.S. banks. This disparity in minimum capital requirements has often been cited as an important disadvantage for U.S. banks competing against Japanese banks because it means that U.S. bank loans must be priced higher than similar Japanese bank loans.

The Japanese have recently taken steps to bring their capital standards more in line with those of other major industrialized countries. In 1986, Japanese bank regulators raised the minimum capital guidelines for Japanese banks, and in December 1987 they agreed in principle that Japanese banks would be subject to the new risk-adjusted capital standards developed by the Basle Committee and the Bank of International Settlements. These standards grew out of a risk-based capital adequacy proposal developed by the Federal Reserve and the Bank of England.

[2]See our report, International Coordination of Bank Supervision: The Record to Date (GAO/NSIAD-86-40) February 1986.

Under the December 1987 proposal, Japanese banks will be allowed to include 45 percent of unrealized securities gains[3] in the calculation of capital, reflecting a compromise between Japanese and foreign bank regulators. Japanese regulators sought a higher percentage, arguing that the extensive securities holdings of Japanese banks were an important component of their total capital, but a component that they could not currently count to satisfy regulatory requirements. U.S. and other national regulators believed that including higher levels of unrealized securities gains in the computations of capital would have been unwarranted, given the price volatility of Japanese banks' securities holdings and the relatively thin markets for those securities.

Regulatory Coordination

In London and Tokyo, the representatives of U.S. financial institutions that we interviewed agreed that removing regulatory disparities would be an essential step toward fostering an equitable international market for financial services. They cited standardized capital adequacy requirements as a primary concern.

Thus far, the banking sector has made the greatest progress in regulatory coordination, including agreement on capital adequacy requirements.

Progress in regulatory standardization has not been as great in the investment community. In September 1986, the United States and the United Kingdom signed "A Memorandum of Understanding for the Exchange of Information Between the United States Securities and Exchange Commission and the U.K. Department of Trade and Industry in Matters Relating to Securities and Between the United States Commodities Futures Trading Commission and the United Kingdom Department of Trade and Industry in Matters Relating to Futures." The agreement is intended to gain better adherence by international firms to financial regulations. Informal discussions among the securities regulators of the G10 nations[4] began in December 1986, but no agreements have been announced.

[3]Unrealized securities gains are appreciations in the market value of securities which have not yet been sold, or realized.

[4]The G10 is composed of the United States, United Kingdom, Japan, Belgium, Germany, Italy, France, Sweden, Canada, and the Netherlands.

Comments From the Board of Governors of the Federal Reserve System

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

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

May 2, 1988

Mr. Richard Fogel
Assistant Comptroller General
General Government Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel,

This is in response to your request for comments on the General Accounting Office draft report of March 21, 1988, on Competitive Concerns of Foreign Financial Institutions in Japan, the United Kingdom and the United States. The report states that U.S. financial firms noted that an exception to national treatment in the United Kingdom faced by foreign banks is that the laws and policy make it difficult or impossible to acquire one of the four major U.K. clearing banks.

The Board would also note that there are significant legal restrictions on the acquisition of an existing bank, including any of the 13 city banks, in Japan. This would appear to be a major inhibition on the ability of foreign banks to compete fully in the Japanese market, since the city banks, which account for slightly more than half of all banking assets in Japan, are the principal competitors for foreign banks operating in Japan. The acquisition of Japanese banks by foreign banks would permit further expansion of the small share of the market that they currently have.

Arguably, the restrictions on the acquisition of a Japanese bank could be considered consistent with national treatment, since generally no financial institution in Japan may hold more than five percent of the shares of another firm, including another financial institution. (In order to allow nine foreign banks, including six U.S. banks, to establish trust banking subsidiaries in Japan in 1986, a waiver of this provision had to be given by Japanese regulatory authorities.) However, the Japanese regulatory authorities have permitted merger acquisitions of some Japanese banks by other Japanese banks.

Accordingly, since the final report would note that the inability of a foreign bank to acquire a major U.K. bank is a concern, it should also mention that foreign banks are restricted in their ability to acquire Japanese banks.

Very truly yours,

William W. Wiles
Secretary

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