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No. 133, July 1979

A PROPOSAL FOR THE ESTABLISHMENT OF AN INTERNATIONAL DEPOSIT INSURANCE CORPORATION

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INTERNATIONAL FINANCE SECTION
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Introduction

During the last ten years, the major banks of Western countries have established large numbers of branches, agencies, and subsidiaries in other countries, and the total amount of their deposits and loans has grown very rapidly. This financial innovation, known as multinational banking, has attracted much attention from financial analysts, lawmakers, and economists. I have recently tried to explain theoretically the causes and welfare effects of multinational banking and the issues surrounding the U.S. International Banking Act of 1978 (Grubel, 1977). The existing literature documents the growth in multinational banking and discusses fully the issues facing policy-makers as a result of this growth.[1]

In this Essay, I assume that the reader is familiar with most of the issues surrounding the multinational banking phenomenon and focus my attention on the narrow problems raised by the fact that in most countries deposits in local branches of foreign banks are not covered by the deposit-insurance schemes of the host countries.

In the following section, I review existing policies designed to reduce the incidence of liquidity crises and bank failures for domestic banks. I consider

This Essay reflects the comments made on an earlier draft by Jane D'Arista, Professional Staff Member of the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives; E. E. Ehrlich of the Federal Reserve Bank of New York; Otmar Emminger of the Deutsche Bundesbank; Robert A. Johnston of the Federal Reserve Bank of San Francisco; Chris W. McMahon of the Bank of England; S. Vachon of the Bank of Canada; and Henry C. Wallich, Robert F. Gemmill, and Henry S. Terrell of the Board of Governors of the Federal Reserve System. None of these individuals or the institutions employing them endorsed the proposal made in this Essay. I acknowledge research support from the Canada Council under grant S75-1194.

[1] The literature on multinational banking seems to have grown even faster than the multinational banks and their deposits. My 1977 paper contains a bibliography of what I considered then to be the most important papers. To this list should be added the paper by Brittain (1977), who documents the interest-rate response of U.S. banks to cumulative past lending to the less developed countries. The U.S. Congress Committee on Banking, Finance and Urban Affairs *Hearings on International Banking Operations* (1977a) and *Hearings on the International Banking Act of 1977* (1977b) contain much useful institutional, empirical, and analytical material presented by many representatives of governments and the private sector. (The Act was actually passed in 1978, but the Congressional hearings show the date of the hearings, 1977.) The Federal Reserve Bank of Boston held a conference on multinational banking in the fall of 1977, and the published proceedings (1978) contain many useful papers. Finally, the *Federal Reserve Bank of San Francisco Economic Review* devoted its Fall 1977 issue to "Banking in the World Economy." In that issue, Cheng (1977) presents recent data on banks' international lending to national governments, and Johnston (1977) supplies an excellent analytical survey of issues surrounding U.S. regulatory policies and the risks from international bank lending and multinational banking. Since much of the business of multinational banks takes place in the Eurocurrency markets, the entire literature on Eurocurrency markets is relevant to an understanding of multinational banks. Little (1975) provides an exceptionally thorough and perceptive study of this subject.

how multinational banks are affected by each policy. Next I analyze the efficacy of deposit-insurance schemes for diminishing the impact of bank failures on the rest of the economy. I then discuss the arguments for and against the inclusion of local branches of foreign banks in national insurance schemes, concluding with a proposal for the establishment of a self-financing International Deposit Insurance Corporation.

Measures to Reduce Liquidity Crises and Bank Failures

To reduce the risk of bank failure, prudent policy calls for banks (a) to maintain part of their asset portfolios in liquid form, (b) to maintain an adequate equity base, (c) to charge interest on loans corresponding to the risk of default of the borrower so as to assure a normal rate of return net of such defaults, and (d) to diversify their loan portfolios to reduce the consequences of default by one or a few borrowers. Brittain (1977) analyzed the behavior of U.S. domestic and multinational banks and found that they were following prudent principles of interest-rate setting and diversification in their loans to developing countries' governments. Ruckdeschel (1975) found that the loan-loss ratios of U.S. banks have been lower on foreign than on domestic loans. Since most of the foreign loans are made by the branches or agencies of U.S. banks abroad, the empirical studies of Brittain and Ruckdeschel imply that U.S. multinational banks act in accordance with sound banking principles.

Nevertheless, the prudence of the international lending policies of U.S. banks has been questioned by a number of the persons mentioned in the acknowledgments above. Even though banks have strong incentives to prevent crises and failures, which diminish or wipe out the net worth of the banks' owners, there is evidence of imprudent investment decisions. Jane D'Arista has provided me with some facts useful in forming an opinion on this matter. She reports that the six largest U.S. banks have loaned in excess of 100 per cent of their equity capital to two countries, Mexico and Brazil. Furthermore, in 1975 the Comptroller of the Currency accused a leading U.S. bank of exceeding its legal lending limit of $200 million by making a loan of $400 million to the government of Italy. The Comptroller's case rested on the view that all of Italy's "legally independent" government agencies should be considered to be part of the government to which the lending limit applies, a view obviously not shared by the bank's counselors when the loans were made. In spite of the ambiguity of a legal definition of the Italian government, the facts cited raise some uncomfortable questions about the prudence of loan policies involving foreign governments.

Second, D'Arista argues that Ruckdeschel's calculation of loan-loss ratios provides an imperfect measure of prudent lending. In its place she proposes consideration of experience with nonperforming assets, that is, assets on which interest payments are in arrears or on which amortization had to be rescheduled. Using this yardstick, we find that both Citicorp and Chase Manhattan noted in their 1976 annual reports that nonperforming loans in international business (which include loans to foreign governments) were fractionally lower than in domestic business, but Citicorp also reported that nonperforming commercial and industrial loans in its international portfolio were proportionately larger than in its domestic portfolio.

Obviously, it would be impossible to establish conclusively that U.S. banks have been or are making international loans that are both profitable and prudent from the private as well as the social point of view, even if it were clear what the latter is. This same problem exists in connection with domestic loans. Multinational banks are not the only banks that have made large loans to foreigners. They are the ones, however, that are most likely to have large claims on foreigners and large obligations to foreigners. Thus, to the extent that their loans are risky, their depositors may be exposed to hazards larger than the hazards confronted by those who have deposits with domestic institutions. It is for this reason, among others, that special measures may be necessary to reduce the risks confronted by those who hold deposits with multinational banks.

As a result of experience and analysis of the negative externalities associated with bank failures, governments in all Western countries have erected two institutional safeguards for those who hold deposits with domestic banks. On the one hand, monetary policy is conducted and instruments have been designed to avoid liquidity crises, which can lead to bankruptcies when banks are forced to sell off long-term assets quickly. Ever since the Bank of England pioneered the development of the discount window in the nineteenth century, it has traditionally been the instrument for providing emergency liquidity when general policies have gone wrong. On the other hand, countries have established procedures for regulating and supervising banking procedures, most often in connection with the operation of deposit-insurance schemes. Both of these special ways of treating the banking industry are justified on the grounds that bank failures produce greater negative externalities than do the failures of firms in other sectors of the economy.

Multinational banks constitute an institutional innovation that was not foreseen by the drafters of domestic bank legislation in most countries. Yet the arguments about negative externalities arising from bank failures apply to both domestic and foreign-owned banks and operations. Furthermore, there is the additional problem that multinational banks can serve as con-

duits for the transmission of liquidity crises and bank failures from one country to another. For these reasons, it is important to understand how existing legislation treats multinational banks in those respects.

Liquidity and Discount Facilities

The branches of multinational banks typically have access to the discount windows at the central banks of their host countries, but only on loans made to domestic residents in the local currency. Such access is afforded foreign banks in the United States under the International Banking Act of 1978.[2]

However, such discounting facilities are not likely to be an important source of liquidity during a crisis, for two reasons. First, the overwhelming majority of loans made by the branches of multinational banks are in currencies other than that of the host country, and, second, these loans tend to be made in the interbank market to other foreign banks and therefore are not eligible for discounting. Mitigating the problems that might arise from this limited access to the national discount window is the efficiency of the international money market. Parent banks normally have ready access to their home-country discount window and can use the proceeds to provide liquidity to their branches and agencies abroad, while at the same time foreign-exchange markets efficiently permit the arbitrage of shortages and excess supplies of liquidity in different currencies.

Ultimately, the contribution to liquidity of borrowing at the home-country discount window is determined by the relevant central bank's willingness and legal authority to lend to the head offices of multinational banks—to advance amounts sufficiently large to counter an international crisis. In this context, H. S. Terrell in a personal letter stated:

> While from a practical standpoint most Federal Reserve discount window credit is collateralized by Government securities, in an emergency where the liquidity problems of a single bank or group of U.S. banks threatened either the domestic or the international financial system, the Federal Reserve has broad authority to advance funds. Presumably other central banks would also extend discount window credit to institutions with head offices in their countries.

Existing institutions and practices thus appear to be adequate to assure the liquidity of multinational banks over a very wide range of foreseeable circumstances. Therefore, it does not seem to be necessary or desirable to create a new and special international discount facility for multinational banks. This conclusion suggests further that it is not necessary to change the basic character of the International Monetary Fund so that it can extend credit to multinational banks. I will discuss below in some detail the actual

[2] As Hutton (1975) has argued, U.S. legislation is likely to become a model for other countries.

and potential rôle of the IMF in assuring the stability of the multinational banking system.

Measures to Reduce Bank Failures

Four types of measures are designed to reduce the incidence of bank failures: bank regulation, bank supervision, informal aid to large debtors of banks, and informal pressures on banks by the government. The following discussion deals primarily with the U.S. institutions responsible for the four types of measures, but they have counterparts in nearly all Western countries.

Bank regulation. The regulation of U.S. banks, partly through federal and partly through state legislation, consists of (a) the requirement that banks maintain minimum reserves on deposit with the central bank if they wish to be members of the Federal Reserve System; (b) rules limiting competition with other financial intermediaries while maintaining competition among banks; and (c) a number of other less important requirements, such as an upper limit on interest rates on deposits. Many of these regulations have been criticized as unnecessary, leading to inefficiencies and loss of competitiveness. Some, such as the minimum-reserve requirement, have become important tools for the execution of monetary policy.

The local branches of foreign banks in the United States were exempted from a large number of these regulations until the recent passage of the International Banking Act of 1978, and similar preferential treatment is afforded local branches of foreign banks in other parts of the world. As many analysts have argued (for references see Dean and Grubel, 1978), exemption from domestic bank regulation has provided foreign multinational banks with a competitive advantage that distorts the efficient allocation of resources. Given the social merit of domestic banking regulations, efficiency as well as equity demands that local branches of multinational banks be subjected to the same regulations. This principle underlies the U.S. International Banking Act of 1978, which has made the local branches of foreign banks in the United States subject to the same regulations as U.S. banks.

Bank supervision. At the most fundamental level, banks must be supervised in order to assure that they obey banking regulations and that criminal elements do not use banks to defraud the public. Such supervision is equivalent to surveillance by law-enforcement agencies and in principle could be carried out by such authorities without any special knowledge of banking. In most Western countries, this is indeed the practice.

In the United States, however, the supervision of banks is carried out by the Comptroller of the Currency for federally chartered banks and by the Federal Deposit Insurance Corporation for banks not members of the Federal Reserve System. The supervision covers both U.S. parents and their

subsidiaries and branches abroad. The regulatory authorities have been charged not only with assuring compliance with regulations and the absence of criminal activities, but also with the supervision of the quality of assets, internal-control mechanisms, liquidity, adequacy of capital, and the competence of management. Supervisory responsibilities in these areas are highly controversial, since they cannot be carried out with the help of objective criteria and therefore simply amount to questioning the professional judgment of bank managers and directors.

These problems of subjective judgment have manifested themselves recently in the evaluation of bank loans to foreign governments. Such loans expanded rapidly in the wake of OPEC-induced payments deficits and the infusion of OPEC-owned liquid funds into the world's financial markets. Banks proceeded with their loans on the basis of presumably prudent principles of banking (see Brittain, 1977) and the best information available to them. Then, after some time, they were faced with risk evaluations of foreign countries made by the Comptroller of the Currency by drawing on intelligence resources of many federal agencies, which are unavailable to the private sector, and by using evaluation principles that are not discussed publicly and may or may not be applicable to the conditions confronting an individual bank. As a result of these *ex post* risk evaluations of borrowers, banks can find themselves in the embarrassing and potentially commercially harmful position of having in their portfolios many loans classified officially as "risky."[3]

Another problem with the official determination of country risk in foreign loans has been the need to identify individual countries. While this takes place confidentially, in practice it seems to be inevitable that the official views become public knowledge. As a result, political complications have arisen when ambassadors and ministers of countries branded as involving high-risk investments have argued the validity of such judgments with the U.S. Department of State and other agencies.

In recognition of the difficulties associated with the application of "official" country-risk assessments by U.S. supervisory authorities, efforts are underway to develop a new supervisory approach to foreign lending. This approach is based on the semiannual country-exposure reports that U.S. banks have been required to file with the Federal Reserve System since December 1977, covering all loans made to foreigners by U.S. banks and their foreign branches and affiliates. Exposure data are compiled for each bank and consolidated with data provided by the Bank for International Settlements Semi-Annual Report of the External Positions of Commercial Banks (*IMF Survey*, Sept. 4, 1978, p. 263). With this information, the Federal Reserve

[3] See the papers and discussion of country risk in the Federal Reserve Bank of Boston Conference Proceedings (1978).

authorities and the Comptroller of the Currency can establish the magnitude and characteristics of loans to individual countries by U.S. banks. The balance of payments, debt service, and domestic conditions of these countries are surveyed continuously, and countries with potential problems are reviewed thoroughly.

> Comprehensive studies would be prepared for the examiners' use in raising questions with the bank under examination and in appraising country risk in portfolio concentrations. Drawing on this analysis of exposure levels and the assessment of country conditions, the examiner would comment on those country exposures which appeared high in relation to the bank's ability to absorb risk and to the country's condition. Certain norms would be established to guide examiners in making critical comments on high concentrations by country. There would be no hard and fast rules. . . . The objective of any critical commentary would be to encourage appropriate diversification in a bank's international lending portfolio. Diversification remains a bank's best protection against risk in an uncertain world (*Federal Reserve Bank of New York Quarterly Review*, Spring 1978, p. 5).

It remains to be seen whether this new supervisory approach to foreign lending can overcome the difficulties inherent in the old approach, since it is still necessary to pit examiners' personal judgments, usually with the benefit of hindsight, against those of the banks' managers and directors.

However controversial U.S. bank-supervision practices may be, the facts are that they exist, have a long history, and are run by a bureaucracy that has created many vested interests. Given these facts, it seems both efficient and equitable that the branches of foreign banks in the United States be made subject to the same supervision as domestic banks. This is the intention of the International Banking Act of 1978, and the arguments for and against this policy parallel those made above in connection with equality of treatment under U.S. bank regulations.

Informal aid to large debtors of banks. During the last decade, the governments of Western countries have prevented the potentially serious consequences for banks arising from the bankruptcy of large corporations or other bank borrowers. The stories of the rescue operations of the Penn Central Railroad, the Lockheed Corporation, and the New York City government in the United States, of British Leyland and U.K. shipyards in Britain, and of BMW in Germany are well known and need not be retold here.

These cases of threatened bankruptcy of large enterprises confront governments with a dilemma. On the one hand, they endanger the stability of a country's financial system and of its banks in particular. Permitting such enterprises to go bankrupt could produce large enough negative externalities to justify government aid and intervention. On the other hand, rescues set precedents that encourage other enterprises to take greater than socially optimal risks and consequently increase the number of threatened bankrupt-

cies. This phenomenon of an increased incidence of losses that are covered by government policies or insurance is known as "moral hazard." Governments have tried to reduce moral hazard by being careful not to set any formal precedents or establish any rules for access to government aid. While governments in recent years have succeeded in preventing the bankruptcy of large borrowers or have contained the consequences and the spread of economic instability, it is difficult to estimate how successful they have been in avoiding encouragement of other firms to incur greater than normal risks. Only history can tell.

National government policies designed to prevent the bankruptcy of large debtors have their analytical counterpart in international efforts to develop facilities capable of assisting national governments unable to meet foreign debt payments. While governments cannot go bankrupt in the conventional sense, they may have temporary difficulties in raising funds internally, especially in the form of foreign currency to pay creditors abroad, many of which are multinational banks. The risks of national governments defaulting on external debt payments and causing bankruptcies among multinational banks have been reduced substantially by the establishment of general and special credit facilities at the International Monetary Fund in recent years. For example, the Fund has increased its lending capabilities beyond the basic gold tranches through medium-term loans to overcome "structural balance of payments maladjustments," the "supplementary" financing facility, the "compensatory" financing facility, and the "buffer stock" financing facility (*IMF Survey*, Dec. 12, 1977, p. 382).

The Fund dispenses the resources available under these programs, typically under conditions designed to minimize the problem that moral hazard may induce increased need for such assistance. It could be argued that through these facilities the Fund has become a "lender of last resort" to governments, since it provides liquidity that is repayable and is used only to overcome temporary shortages, somewhat analogously to the operation of the central-bank discount facilities, though the latter do not typically attach conditions to their cash advances. Through these operations, the Fund makes an indirect contribution to the stability of multinational banks that is consistent with its tradition of lending only to national governments. If the Fund wanted to assume the role of a lender of last resort to multinational banks directly, fundamental changes would have to be made in its Articles of Agreement. The preceding analysis suggests that such changes are not required: national discount facilities are available to serve the liquidity needs of multinational banks indirectly through the efficient operation of financial markets, while the Fund reduces the dangers to multinational banks emanating from the illiquidity of national states that are major bank debtors.

While these measures undoubtedly have succeeded in reducing the fre-

quency of bank failures, they have not eliminated them completely. Besides a sizable number of failures of small banks annually in the United States, in recent years several large banks have failed. The Franklin National Bank and the Herstatt Bank of Germany are the best-known examples in this category. Additional measures may therefore be needed.

One proposal has been made by Xenophon Zolotas, Governor of the Bank of Greece, suggesting the establishment of an international loan-insurance program (Zolotas, 1978). Under this program, the foreign loans of all banks would be insurable under sound banking principles; national governments, private financial institutions, or international organizations would serve as the guarantors of the insurance obligations. The scheme would be self-supporting, operating in much the same manner as national export-insurance schemes, which have been functioning successfully for many years in industrial countries. As we have seen, such a program would strengthen the international financial system and thus be very much in the interest of world economic stability.

Informal pressures on banks. The financial institutions of most Western countries are subject to informal governmental controls, the more so, the more oligopolistic the industrial structure. The Bank of England and the Bank of Canada, both of which have to deal with only a few large commercial banks, are known to be able to invite the heads of these banks for informal discussions about special problems. While there are few written records of the business transacted at these meetings, it is not difficult to imagine that, under the threat of special legislation or the loss of certain privileges, the governments can exact from these banks changes in business behavior deemed to be in the national interest. Even in the United States, the Board of Governors of the Federal Reserve System issues informal directives without the force of law to influence the behavior of commercial banks.

The multinational banking industry is also stabilized by such informal controls. For example, McMahon (1978) reports that during a crisis in 1974, "the Governor of the Bank of England sought from shareholders in the consortium banks in London and from the overseas parents of banking subsidiaries in London acknowledgements that they accepted a moral responsibility for their offspring in London that went beyond the narrow limits laid down by laws of limited liability and that extended in particular to the protection of depositors with these banks." When such acknowledgments were obtained and made known to the financial community, they helped to calm the crisis, which was prompted in part by fears about the bankruptcy of Eurodollar banks as a result of the possible default of major borrowers. Other such informal agreements undoubtedly have been reached in the past but are not generally known. And they can be expected to be used in future crises to deal with situations endangering the stability of multinational banks.