Chapter 1

Financial Services and Global Markets

Overview

A global marketplace for financial services has developed. It was made possible by international telecommunications networks and liberalization or deregulation of banking and financial markets. It was made necessary by the burgeoning of world trade. Until the late 1980s, U.S. banks, enjoying the advantages of superior information technology, were eager to compete in the new global market. Now some U.S. banks are withdrawing from overseas activities, closing many or all of their overseas branches and subsidiaries. Some of this withdrawal may be temporary, and some results from rationalizing activities or accommodating changes in European laws, regulations, or business conditions (i.e., by consolidating facilities).[1] In other cases, under the pressure of strong competition from European and Japanese ''universal banks,' American banks are controlling costs and safeguarding their returns by concentrating on domestic markets. There has long been a widespread belief that international banks suffer a disadvantage in domestic markets compared with local firms that are closely identified with a single community.[2] In addition, the full internationalization of financial services is still inhibited by domestic and foreign government regulations, the high cost of international operations, and differences in business culture among nations. Technological advantages may not be sufficient to offset the caution instilled by current economic and management problems.

A few of the largest U.S. banks, however, continue to vigorously pursue European (as well as Asian and Latin American) market opportunities.[3] (See table l-l.) These banks are confident that technology gives them a competitive edge in overseas markets. A widening market may also be necessary to justify the expense of the global networks to which they are now committed. These financial institutions are currently reassessing the comparative advantages of private vs. public communications networks in light of new telecommunications technologies and services. The results are often hybrid systems, with a mix of services, providers, and managers. U.S. banks increasingly see the need for close cooperation with telecommunications providers to support their overseas activities. Cooperation is, however, complicated by increasing competition between the two industries.

Table l-l—The Ten Largest U.S. Banks
(Year-End 1991)

Bank	Total assets ($ billions)
Citibank, NA.	$216.9
Chemical Banking	138.9[a]
Bank of America, NT&SA	115.5b
Nationsbank.	110.3C
Morgan Guaranty Trust Co..	103.5
Chase Manhattan Bank, NA..	98.2
Security Pacific National Bank.	76.4
Bankers Trust Co.	64.0
Wells Fargo Bank	55.5
First Chicago Bank	49.0

[a]Combined with Manufacturers Hanover Trust Company, previously the fifth largest bank, in 1991.
[b]subsequently merged with Security Pacific National Bank, which will make it the second largest bank, with total assets of $191.9 billion.
[c]A 1991 merger of North Carolina National Bank and C&S/Sovran banks.
SOURCE: Rivka Nachoma, researcher, in the *Financial Times*, Section III, May 20, 1992. Based on company reports.

New Markets Bring New Issues

It appears that the U.S. telecommunications industry and information services industry have been generally successful in meeting the needs of financial institutions in this country. The technological and related regulatory problems on the overseas ends of networks are more troublesome, but are gradually being reduced. While U.S. banks may be at some disadvantage because of regulatory restrictions on size, geographical range, or diversity of activities, these have not been shown to be major

1 For example, Bankers Trust is closing down a large &~ processing center in Frankfort, but only because European Community directives rendered obsolete a German law requiring such data processing be done within Germany, thus making it possible to consolidate the bank's processing operations in London.

2 John Langdale, *Internationalization of Australia's Service Industries* (Canberra: Australian Department of Industry, Technology, and Commerce, April 1991),

3 This background paper was prepared as part of an assessment of ''International Telecommunications Networks and U.S.-European Trade in Services.'' It therefore focuses on U.S. banking activities in Europe.

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factors in overseas performance. The few large American banks that maintain a strong presence in Europe operate global private communications networks. They have benefited by their ability to create and supply innovative value-added services. Middle-sized and smaller banks participate less directly, generally meeting their domestic customers overseas needs through correspondent banks, through the use of shared communications networks such as SWIFT (an international electronic message system owned and operated by European and North American banks) and CHIPS (operated by the New York Clearing House). Several new or emerging technologies and services hold promise for U.S. banks deciding to compete in world markets. These include virtual private networks, integrated services digital network (ISDN), fast packet-switching technology, electronic imaging, and most important, electronic data interchange (EDI). EDI will change the way banks interact with their domestic and international customers. As described in chapter 4, in the long term EDI could threaten some of banking's core functions, but may, on the other hand, offer opportunities for banks to expand their services to multinational corporate clients. Several issues arise from expanded use of international telecommunications networks by U.S. banks:

- Increased payment risks resulting from reliance on international electronic payment and netting systems;
- Overlapping and confused regulatory jurisdictions resulting from competition between banks and telecommunications companies in delivering financial services;
- Unresolved trade issues with the European Community or other European countries;
- National laws or possible European Community Directives dealing with privacy of financial data;
- Location in countries with less regulation or taxation in order to avoid national control and obligations, or to perpetrate illegal and unethical activities;
- Increased scale and seriousness of violations of data security, systems failure, and human error resulting from the globalization and interconnection of networks; and
- The likelihood that the immense monetary value on communications networks, the speed with which it moves around the globe, and the possibly diminished role of banks may make implementing national monetary policy more difficult.

The most serious problem related to international banking is the increased payment risk on telecommunications networks used for electronic funds transfer. In shared networks, whether operated by central banks or consortia of banks, and in a growing number of offshore payments netting systems, the failure of one or more participants to settle end-of-day deficits resulting from "daylight overdrafts" could result in unacceptable demands on central banks as lenders of last resort, or in a cascade of settlement failures that would precipitate national or even international financial crises.

The technology that makes it possible for regulated U.S. banks to compete overseas is also creating direct competition with telecommunications companies that offer unregulated financial services under newly liberalized rules of market entry. (Other nonfinancial institutions also compete with banks in offering financial services; examples are retail organizations such as Sears, and manufacturers, such as General Motors, who have setup credit and financing subsidiaries.) Financial institutions, in turn, participate in a more limited way in providing telecommunications services. In the United States, some financial services may escape consumer protection and antitrust laws and other traditional oversight (i.e., financial products trading systems and shared networks); in other countries banks may be subjected to dual regulation. Policies may be needed to either: a) further deregulate the banking industry to put competitors on an even basis, or b) adopt functional regulation (i.e., regulate specific business activities instead of regulating institutions).

U.S. international banks hope that several trade issues will be resolved by a strong GATT (General Agreement on Tariffs and Trade) treaty or, if necessary through bilateral negotiations. These include: 1) cost-based tariffs and leasing rates, 2)

"Here's the story, gentlemen. Sometime last night, an eleven-year-old kid in Akron, Ohio, got into our computer and transferred all our assets to a bank in Zurich."

Photo credit: Drawing by Stevenson;@ 1983. The New Yorker Magazine, Inc.

interconnection of private networks with public networks, 3) shared use of private networks and the right to offer value-added services, 4) connection of preferred terminal and network equipment, and 5) intellectual property rights over proprietary software.

Some European data privacy laws have limited the transmission of financial data across national lines. An EC Directive proposed in 1990 would have prevented the electronic delivery of some services and forced financial institutions to maintain dispersed data processing centers rather than concentrating them, but it now appears likely that a revised proposal will not include this provision. Both American business interests and European policymakers sometimes allege that disputes over data privacy conceal struggles over other economic and sovereignty interests.

International telecommunications progressively opened world markets for financial institutions, but have also had a more immediate and darker effect on world banking, encouraging many banks to locate offices or branches "offshore" in countries where there are few or no regulations or taxes. Some of these banks allegedly engage in "money laundering" and other kinds of illicit or unethical behavior. Information technology also makes possible new types of crime that victimize banks, and subjects them to possible data loss, systems failure, and other vulnerabilities.[4]

The general movement toward deregulation of both telecommunications and financial services is

[4] A number of three were reported during the summer of 1992 in the course of investigations of the activities of BCCI. For example, a manager of a Sri Lankan branch of BCCI was said to have stolen a computer chip from a telex machine in the bank's branch in Oman and used it to transfer $10 million from three banks in the United States and Japan to his own account in Switzerland. (Sonia Purnel, "Workers Were Tbo Scared To Tell About Mafia Links," *The Daily Telegraph,* Aug. 3, 1991, p. 2.)

A new relationship between economic policy and telecommunications policy has emerged as a side effect of the reliance of international banking on global networks.

running into a growing realization that global networks move some long-recognized risks beyond the reach of traditional oversight and enforcement mechanisms. International cooperation is needed to address many of these issues. This cooperation in some cases may be handled by industries themselves, to find solutions to shared problems such as standards development, systems failure, or security risks. On the other hand, payment risk reduction, trade negotiations, and control of criminal behavior require involvement of national governments as well.

Control of money supply by national banks is a critical lever for implementing monetary policy, which in turn affects the flow of capital across national borders, currency exchange rates, trade balances, and general economic conditions. The links between the volume of bank balances, the volume of transactions supported by these balances, and the amount of money in circulation have been changed or confused by the rapidly increasing use of electronic netting and payments systems.[5] Some experts believe that the ability to develop effective monetary policy has been compromised. A new relationship between economic policy and telecommunications policy has emerged as a side effect of the reliance of international banking on global networks.

Technology and Competitiveness

International telecommunications networks provide the essential infrastructure for doing business in world markets, allowing a faster flow of funds and making possible the integration of transactions, payment, verification, settlement, recordmaking, and other functions. For banks, communications are not just a business support system but an integral part of a growing array of modem products and services. Telecommunications make it attractive to do net payment or net settlement,[6] thus reducing the high level of uncertainty about markets and about counterpart risk (i.e., the risk that the other party to a transaction will fail to pay or to deliver goods). It is widely assumed that in financial services such as securities and currency trading, international business will gravitate to the market with the most flexible and efficient information systems.[7] Payment capabilities are thus increasingly important in competition within the banking industry in the same way that reservations systems are in the airline industry. U.S. banks have based a large part of their product strategies on the capabilities of their networks. Yet it is not necessarily true that superior telecommunications systems can guarantee competitiveness in world markets. About 10 or 15 years ago, a global communications network conferred a strong competitive edge; now it is an essential. Says Robert Heller of the Federal Reserve Board of Governors:

> . . . IO]ver time, the competitive advantage of the new technology will be eroded as new techniques are generalized and applied to the mass market. Eventually the wizardry of yesterday will become the plain vanilla standardized product of tomorrow.[8]

About 5 percent of U.S. services exports are financial services, primarily commercial and investment banking.[9] The International Monetary Fund ranked the United States third among major exporting nations in total value of foreign assets held by

5 Netting systems are set up to allow each participant to make or receive one payment at the end of a specified period (usually the business day) to cover the differences between deposits and outflows during that period.

6 In financial services, there is a uniquely high volume of information flow between competitors because one transaction Often involves two Or more banks.

7 Robert R. Bruce, Jeffrey P. Cunard, and Mark D. Director, *The Telecom Mosaic: Assembling the New International Structure* (London: Butterworths, 1988), chapter It, Telecommunications and Transaction Services.

8 H. Robert Heller (Member, Board of Governors of the Federal Reserve System), "Future Directions in the Financial Services Industry—International Markets," *World of Banking,* vol. 6, May-June 1987, p. 19.

9 The United States has a positive trade balance in services. Net exports of services have risen from $8.6 billion in 1986 to $42.8 billion in 1991; however, the rate of increase is declining. The U.S. overall trade balance-all goods and services—is negative, $17.6 billion in 1991. *Economic Report of the President* transmitted to Congress February 1992, table B19, p. 319.

commercial banks in 1989.[10] The *Financial Times* reported in mid-1992 that the United States holds 66.3 percent of the world market for financial services based on fees earned by commercial and merchant banks.[11] U.S. banks may well be more successful in European markets than is generally acknowledged; the benchmarks that are used to measure success are probably inaccurate and misleading.

At the end of 1990, 126 U.S. banks (members of the Federal Reserve system) were operating overseas, through 819 branches.[12] U.S. banks control $230 billion in assets in Europe, while European banks have about $184 billion in the United States.[13] These figures may however understate the presence of U.S. banks overseas, since many governments do not permit foreign 'branches' but do permit subsidiaries, representative offices, affiliates, etc.[14] It is generally assumed that financial services are best delivered through direct interaction between provider and consumer, and that therefore international activity requires a bank to establish a physical presence in foreign countries (direct investment). This is probably less true of wholesale services—i.e., cash management, electronic data interchange, foreign exchange and currency trading-than it is of retail services. However, foreign establishment is still generally the rule. Sales that a financial institution makes through a foreign affiliate do not constitute international trade, although revenue returned to the parent firm will show up in national accounts, and will certainly affect the strength and competitiveness of the parent bank. This is another factor making it difficult to talk with precision about competitiveness in international trade in financial services.

U.S. banks have excellent technology for overseas competition, but suffer some nontechnological handicaps.

Financial institutions are among the heaviest users of international communications networks, both to deliver overseas services directly and to communicate with subsidiaries. United States banks have excellent technology for overseas competition, but suffer some nontechnological handicaps. They tend, for example, to be smaller and less diversified than foreign competitors. The largest 10 U.S. banks in terms of assets rank from number 26 to 119 in a list of the world's largest banks.[15] U.S. banks have been kept relatively small by laws restricting interstate banking and preventing banks from engaging in activities such as insurance and securities brokerage. These and other regulations were aimed at preventing monopolistic aggregation of financial capital and power.

According to a member of the Federal Reserve Board of Governors:

> The United States is perhaps the only nation in the world that does not have an integrated national

10 This is in fact a poor measure of trade because it uses the value of outstanding loans as a proxy for the value of services provided to foreign borrowers, neglecting revenues from fees and commissions for other services provided overseas. It merely gives some rough indication of market share. It is notoriously difficult to define or measure trade in financial services. Financial institutions are intermediaries. For purposes of figuring gross domestic product, gross national product, and current national accounts, services produced by financial institutions for businesses (which includes most services offered in international markets) are considered to be embedded in the value of other goods and services rather than being treated separately. For this and other reasons, national account statistics probably give a distorted and understated picture of financial services exports and imports.

11 "U.K. Financial Service Hold 17 percent of Market," *Financial Times,* Aug. 25, 1992, p. 6. According to the article, Japanese firms are third with 5.1 percent, followed by France (4.2 percent), Canada (3.2 percent), and Switzerland (2.1 percent).

12 *Industrial Outlook,* 1992. This was a decline from 916 branches in 1985. The other side of this picture is the operation of foreign banks within the United States. This country has one of the most open and competitive markets for financial services. There were 727 foreign bank offices in the United States (at the beginning of 1991). Their assets have risen from $198 billion in 1980 to $787 billion in 1991 (constant dollars). Foreign banks (most of them from Japan, Canada, France, and the United Kingdom) hold nearly 23 percent of total bank assets in this country and make nearly a third of all commercial and industrial loans made by banks.

13 The story is different with Japan. While U.S. banks hold only 1 percent of total bank assets in Japan (and all foreign banks together only 3 percent), Japanese banks control 15 percent of bank assets in the United States and this is projected to rise to 25 percent by the end of the decade. Senator Donald W. Riegle, Jr., chairman of the Senate Committee on Banking, fears that this may give the Japanese some control over which U.S. industries get credit and are able to grow. See "Fair Trade in Financial Services Act," Hearing before the Subcommittee on Trade of the House Committee on Ways and Means, House of Representatives, 102 Cong., lst Sess., July 29, 1991, Serial 102-60.

14 For example, Citicorp alone has over 2,000 overseas offices, consisting of 303 branches, 8 representative offices, 643 banking subsidiaries, 116 banking affiiates, 837 other financial subsidiaries, and 146 other financial affiliates. (Information supplied by Citicorp/Citibank Director of International Government Relations to OTA, July 31, 1991.)

15 List compiled by *American Banker,* Sept. 12, 1991. Of the 25 largest banks, 16 were Japanese, 5 French, 2 British, 1 German, and 1 Swiss.

banking system. Clearly, this has a major impact on the ability of American banks to compete abroad and on their capacity to serve domestic customers active in international trade and finance.[16]

The Edge Act (1929) allows national banks to conduct foreign lending operations only through Federal or State chartered subsidiaries. These Edge Act corporations, unlike domestic banks, can own banks in foreign countries. Only very large banks tend to have Edge Act subsidiaries that can provide international services. This factor should not be overstated, however. While a bank must be fairly large to sustain overseas activities, it is not clear that greater size and diversity would guarantee successful international operations.

Traditionally, banks moved to the international arena primarily to follow their big customers overseas[17]—i.e., to serve American companies that have become multinational corporations-although they may then compete with foreign banks in their own markets. U.S. international banks lack the close corporate ties enjoyed by Japanese and German banks. By contrast, U.S. corporations are increasingly bypassing banks, raising their own capital through commercial paper.[18]

U.S. banks have also been hurt in recent years by the weakening economy, the large trade deficit, the low savings rate, losses on developing countries' debt and on commercial real estate, and a migration of retail deposits to nonbank competitors such as mutual funds. The Federal Deposit Insurance Corporation Improvement Act of 1991 (Public Law 102-242) may further inhibit international banking because it requires U.S. banks to increase capital reserves and foreign banks to undergo more stringent supervision. In the long run, however, with higher levels of capital U.S. banks maybe better able to compete in the global economy .19

There are now probably no more than a dozen American banks with ''abroadly-ba.sed, truly global presence,' according to the American Bankers Association. The number of U.S. banks with foreign branches has fallen in the last 5 years, and the U.S. share of international markets has fallen. In spite of superior information technology that should be a strong advantage in international banking, Chemical Bank, the Bank of America, and Chase Manhattan Bank, among others, have shrunk their overseas activities.

In some cases this withdrawal may be reversed when economic conditions imp-rove and the current restructuring of the banking industry through mergers and bank failures is over.[20] For example, Chemical Bank reduced its substantial overseas holdings to three European and three Japanese locations in order to buy banks in Texas and New Jersey. Then in 1991 it took over Manufacturers Hanover Trust Company, the fifth largest bank in the United States in 1991. Manufacturers Hanover Trust was operating in 30 countries, and chemical Bank reportedly intends to continue most of those activities. Officers say it has the capital strength to again emphasize international as well as domestic services. The ***Industrial Outlook*** of the U.S. Department of Commerce projects stable and sustainable economic growth in overseas banking in 1992.[21]

16 Heller, op. cit., footnote *8*, p. 21.

17 Walter W. Eubanks et al., *U.S. Banks in the Global Economy: Effects of Capital, Tax, and Regulatory Requirements,* Congressional Research *Service* Report for Congress, 90-293 E, June 12, 1990; see also John Langdale, op. cit., footnote 2.

18 U.S. banks are suffering from changing interest rate structures and competition from nonfinancial institutions that operate money market funds or make 10ans—such as automobile manufacturers that set up credit operations. For some years there has been a strong trend to disintermediation-i.e., direct transactions between lenders and borrowers, with banks becoming less the intermediary and more often the broker, advisor, or guarantor of direct transactions.

19 Walter W. Eubanks, ''Banking Reform and International Banking, " Congressional Research Service Report for Congress 91-197 E, Feb. 20, 1992.

20 It is expected by many experts that the number of U.S. banks (12,800 individual banks, or 9,500 independent banks and bank holding companies) will drop by about 25 percent by 2000, as a result of mergers, acquisitions, and bank failures. There may be, by 2000,7 to 10 very large banks with $100 billion or more in assets. These projections are from a survey conducted by the Bank Administration Institute aiAndersen Consulting Co., reported in Keith Stock, "The Banking Industry of the Future, "*The Planning Forum Network,* May 1992, vol. 5, No. 5.

21 *Industrial Outlook,* '92, chapter 46, pp. 3-4.