Regional Banks and International Banking

By Richard K Abrams

Before 1960, most domestic banks were almost solely concerned with developments within their region. In the last 20 years, however, the perspective of U.S. bankers has broadened as they have become aware of many profitable opportunities outside the United States. While most public attention has been directed toward the international banking activities of the major money center banks, many subtler but highly significant changes have involved the smaller regional banks. This paper deals with the role of smaller regional banks in international banking.[1]

[1] In this paper, international banking is defined as any bank-related activity in which one or more of the transactors is located outside the United States. In the area of international banking, a small bank can be defined as having domestic assets in the range of $500 million to $1 billion. A regional bank is a bank located outside of the nation's money centers. New York City, Chicago, and San Francisco are considered money centers.

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Consideration is given to areas where regional banks have and have not been successful, as well as to the special problems they have faced while pursuing international business. Organizationally, the paper examines the growth of international banking, the range of activities of internationally oriented banks, the methods of expanding into international banking, and the special problems a bank, especially a regional one, faces when transacting international business.

THE GROWTH OF INTERNATIONAL BANKING

Before 1960, international banking was almost solely the realm of the large money center banks, with seven U.S. banks controlling all 132 American foreign branch banks. U.S. international banking expanded moderately in the early 1960s, and by 1964, 11 U.S. banks operated a total of 180 foreign branches. Beginning about 1964, the United States saw a massive movement toward the internationalization of its banking system. By the time the boom in foreign branching abated in 1974, 125 U.S. banks were operating a total of 732 foreign branches.

Since 1974, the growth in direct foreign branching activities of U.S. banks has slowed markedly, and, by the end of 1979, a total of 130 banks were operating just under 800 foreign branches. However, the slower expansion rate of foreign branches has not been fully matched by a slowing of the expansion of U.S. bank holdings of foreign assets. While foreign assets held by U.S. banks increased at nearly a 50 per cent annual rate between 1971 and 1974, their rate of expansion slowed to only 29 per cent during the 1974-79 period. At the end of 1979, the foreign assets of U.S. banks totaled over $364 billion.

The reasons given for the growth in international banking are straightforward. Banks usually have expanded international operations to either expand, protect, or stabilize their expected flows of future earnings. Beyond this point, however, the specific reasons vary markedly.

Many banks expand internationally because they feel their special expertise gives them a comparative advantage in a certain area. For example, some bankers believe the additional cost of handling a given domestic customer's banking needs abroad may be low because of prior knowledge of his prospective needs. Some bankers also feel that their special knowledge of certain types of projects, products, or business procedures will make them effective international competitors. Other banks have expanded their international operations to take advantage of the expansion of U.S. international trade or to get a foothold in foreign loan or deposit markets.

Smaller banks often feel they are forced to expand internationally to defend their domestic customer base. This occurs because money center banks, larger regional banks, and even some local banks are using their international services as a basis for attracting the bank's better customers. In other cases, a bank finds it must provide for an existing customer's newly developed international needs in order to protect its relationship.

Some banks also begin or expand their international operations for reason of portfolio diversification. Diversification can take place because loan demand and loan default patterns may be markedly different abroad than at home. With an internationally diversified customer base and loan portfolio, a bank may not only improve its expected return on assets, but also reduce the variability of its income stream.

Finally, government regulations have probably had a major impact on the extent of many banks' international involvements. Two prime examples of this regulatory effect were seen when capital controls were instituted by the U.S. government in 1964 and when Regulation Q became binding during the tight money periods of 1966 and 1969-70.[2]

In an attempt to alleviate the U.S. balance of payments problems in the 1964-65 period, the U.S. government instituted several capital control programs which lasted through the beginning of 1974. These programs limited the funds U.S. corporations could transfer to foreign overseas affiliates, restricted the earnings the affiliates could retain for reinvestment, taxed earnings on foreign securities issued in the United States, and place ceilings on the foreign lending of the U.S. offices of U.S. banks.[3] As a result of these programs, not only were corporations limited in their ability to directly fund their foreign operations, but U.S. banks were unable to fully fund their customers' foreign activities. Some U.S. banks had to expand their operations abroad or face losing their customers to other banks capable of satisfying their customers' international needs.

Before June 1970, the Federal Reserve System's Regulation Q placed ceilings on the

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2 For a more complete discussion of these events, see A. B. Frankel, "International Banking: Part I," *Business Conditions,* Federal Reserve Bank of Chicago, January 1975, pp. 3-9, and R. K. Abrams, "The Role of Regional Banks in International Banking," working paper, Federal Reserve Bank of Kansas City, forthcoming.

3 These programs were the Foreign Direct Investment Program (FDIP), the Interest Equalization Tax (IET), and the Voluntary Foreign Credit Restraint Program (VCFR).

rates of interest banks could pay on their large certificates of deposit (CD's). In 1966 and again in 1969-70, a strong domestic economy, coupled with a tight monetary policy, increased the interest rates on alternative short-term investments above the Regulation Q ceiling. To defend against outflows of their large deposits, many banks opened foreign branches which could offer Eurodollar time deposits and Eurodollar CD's at rates competitive with domestic alternative instruments.

ACTIVITIES IN INTERNATIONAL BANKING

Banks engaging in international banking have the ability to handle documentary drafts, foreign collections, and remittances. Beyond these basic services, a bank may offer a limited or a wide range of services depending on its international commitment. Some banks find foreign exchange (FOREX) a profitable service to offer. As a bank becomes more involved with international trade, it often issues letters of credit (LC's) and may then begin to sell bankers' acceptances (BA's). Banks with significant international commitments may also enter the Eurocurrency market as well as offering other foreign banking services.

Foreign Exchange

FOREX services are usually necessary for a bank with significant international dealings. The largest international banks often have dealers who specialize in specific currencies or groups of currencies. These dealers hold open positions in foreign currencies and offer a wide range of forward commitments. If a bank holds foreign exchange or a forward contract to accept or deliver foreign exchange without a contract to offset this position, the bank is defined as holding an open foreign exchange position. With an open position a bank may receive foreign exchange profits if the currency in which it is long (short) appreciates (depreciates). However, such positions are risky since losses will be incurred if the currency moves in the wrong direction. To offset these risks, many banks immediately cover their open positions by selling contracts.

The regional banks vary markedly in the extent of their FOREX commitments. Some larger regional banks have relatively small FOREX departments which do not hold open positions and offer only a limited range of forward contracts. On the other hand, some smaller banks have active FOREX sections that maintain open positions and offer a wide range of forward contracts. Apparently, the quality of a bank's chief trader and management's attitudes toward FOREX may be more important in deciding a bank's commitment than the overall international orientation of the bank.

Letters of Credit

Most banks' international involvement begins with trade finance. Generally, this starts by issuing LC's. LC's may be issued for imports, exports, or third-country transactions —that is, for goods stored overseas or shipped between two foreign nations, or for standby credit.[4] Letters of credit expedite trade by allowing the bank to substitute its credit worthiness for the unknown credit worthiness of the buyer.

The LC business has historically been dominated by the nation's largest banks. In recent years, however, many regional banks with a billion dollars or less in assets have profitably entered the LC market. The smaller banks give two reasons for their success. First, many companies avoid the large money center banks because these banks are slow and impersonal.

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[4] Nationally chartered banks are sometimes hesitant to issue standby LC's because these credits count against their customer lending limits.

Second, U.S. trade has increasingly involved smaller importers and exporters who need more physically convenient and personalized services than the large money center banks normally provide.

Bankers' Acceptances

An area that has grown rapidly in recent years is acceptance financing. BA's are created from time drafts which are generally created to finance the movement of goods.[5] When the bank on whom the draft is drawn receives it, the bank signs it and marks it "accepted," and the draft becomes a BA. By accepting the draft, the bank lends its name and credit standing to the borrower and assumes responsibility for payment of the draft. A bank issuing BA's earns a fee for its services by buying the draft at a discount from its value at maturity.

Bankers' acceptances are attractive sources of funds to large banks whose names are recognized in the secondary BA market. These banks often immediately resell their paper at competitive rates and collect their fees as profit. However, a bank can only have outstanding BA's amounting to 50 per cent of its capital and surplus, or 100 per cent with permission from the Board of Governors of the Federal Reserve System. With the rise in the use of BA's, many banks have found these limits to be a constraint.

Larger regional banks with well developed correspondent networks often receive favorable rates when selling their BA's. However, until a bank can sell its BA's on the secondary market at a rate approaching that of the large money center banks, it cannot be fully competitive. This usually takes a period of exposure in the market, as well as a concerted effort to regularly resell some BA's in the market even when terms are not favorable. Smaller regional banks thus have difficulty marketing BA's. A smaller bank's name will usually command little respect in the secondary market, and its lending limits may force its notes to be too small for this wholesale market.

In 1960, only about $1 billion in BA's were outstanding, while in June 1980 there were about $54 billion. Although the large New York and West Coast banks dominate the BA market, banks in secondary money centers, such as Chicago, and regional banks are expanding their market share. Between 1969 and 1979, the New York Federal Reserve District share of the market declined from 67.9 to 51.5 per cent, while San Francisco's grew from 20.0 to 26.1 per cent, and Chicago's grew from 3.5 to 7.8 per cent. More interestingly, the other Districts' shares grew from 8.5 to 14.6 per cent (Table 1).

Eurocurrency Market

The area of international banking that probably receives the most attention is the Eurocurrency market. This market consists of a network of banks that issue and accept deposits in currencies other than those of the country in which the bank is located. The market is almost strictly wholesale in nature, and it is almost totally exempt from national regulation. The Eurocurrency market has grown rapidly since its inception in the late 1950s. The gross size of the market has increased tenfold from $115 billion in 1970 to $1,155 billion at the end of 1979.[6]

Many customers prefer to have their deposits in the Eurocurrency market. Some governments, while desiring accounts denominated in "hard" western currencies, wish to avoid the

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[5] For a discussion of bankers' acceptances, including eligibility requirements, see J. L. Harvey, "Bankers' Acceptances," *Business Conditions*, Federal Reserve Bank of Chicago, May 1976, pp. 3-11.

[6] Morgan Guaranty Trust Company of New York, *World Financial Markets*, various issues.

possibility of foreign government seizure of their accounts in the event of international hostilities. The Eurocurrency market allows them to hold hard currency accounts in countries where seizure is unlikely. Also, many companies find it convenient to keep foreign currency deposits for trade payments. Finally, the Eurocurrency market allows companies to hold time deposits with maturities of less than 30 days, which is prohibited in the United States by Regulation Q.

A bank will sometimes have no immediate use for an incoming Eurocurrency deposit. In such cases, the bank may lend the deposit in the interbank market. In this intensely competitive market, the spread between bid and asked rates on deposits rarely exceeds 1/8 of 1 per cent. Banks in this market operate on a name basis, and since the loans are unsecured, they generally have credit limits for other bank participants.

Although Eurodollar rates are generally above similar U.S. deposit rates, many banks still find them a convenient source of funds. Some banks experiencing strong growth view this market as an easy, reliable way to obtain needed funds. Other banks find the market to be the most reliable source and the easiest way to fund any Eurocurrency loans or syndication participations they may engage in. Most Eurocurrency loans and syndications have floating rates which are reset regularly at the London Interbank Offer Rate (LIBOR) on three- or six-month deposits, plus a fixed spread. By borrowing the appropriate deposit at the time the loan is being repriced, the bank locks in its spread. The smaller regional banks generally pay slightly higher rates on their deposits than the major money center banks.

Regional bank activity in direct Eurocurrency loans, as well as syndications, has been

Table 1
BANKERS' ACCEPTANCES OUTSTANDING BY FEDERAL RESERVE DISTRICT
(In billions of dollars)

	New York		San Francisco		Chicago		Other Districts		
Yearend	Outstanding	Per Cent of Total	Outstanding	Per Cent of Total	Outstanding	Per Cent of Total	Outstanding	Per Cent of Total	Total Outstanding
1969	3.7	67.9	1.1	20.0	0.2	3.5	0.5	8.5	5.5
1971	5.0	63.6	1.7	21.5	0.5	6.0	0.7	8.9	7.9
1973	5.2	58.4	2.5	28.3	0.3	3.3	0.9	10.3	8.9
1975	10.4	55.7	5.3	28.2	0.8	4.5	2.2	11.6	18.7
1977	14.2	55.9	6.5	25.7	1.6	6.2	3.1	12.2	25.4
1979	23.3	51.5	11.8	26.1	3.5	7.8	6.6	14.6	45.3
Annual Growth Rate									
1969-78	18.4		23.8		29.3		26.5		21.2
1969-75	17.3		26.2		24.8		25.7		20.6
1975-79	20.1		20.1		40.0		27.8		22.1

SOURCE: Federal Reserve Bank of New York.

limited. Many regionals report they have withdrawn or reduced their activities in this area in recent years. Some now require that the loan be directly related to trade with their local marketing area before they will make the loan. Others will make foreign loans only to companies or foreign governments with whom they have had extensive dealings.

Regional banks have difficulties assuming either lead manager or co-manager status on syndicated Eurocurrency loans of any significant size. This problem not only results from lack of size and recognition in the market, but because the competition in syndicate management is intense and many large banks have a large amount of resources devoted to this area.

The reason most regionals have partly or completely withdrawn from buying participations in syndications is that competition has narrowed the spreads on these loans to below 1 per cent in most cases. Most regional banks believe current spreads do not cover the risk and cost of the loan. Some still buy a few participations when the loan involves a good, or potentially good, well-known customer in a country where the bank is not approaching its lending limit. However, most regional banks feel the goodwill gained from participations is minor compared to the risks.

ORGANIZATIONAL APPROACHES TO INTERNATIONAL BANKING

A bank's size and location often dictate its range of organizational approaches to international banking. By the same token, a bank choice of organizational approaches will largely determine the range of services the bank may provide and its flexibility in pursuing international business.[7]

[7] For a discussion of the organizational alternatives available, see F. A. Lees, *International Banking and Finance*, New York: Wiley & Sons, 1973.

If a bank foresees potential profits from international activities, its first step is to open an international department. Only in this way can the bank offer the services necessary to attract customers with significant international activities. When a bank considers expanding its international activities beyond its head office, it is faced with a myriad of choices. The bank must first decide whether to open a domestic international office, an Edge Act or Agreement Corporation, or to go abroad. If the bank chooses to open a foreign office, it may do so in a modest way by opening a shell branch or a representative office, or it may choose to have a greater foreign presence by opening a branch office or joining with other banks in forming a consortium bank. A bank may also buy shares of an existing foreign bank or other financial institution.

International Department

Depending on the size, location, and managerial orientation of the bank, an international department can vary in size from a few people, providing only basic international services, to a major division of the bank which can provide for virtually any of its customers' foreseeable needs.

International departments at regional banks usually range from 4 to 25 people. Smaller departments tend to specialize in basic services, while offering little or no FOREX service. Usually trade finance is limited to the issuance of LC's. Larger departments usually offer FOREX services and BA's. As the department starts to grow, marketing becomes important, as does the establishment of close foreign correspondent relationships. Without correspondents, a bank cannot provide direct service to all parts of the globe. Many banks have several hundred foreign correspondents. An expanding international department generally uses calling officers to broaden and cement its foreign relationships. Foreign banks, rather than foreign corporations, are usually emphasized when calling, because banks generally provide more business. Most regionals try to send referrals to foreign correspondents over domestic ones because a foreign bank is more likely to reciprocate.

International departments do have drawbacks. They are a drain on manpower, and hiring trained personnel is often both difficult and expensive. The market is also competitive. Even if a local market is potentially profitable, it may take some time for the department to become profitable.

Edge Act and Agreement Corporations

Edge Act and Agreement Corporations are international banking organizations that may be located outside of a bank's home state. There are three major differences between Edge Act and Agreement Corporations. First, Edges are chartered by the Federal Reserve System and not subject to state corporate and banking laws, while Agreements are chartered under state laws. Second, Edges must be capitalized to a minimum of $2 million, which may not constitute more than 10 per cent of the parent's capital and surplus. Agreements have no such restrictions. Third, Edges may engage in both international banking and other foreign financial operations, while Agreements can only engage in international banking. Both can engage only in domestic business that is incidental to international trade. In recent years, Edges have been far more popular than Agreements.

The number of Edges expanded rapidly throughout the 1960s and early 1970s. Between 1960 and 1974, their number increased from 15 to 117, while their assets expanded from $0.6 billion to $10.1 billion. This growth occurred largely because these banks could open operations in money market or international trade centers. This allowed local customers to carry out their international trade with their local bank but in a more convenient location for conducting international business.

While Edge Act Corporations offer a bank a number of advantages, few regional banks have chosen to open one. Nationally, only three banks with less than $1 billion in total assets have opened Edges (Table 2). Edges are generally owned by multibillion dollar banks located in major port cities or in a major money center. In fact, each of the 14 banks with assets of over $10 billion had at least one Edge Act. The median total domestic assets of the 71 banks with Edge Act or Agreement Corporations were $2.9 billion, and the average share of total assets coming from foreign sources was 16 per cent.

Apparently, regional banks below the multibillion dollar asset range have avoided Edges because of their one severe drawback —expense. Edges must have at least $2 million in capitalization, and they must also be staffed with a full complement of calling officers and operations personnel. The high cost of trained personnel, coupled with the high cost of real estate, requires a large volume of international

Table 2
EDGE ACT CORPORATIONS AND BANK SIZE
December 31, 1979

Total Domestic Assets ($ Bil.)	No. of Banks	Per Cent of Banks with Edge Acts	No. of Edges
0.3-1.0	3	0.7	3
1.0-1.999	5	4.2	5
2.0-2.999	25	62.5	28
3.0-9.999	24	58.6	35
Over 10.0	14	100.0	60
All Banks	71	0.5	131

SOURCE: Board of Governors of the Federal Reserve System, unpublished data.

business for profitability. Only the largest inland regionals, with major wholesale banking operations, normally consider such an expansion worthwhile.

Shell Branches and Representative Offices

Some banks desire banking or quasi-banking operations abroad. The most basic types of such foreign entities are shell branches and representative offices. A shell branch is the easiest and cheapest way to gain access to the Eurocurrency market either for domestic funding or for a reserve-free location from which to issue foreign loans. Shells are booking offices located abroad which have no contact with their local market. The shell's actual banking activities take place at the U.S. head office. Most were originally located in the Bahamas because it offered a stable government and did not tax the income of the shells. Recently, most shells have been opened in the Grand Cayman Islands for the same reasons.

Shells have proven to be popular with large money center and regional banks alike. In 1979, of the 139 U.S. member banks with overseas offices, 84 had only a shell branch in the Caribbean. Further, many regional banks operate shells. In 1979, for example, 29 banks with less than $1 billion in domestic assets operated shells, while half of the 153 shells were owned by banks of less than $2 billion (Table 3).

Some banks have widespread dealings in specific global regions, but the potential business volume is too small to warrant a major investment or the country prohibits direct foreign bank entry. In either case, the bank might respond by opening a representative office. Representative offices are foreign loan production offices. They usually have a very small staff which searches out local business and handles local problems involving ongoing business. They cannot provide a full range of services or accept deposits. In areas where rents are not high, representative offices are a relatively inexpensive way to establish a local presence.

Full-Service Foreign Branches

A full-service foreign branch offers numerous advantages to a bank desiring a direct foreign banking presence. It is a legal extension of the bank and does not require separate capitalization. Since a branch is an integral part of the bank, it has the same status in the international market as the bank of which it is a part. It is also the most flexible foreign banking vehicle available to a U.S. bank.

A foreign branch gives its domestic head office several competitive advantages in the foreign market. First, the branch may be well located to gather new business and reestablish old relationships by offering local customers abroad a service facility backed by the head office's name. Second, it can be used to gather foreign credit information. Third, the head office and the branch can easily and quickly transfer funds between each other when either's loan or deposit conditions change.

Table 3
SHELLS AND BANK SIZE
December 31, 1979

Total Domestic Assets ($ Bil.)	Number of Banks with Shells	Per Cent of Banks in Size Category
0.1-0.999	29	7.5
1.0-1.999	49	41.2
2.0-2.999	25	62.5
3.0-4.999	24	85.7
5.0-9.999	14	100.0
Over 10.0	12	85.7
All Banks	153	1.0

SOURCE: Board of Governors of the Federal Reserve System, unpublished data.

While a foreign branch offers many advantages, it has a number of problems and restrictions. The largest drawback is the expense. A foreign branch can be prohibitively expensive. Not only is office space often a major expense, but providing staff is also a problem. A foreign branch can either be staffed with the parent's own personnel, which is expensive and a drain on home office manpower, or it can bear the expense and the risk of bidding personnel away from other banks in the area. Higher level international banking personnel are usually quite expensive. A new foreign branch may also have difficulties establishing a domestic deposit base, and its income is often heavily taxed. U.S. regulations prohibit branches from undertaking operations prohibited for its parent. Most foreign branches are also limited to wholesale banking activities either by law or by business conditions.

The locational choice of branches is restricted by national laws. Many nations, including Canada, Mexico, Australia, India, Saudi Arabia, and Brazil, expressly forbid new foreign commercial banking branches. In some other countries the risk of expropriation is simply too great to warrant the risk.

Most regional banks have chosen to avoid or to strictly limit their foreign branching. Few have more than a branch in London. The reasons for such limited activities are rather simple. First, the expense and the customer base necessary for profitable operation generally limit foreign branching to only the largest banks (Table 4). Second, the competition in most foreign money centers is quite intense, and only the largest regionals can afford to offer a package of services that will compete with branches of the large money center banks. Third, many good domestic customers prefer to carry on their foreign business with branches of better-known banks. Some regionals, however, by offering specialized packages of services or specializing in particular types of lending activities, have been able to establish successful and profitable foreign branches.

Table 4
FOREIGN BRANCHES AND BANK SIZE*
December 31, 1979

Total Domestic Assets ($ Bil.)	No. of Banks	Per Cent of Banks with Foreign Branches	No. of Branches
1.0-1.999	4	3.4	4
2.0-2.999	5	12.5	5
3.0-4.999	11	20.4	19
5.0-9.999	12	92.3	66
Over 10.0	14	100.0	501
All Banks	46	0.3	595

*Does not include shell branches or branches in U.S. territories and possessions.
SOURCE: Board of Governors of the Federal Reserve System, unpublished data.

Foreign Equity Investments

Some banks and holding companies want a foreign presence but because of foreign laws, country risk, or expense do not want to open a foreign branch. In this case, they may buy stock in a foreign bank or other type of financial institution. The purchase can constitute either majority ownership, in the form of subsidiary, or minority ownership, as an affiliate. In recent years, foreign purchases have included not only commercial banks, but also finance companies, factoring and leasing organizations, computer service companies, and merchant banks.

Foreign subsidiaries and affiliates are permitted to engage in activities that may be prohibited for the parent bank, such as security underwriting. By buying a share of an existing company, a bank also has an immediate entry into the foreign market, with an existing staff and customer base. Stock ownership in an existing company can sometimes provide favorable tax treatment or minimize the potential risk of nationalization. However, some countries permit only minority ownership of domestic financial institutions.

Equity purchases of foreign financial institutions also have certain drawbacks. The most important is that affiliates and subsidiaries are less operationally flexible than foreign branches. Difficulties are often experienced when trying to instill U.S. banking standards in the existing staff of a foreign country. If the company is an affiliate, the U.S. parent may also not get as much potential referral business or have as complete managerial control as it would if the institution were a fully owned subsidiary.

Regional bank stock purchases of foreign companies have been limited. Virtually all U.S. banks with foreign subsidiaries are located in New York, Chicago, San Francisco, or Boston. Only the very largest banks normally engage in such purchases. Fourteen of the 20 banks with foreign subsidiaries have over $3 billion in domestic assets, and 159 of the 183 subsidiaries are controlled by banks with more than $10 billion in domestic assets.

In the last 15 years, many banks have invested in consortium banks. Consortia are made up of groups of very large banks representing various nationalities. These groups generally pool resources and try to work as a worldwide network. The advantage of consortia is that they allow members to pool risk and handle large multicurrency lending arrangements and large Eurocurrency loans. Such activities are generally best suited for the world's largest international banks.

SPECIAL PROBLEMS IN INTERNATIONAL BANKING

The problems encountered by regional banks in international banking result from their limited size, their disadvantageous location, their limited resources, competition, and the problem of convincing the market that the bank is a viable provider of international services. However, the problems of regional as well as money center banks do not end here. All banks also face problems with foreign lending risks.

Engaging in business with foreign customers and making loans in foreign countries involve several types of risk not present in domestic banking activities, including evaluating foreign credit risk, foreign exchange exposure, and country risk. Credit analysis of foreign companies is often more difficult than for domestic corporations. Adequate credit information may be difficult or impossible to obtain. While foreign correspondents and foreign branches may help ameliorate this problem, credit information that would be considered complete by U.S. standards may simply be unavailable.

If a bank makes loans or accepts deposits denominated in foreign currencies, the bank also faces the risk of losses resulting from exchange rate variation. If the bank feels this risk is unacceptable, it must cover its exposed foreign exchange position. This may be done by buying a forward foreign exchange contract or foreign currency-denominated deposit, or by issuing a foreign currency-denominated loan to offset the open position. Inadequate management of open foreign exchange positions may pose a grave risk to the solvency of a bank.

Country Risk

In recent years, no area of foreign lending has received more attention than country risk. Country risk is the possibility that political or economic conditions in a foreign country could interfere with or interrupt the servicing of external debt by either public or private borrowers.[8]

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[8] For a more complete discussion, see P. H. Kuwayama (Federal Reserve Bank of New York), "Analyzing 'Country Risk' of Banks' International Lending," presented at the 10th meeting of Central Bank Technicians of the American Continent, San Jose, Costa Rica, November 25-30, 1979.

One recent study showed that, as of September 1979, U.S. bank claims on nonoil-developing countries and Eastern European Bloc countries totaled $62.7 billion.[9] This exposure constituted 117 per cent of the combined capital of the 128 banks completing the Country Exposure Report. Further, the debt service costs for the nonoil-developing countries at the end of 1979 had reached a total of $33 billion annually, or over 17 per cent of their export income.

The analysis of country risk is at best an inexact science. Current information on many countries' economic conditions is difficult or impossible to obtain. Moreover, the study of political risk is often tantamount to gazing into a crystal ball. Not only must a bank judge whether a country's current political situation may infringe on its debt service, but also make judgments as to what a country's political future may be. Also to be judged is whether a country will continue to make payments in the event of defaults elsewhere.

While the analysis of country risk may be difficult for a large bank, the task may seem insurmountable to a regional bank. At best, a smaller regional bank may be able to devote one or two people to the study of risk in a limited number of countries. As a result, many regional and larger banks curtail the number of countries in which they will make loans.

Several organizations exist that insure exporters against foreign lending risk and country risk. These organizations include both public and private corporations which issue insurance for U.S. exports. The largest insurers of U.S. exports are the Federal Credit Insurance Association (FCIA) and the Export-Import (EXIM) Bank.

The FCIA is a privately owned export insurance company. It specializes in insuring exporters against foreign credit and country risk for periods of up to five years. While much of the FCIA's work is done directly with exporters, the FCIA also cooperates directly with banks, helping them obtain coverage for their customers. Banks are usually willing to provide low-cost international credit to FCIA-insured shipments.

The EXIM Bank generally specializes in large and longer term transactions, especially those involving capital goods, but does not engage in transactions involving periods of less than six months. Its medium-term operations, ranging from six months to five years, often involve assisting the FCIA by providing its customers coverage against country risk. The EXIM Bank concentrates on financing and providing guarantees for long-term commitments. Many banks have found EXIM guarantees helpful because they minimize both foreign credit and country risk.

While only about half the regional banks with international departments make use of FCIA or EXIM, most banks find these facilities to be helpful. However, complaints have been voiced that the EXIM Bank has acted as a competitor and usurped bank business in some cases. This complaint is rather uncommon, and more bankers seem to believe their biggest problem in this area is the limited level of official funding the facility has received in recent years.

CONCLUSION

The activities of regional banks in the area of international banking have expanded markedly in the last two decades. Numerous banks which once had little interest in developments beyond their states' boundaries now have shell branches in the Caribbean and calling officers traveling worldwide. Some also have Edges in domestic money market and trade centers, operate branches or representative offices in far-flung corners of the globe, and own shares

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[9] H. C. Wallich, statement to Subcommittee on International Trade, Investment, and Monetary Policy, Committee on Banking, Finance, and Urban Affairs, U.S. House of Represenatives, April 1980.

in various types of foreign banks and other financial institutions.

However, this study of regional banks shows their internationalization generally to be more modest in nature. Only the largest and best located regionals have opened foreign branches or Edge Acts, and many of those have chosen to specialize in a limited set of services, rather than trying to compete directly with the larger banks. Almost no regionals have bought majority interests in foreign financial organizations or made any attempt at large-scale foreign branching.

Many regional banks have opened shell branches. Shells have been found to be convenient for domestic funding during periods of strong local growth and a reserve-free source of funds for foreign lending activities. The low cost of shells makes them affordable to most banks large enough to consider supporting a significant international commitment.

Other regional banks have evolved such that a large portion of their business is concentrated in one or a few global areas. When business development and maintenance costs exceeded that which could be covered by a home-based calling officer, the banks often have responded by opening a foreign representative office.

The most significant expansion on the part of regional bankers has been through the opening of international departments. According to a recent study, more than half the regionals among the top 300 U.S. banks now have international departments, and many smaller banks provide various types of international services.[10] While many of these banks provide only the basic services and letter of credit facilities, others also provide FOREX services and issue bankers' acceptances. Also roughly half of these banks work with FCIA and the EXIM Bank. Some also engage in direct foreign loans or participations.

Although some larger money center bankers expect regionals to find the international marketplace unprofitable in the coming years, more large banks and most regional international bankers expect their international activities to continue to expand. Many regional banks are currently enlarging their departments, and some plan to expand their off-premise services in the coming years. Thus, while some authors have recently been saying that international banking is in a consolidation stage, international banking at the regional level is still experiencing a healthy expansion.

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[10] I. B. Thompson, "The International Banking Activities of Regional Banks," *American Banker*, March 23, 1979, pp. 14, 36, 38.