

A THEORY OF INTERNATIONAL BANKING EXPANSION

by

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ABSTRACT

This study represents an attempt to develop a theory to explain the rapid growth of international banking witnessed during the past decade. The focus is on two major banking nations: Canada and the United States.

The definition of international banking adopted for the purposes of this study is very broad in nature and includes several types of financial activities. In addition to usual commercial banking activities we include the so-called congeneric services associated with merchant banking.

The research process involved a comprehensive review of banking journals, sundry periodicals, and the annual reports of major Canadian and American banks. This material provided descriptive information on the international activities of the banks.

After international banking is defined a chapter is devoted to a discussion of the importance of banking to various world economies. In this area, much reliance is placed on the writings of R. W. Goldsmith who developed a measure of the level of financial sophistication for a country.

Two chapters are then devoted to a description of the recent rapid growth of the international activities of Canadian and American banks. One conclusion is that international growth has proceeded at a considerably faster pace than domestic growth.

Several observers of the international banking scene have offered

explanations for the rapid growth. The most popular explanation is that the growth of world trade has caused or at least heavily influenced the growth of international banking. It is at this point that we identify some flaws in the 'following trade' argument. Dissatisfaction with this popular explanation provides the 'jumping off point' for development of our theory of international banking expansion.

In order to lay the foundation for development of a theory of international banking expansion, the literature on the theory of the firm and on the theory of foreign direct investment is surveyed.

Based on the above material, a model has been developed which builds upon the school of direct investment theory that focuses on oligopolistic industry structure and maximization of growth. The banks are seen to have an almost innate need for growth which is the critical variable influencing international expansion. Several environmental variables are identified that tend to retard growth in the domestic sector. It is argued that the logical consequence of this is that the banks turned to international markets in order to achieve their growth objectives.

Foreign growth does not proceed without limit however. A profit constraint (drawing from the writings of W. J. Baumol) is identified and incorporated into the theoretical model.

Some of the other theories of direct investment (including the popular Hymer/Kindleberger 'superior knowledge' theory) have only limited explanatory power in international banking.

After a preliminary theoretical model was developed, interviews

were arranged with senior executives in the international divisions of the five major chartered banks. Their reactions to the model are discussed (where appropriate) in chapters seven and eight.

The study closes with a discussion of recent events that have tended to shake up international banking. Inadequate capitalization and various types of governmental interference are currently having a retarding effect on international growth. Finally, a chapter is devoted to a prediction of the future of international banking. It is concluded that, while many problems will be present, the need for growth will continue to be the major factor in explaining the development of international banking.

TABLE OF CONTENTS

	Page
LIST OF TABLES	viii
LIST OF FIGURES	ix
Chapter	
1. INTRODUCTION	1
Objectives of Study	1
Research Methodology	2
Organization of Study	5
2. INTERNATIONAL BANKING	8
Definition	8
Correspondent Banks	9
Resident Representatives	12
Agencies	14
Foreign Branches	16
Subsidiaries and Affiliates	18
Joint Ventures or Consortia	19
Summary	21
3. IMPORTANCE OF INTERNATIONAL BANKING	25
Summary	31
4. GROWTH OF INTERNATIONAL BANKING	34
Growth of U.S. International Banking	44

Chapter	Page
Canadian Growth	55
Summary	66
5. EXISTING EXPLANATIONS FOR THE GROWTH OF INTERNATIONAL BANKING	70
6. THEORIES OF THE CAUSES OF DIRECT FOREIGN INVESTMENT	79
Aliber's Theory	84
Imperfect Capital Markets	88
Monopolistic Advantage	90
Oligopoly and Need for Growth	94
Summary	97
7. TOWARD A THEORY OF INTERNATIONAL BANKING EXPANSION	102
Banking: An Oligopolistic Industry	102
Need for Growth	105
Profit Constraint	112
Maintenance of Market Share	113
Government Interference	115
Superior Knowledge Theory	123
Preference for Direct Investment	129
Cross Hauling	131
Aliber's Theory	133
Summary	134
8. A THEORY OF INTERNATIONAL BANKING EXPANSION	138

Chapter	Page
Results of Interviews	154
Summary	155
9. CURRENT EVENTS AND THE THEORETICAL MODEL	157
10. THE FUTURE	169
BIBLIOGRAPHY	181
APPENDIXES	186
I. Interview Guide for Field Study	187
II. The Foreign Investment Decision	193

LIST OF TABLES

Table	Page
1-1. Relative Size of Canadian and American Banks	4
4-1. The World's Major Banks - 1973	35
4-2. Comparative Growth Rates of Major Banks	40
4-3. Money Expressed as a Percentage of Gross National Expenditure (Relative to the U.K. in brackets) Estimated Level at June 1973	42
4-4. Adjusted Ranking of Top Ten Banks	43
4-5. Foreign Branches of National Banks By Region and By Country, March 31, 1965	45
4-6. Assets and Liabilities of Foreign Branches of National Banks, December 31, 1964	46
4-7. Assets of Foreign Branches of U.S. Banks 1971-1974	47
4-8. Foreign Branches of U.S. Banks 1973	48
4-9. Worldwide International Network--Chase Manhattan Bank	53
4-10. Expansion of Branch Banking Overseas Compared with Foreign Trade and U.S. Direct Invest- ment Abroad 1967-1972	54
4-11. Growth in Assets of Chartered Banks	56
4-12. Bank Branches, Agencies, Subsidiaries and Affiliates - December 1973	57
4-13. Chartered Banks: Total Foreign Currency Assets and Liabilities, 1963-1974	60
4-14. Assets of Banks in the United Kingdom	63
7-1. Profit Ratios By Size of U.S. Banks	109
7-2. Profit Ratios of Selected Banks	110

LIST OF FIGURES

Figure	Page
2-1. Organizational Structure of the Foreign Activities of a Large U.S. Bank	23
8-1. Model of Foreign Expansion	139
8-2. Model of Profit Constraint	142
8-3. Numerical Example of the Static Determination of Bank Size	144
9-1. Capital/Asset Ratios of U.S. Banking Industry	159
AI-1. Schematic of Bank Expansion Abroad	192

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The writer remains solely responsible for any errors or omissions.

DEDICATION

This thesis is dedicated to my wife Shirley who (almost always) cheerfully tolerated the long hours of playing 'second fiddle' to a stack of books.

A THEORY OF INTERNATIONAL BANKING EXPANSION

Chapter One

INTRODUCTION

OBJECTIVES OF STUDY

The primary objective of this study is to develop a theory to explain the rapid growth of international banking witnessed during the past decade. The United States is the world leader in international banking and Canada ranks as the third largest international banking nation. Accordingly, the main focus of our research will be on the Canadian and American banks.

There has been much written on the theory of foreign direct investment and considerable study of multinational enterprise. However, every serious study which this writer has been able to locate deals with manufacturing and/or resource based industries virtually exclusively and pays scant attention to the service industries. It may be because the service industries are not amenable to analysis that they are neglected. Raymond Vernon, for example, dismissed the service industries as follows:

The banks, insurance companies, airlines, shipping companies, and tourist agencies that sell their services across international boundaries generally find themselves obliged to develop highly specialized business skills and to adapt to specially tailored national laws and national institutions. Accordingly, the problems of the international service industries will not be explored in depth in the pages ahead.¹

Vernon has a good point for very early on in the research stages this writer became somewhat frustrated by the 'messiness' of the

expansion process exhibited by the banking industry. In this connection an observer of the international banking scene has written:

The expansion now taking place does not amount to any movement proceeding on some grand, deliberate design. The process is an untidy one, motivated by considerations varying from bank to bank and country to country, and taking place piecemeal by a variety of methods. Yet however amorphous, it feeds on itself, acquiring a drive of its own.²

A British banker warned recently that those who seek to find order and make some sense out of the development of international banking will meet with despair. However this writer finds no a priori reason to assume that there are not some common underlying factors that influence the development of multinational enterprise--be it banking or the manufacture of farm equipment. With this in mind we will explore the more popular theories of foreign direct investment--theories developed to explain the expansion of industrial enterprises--and attempt to identify some aspects of that phenomenon that might be applicable to the explanation of international banking expansion.

Once these common aspects are located, an attempt will be made to pull the strands together into a theory of international banking expansion that is able to withstand the dual tests of being logically consistent and in conformity with the major facts.

RESEARCH METHODOLOGY

The research process involved a comprehensive survey of statistics, annual reports, and various publications (newspapers, magazines, banking journals) that contain articles on the subject of international

banking. Information from these sources coupled with the writer's personal banking experience (eleven years in Canada and one year in the United States) led to the development of a theory of international banking expansion.

After a preliminary theoretical model had been developed, we then conducted interviews with senior executives in the international divisions of the five major chartered banks. The objective of the interviews was to obtain insights into the major concepts upon which our model rests. We were also interested in obtaining reaction to the model developed. The guide questionnaire and model utilized in the field study are included as Appendix I.

It is fair to say that the reaction to our preliminary model was mixed. Some areas of general agreement were identified. So too, were some areas of general disagreement. In areas where general disagreement was identified we reconsidered our position and in some cases altered our approach.

Problems were encountered however in cases where the responses to specific questions or reaction to certain variables in the model were mixed. In these cases the writer has searched for outside information that tends to point in one direction or the other.

The following table is presented to give the reader a feel for the size and economic power of the major Canadian and American banks.³ The big five Canadian banks control about 92 per cent of the Canadian banking industry, while the big five American banks control about 25 per cent of the U.S. industry. These ten banks dominate their domestic competitors in the international banking scene.

Table 1-1

RELATIVE SIZE OF CANADIAN AND AMERICAN BANKS

	1973 Assets (millions)	1973 World Rank	1964 World Rank
UNITED STATES			
BankAmerica Corporation	\$49,404	1st	1st
Citicorp	44,019	2nd	3rd
The Chase Manhattan Corp.	36,790	3rd	2nd
J. P. Morgan & Co. Inc.	20,375	17th	9th
Manufacturers Hanover Corp.	19,850	18th	4th
CANADA			
The Royal Bank of Canada	\$18,381	28th	8th
Canadian Imp. B. of Commerce	16,117	35th	10th
Bank of Montreal	14,409	41st	16th
The Bank of Nova Scotia	10,328	55th	38th
The Toronto-Dominion Bank	9,422	71st	47th

It is quite apparent from the above table that Canadian banks have slipped considerably over the past ten years in size relative to other major international banks. The three largest U.S. banks on the other hand have maintained their world dominance. It would seem that this fact might indicate that Canadian banks have taken a less aggressive approach to the pursuit of growth than the other major world banks. We will explore this possibility further below. It can be pointed out at this time however that over the past few years there have been a number of banking mergers in both Europe and Japan. These mergers have

catapulted some moderate-sized institutions into world prominence in banking. An example is the merger of the National Provincial Bank Ltd. and Westminster Bank Ltd., both of London, to form the National Westminster Bank Ltd. which is now the seventh largest in the world.

An important motivating factor behind at least some of the mergers is thought to be the widely held European view that firms must be encouraged to merge in order to reap economies of scale and meet the challenge of large American firms. The chief proponent of this view is the French journalist, Jean-Jacques Servan-Schreiber. His book, The American Challenge, outlines his view of the problems facing European business and the measures necessary to overcome them.⁴ Recently, the validity of Servan-Schreiber's views have been questioned by R. Rowthorn (International Big Business 1957-67: A Study of Comparative Growth)⁵ and Stephen Hymer (Multinational Corporations and International Oligopoly: The Non American Challenge).⁶ A more detailed examination of the issues involved will be included below when we discuss the size and the apparent need or desire for growth of the banking industry.

ORGANIZATION OF THE STUDY

Chapter two is devoted to the development of a definition of international banking. It is important for the reader to be clear about what we mean when we use the term 'international banking' since the definition has a bearing on our theoretical model.

Chapter three represents an attempt to give the reader some understanding of the contribution that international banking can make to various world economies.

Chapters four and five trace the recent growth of international banking and discuss the attempts that have been made to explain the phenomenon observed.

Chapters six, seven and eight form the heart of the thesis. Chapter six surveys the various theories of direct investment and Chapters seven and eight represent our attempt to develop a theory of international banking expansion.

In Chapter nine we discuss some recent events affecting the international banking environment which might call for some minor alterations to our model.

Finally, it would seem that no paper dealing with an institutional problem is complete without some treatment of the future. Accordingly, we will close out the study by attempting to utilize the concepts developed to make some predictions about what might lie in store for international banking over the next decade.

Notes for Chapter One

¹ Raymond Vernon, The Economic Environment of International Business (Englewood Cliffs, N.J.: Prentice-Hall, 1972), p. 7.

² Quoted in The Economist (November 21, 1964), p. 845.

³ The Banker (June 1974) and Banks of the World (1964).

⁴ J. J. Servan-Schreiber, The American Challenge (New York: Atheneum, 1968).

⁵ S. Hymer and R. Rowthorn. International Big Business 1957-67: A Study of Comparative Growth (Cambridge: Cambridge University Press, 1971).

⁶ Hymer and Rowthorn, "Multinational Corporations and International Oligopoly: The Non American Challenge," in The International Corporations: A Symposium, C. Kindleberger (ed.) (Cambridge, Mass.: M.I.T. Press, 1970).

Chapter Two

INTERNATIONAL BANKING

Definition

International banking is a term that is commonly used to describe a wide range of banking activities--from facilitating a simple foreign remittance to mobilizing Euro dollars throughout the world. There is however no widely accepted 'tidy' definition of the term 'international banking.' This is not really surprising. Experts have long ago given up the attempt to set out a reasonable definition of domestic banking.

The Canadian Bank Act contains no definition of banking. Section 2 of the Act contains a classic definition that a bank "means a bank to which this Act applies."¹ Section 75 of the Act contains a list of the general powers of a bank and sets out types of business that may be undertaken. The 'out' used by the Act to avoid a definition is the restriction that prohibits the use of the words 'bank' or 'bankers' in the corporate title of any company unless it is chartered under the Act.

For the purposes of this paper we will assert that a bank becomes international when it makes a foreign direct investment in a company engaged in financial services. These financial services will include issuing demand and notice liabilities and granting loans (usual commercial banking) but also will include the wide range of financial services offered by merchant banking. The nature of merchant banking will be discussed later in the chapter.

The key to the definition is that a direct investment must be made.

We will now enter into a discussion of the various operating forms employed by the banks in their international operations. Those operating forms that fit within our definition of international banking will then be identified at the conclusion of the chapter.

A. Correspondent Banks

Correspondent banking is a system whereby banks maintain a deposit relationship with each other. U.S. banks have used the system domestically for years to help in overcoming legislation that prohibits branching. Small unit banks in towns and villages maintain deposits with large city banks who in turn maintain accounts with large money centre banks. In this way surplus funds from rural areas could be put to productive use in the larger industrialized areas.

Correspondent relationships with foreign banks serve a somewhat different purpose: the settlement of international clearings. In foreign centres where a Canadian or U.S. bank is not directly represented, an account with a foreign correspondent can serve as a vehicle through which payments or collections can be made on behalf of importers and exporters.

The foreign exchange market, which is the link between the domestic financial system and the financial system of other countries, can be operated entirely through a system of correspondent banks. While it is true that some foreign transactions can become fairly complex, in the final analysis there is virtually no financial transaction involving

foreign trade or capital flows that cannot be handled through correspondents. To clarify the concept of correspondent banking an example of a rather typical transaction follows:

- a) assume The Royal Bank of Canada maintains a Canadian dollar account with the Tokai Bank of Japan;
- b) assume a Canadian exporter enters into a contract to sell \$1,000,000 iron ore to a Japanese importer on terms of thirty days after acceptance;
- c) The Royal would forward the bill of exchange and supporting documents to the Tokai Bank;
- d) Tokai would notify the Japanese importer;
- e) when shipment arrives in port the importer would 'accept' the bill from the Tokai Bank who would hold it for thirty days;
- f) on the due date the Tokai Bank would collect the bill and credit the Canadian dollar account maintained by the Royal Bank;
- g) The Royal would then simply debit the Canadian dollar account and credit the account of the exporter.

Balances with foreign banks constitute a significant proportion of total foreign assets and liabilities of the chartered banks. As at June 30, 1974, the chartered banks had \$15,898 million on deposit with foreign banks. In turn, foreign banks had \$14,410 million on deposit with Canadian banks. These figures represented respectively 61.8 per cent and 50.2 per cent of total foreign assets and liabilities.

It appears that the magnitude of correspondent balances is well

in excess of the transactions balances required to facilitate the flows of trade and capital and that, in part, they reflect inter-bank lending. Some analysts, in noting the rapid build up of international bank deposits--especially Euro dollars--have warned that losses will likely occur. D. R. Mandich, Senior Vice-President, Detroit Bank and Trust Company, warned in 1972:

overly large Euro dollar deposits have been and are being granted to foreign banks in relation to their individual capitals and financial proportions, with very little real knowledge of the people or their financial engagements. The theory reportedly is that the deposits are short term ones and therefore safe, but there is clearly a process of credit being extended without normal credit studies and safeguards. Obviously, this is a practise which invites misfortune at some future time.²

The several bank failures of 1974 have certainly supported the foregoing statement. It is known that most major banks are looking very closely at their correspondent relationships. Britain's National Westminster Bank reportedly eliminated \$100 million worth of credit lines with American banks as a result of being burned by the failure of the U.S. National Bank of San Diego.³ Furthermore, National Westminster Bank has adopted the policy of refusing to handle letters of credit from U.S. banks unless they have assets in Britain. Thus because of carelessness in inter bank dealing an impediment to foreign trade has been erected.

It was originally intended that the primary function of inter bank deposits would be to facilitate the reverse flows of funds that accompany all transaction in real goods and services. It now seems that inter bank deposits constitute an important investment outlet as well. An interesting and important issue which arises is whether or not

these activities can be adequately supervised from a domestic base.

Traditional functions of correspondents also include the exchange of information on economic conditions, political events and credit reports on commercial enterprises. In addition the correspondent bank can be thought of as the Canadian or U.S. window to a foreign market.

It is reported that Canadian banks have at least 5,000 correspondent banks throughout the world and, while no figures could be located, it is very likely that U.S. banks have substantially more correspondents.

B. Resident Representatives

The representative office is used by both Canadian and U.S. banks, primarily in areas where full service banking is prohibited. This operating form has been described as the weak link in the banking structure of any country because the function is ill-defined and is not readily susceptible to control by the monetary authorities. The function of a resident representative of a Canadian or U.S. bank is to "hunt down business and make money for us."⁴ This function however is subject to the constraint that normal banking activities (acceptance of deposits, granting loans) are prohibited. In several countries the representative is also prohibited from entering into a contract. Any business obtained in the foreign country is supposed to be contracted for and booked at head office.

The representative is essentially a roving marketing officer for the head office. He visits correspondent banks, maintains liaison with local officers of multinational clients of head office, and attempts to

contact potential customers.

The banks often regard the representative office as the first step toward a full branch. In some markets it is thought advisable to test the waters in a relatively inexpensive way by setting up a representative office. In the majority of cases however the representative is used in areas that prohibit full service banking by foreigners.

Canada is a good example. The 1967 Bank Act states that no foreign corporation carrying on business in Canada may use the word bank, banker, or banking to describe its activities. Despite this at least thirty foreign banks have, with immunity, established offices in Canada using the name of the bank above the door. Canadian officials have turned a blind eye toward the representative office.

The importance of a resident representative to the international activities of a bank is difficult to assess because a separate profit centre cannot be created. It appears unlikely however that the contribution of the representative is significant in relation to other operating forms. The representative office appears to be used more extensively by those banks that are less committed to international activities. For example, Bankers Trust New York Corporation, sixth largest bank in the U.S. with assets of \$21 billion, had (at December 31, 1973) nineteen representative offices around the world and only seven full service branches.⁵ On the other hand BankAmerica Corporation maintained only twelve representative offices while its foreign branches totalled 103 in 1973.⁶

C. Agencies

The Porter Commission described an agency as an office free to conduct all phases of banking business other than the acceptance of deposits.⁷ The best known, and oldest, Canadian agencies are located in New York. Prior to the development of Canadian financial markets the chartered banks carried the bulk of their secondary reserves in the form of call loans to New York brokers. The New York agencies facilitated these transactions. Call loans have recently declined both in absolute and relative terms. As at June 30th, 1974, call loans in a foreign currency totalled \$225 million compared to \$1,017 million in 1964.⁸ In relative terms foreign call loans have declined from 24 per cent of total foreign currency assets in 1964 to less than 1 per cent in 1974.

In addition to granting loans, the agencies also provide a wide range of 'fringe' banking services including buying and selling securities and handling foreign exchange transactions.

There is a significant advantage in opting for agency rather than branch status since an agency is not usually subject to reserve requirements. It can borrow funds from the local public, book them at head office, and then borrow a like amount from head office for placement in the local markets. The advantage of the agencies over local banks who are subject to reserve requirements can be substantial as the following hypothetical example illustrates:

assume: loan rate 10% deposit rate 8%

 reserve requirement 10%

 - customer deposits \$1,000,000

New York Agency of Canadian Bank

unproductive assets (reserves)	0	deposit	\$1,000,000
productive loan	\$1,000,000		
	<hr/>		<hr/>
	\$1,000,000		\$1,000,000
revenue (10%)	\$100,000		
interest expense (8%)	80,000		
	<hr/>		
net revenue	\$ 20,000		

The Chase Manhattan Bank

unproductive assets (reserves)	\$ 100,000	deposits	\$1,000,000
productive loan	900,000		
	<hr/>		<hr/>
	\$1,000,000		\$1,000,000
revenue (10%)	\$ 90,000		
interest expense	80,000		
	<hr/>		
net revenue	\$ 10,000		

In a highly competitive market it is easy to see that the agency could, if it desired, cut the loan rate or bid up the deposit rate to make it unattractive for the U.S. bank to enter the market.

Another advantage of agency status in the United States is that an agency can avoid Regulation "Q," which restricts U.S. banks in the rate of interest they can pay on time deposits.

The above advantages have not gone unnoticed in the United States and we appear to be heading into "a new era of supervision and constraints for the operations of Canadian banks in the U.S."⁹ There is currently before Congress a piece of legislation aimed at establishing a national policy covering the operations of foreign banks in the U.S. Some areas of the legislation would directly affect agency operations. Membership in the Federal Reserve System would be compulsory and would mean that agencies would have to carry reserves and be subject to various Federal regulations, including the interest rate ceiling.

If passed, this legislation could well signal the end of the agencies. It appears likely that the chartered banks would opt instead for full service branches.

D. Foreign Branches

The most popular method of establishing in the international arena is via the foreign branch. Full service banking offers several advantages over the three operating forms mentioned above. A branch operation allows the bank to compete directly for indigenous business if it so desires. The establishment of a deposit base in the local currency can enable an international bank to serve local financing needs as well as the needs of multinational clients. The extensive branch network of Canadian banks in the Caribbean is a good example.

Another advantage of branching is that head office can completely control policy--subject of course to the laws of the host country. Bigness is associated with safety in banking and this results in an advantage for branching. The public is likely to have more confidence in

dealing with a foreign branch of the BankAmerica than if say BankAmerica Corporation opened a foreign subsidiary under a different name. A well known name above the door is an undeniable advantage to branching.

The fact remains however that, of the many forms of international banking, the creation of foreign branches is the most controversial:

However scrupulously a foreign branch refrains from poaching on the preserve of its hosts, its mere existence takes business from them, because whenever a foreign branch is established, the parent bank transfers to it the business and deposits that previously went to its local correspondent banks.¹⁰

There is disagreement among bankers about the preferred method of foreign expansion in the face of a mounting tide of nationalism around the world. John Coleman, formerly Deputy Chairman of The Royal Bank of Canada, stated in 1971 that: "The world wide branch system is not the system of the future."¹¹

Until recently it appeared as if the Canadian Imperial Bank of Commerce and Citibank had (in spite of Coleman's remarks) opted for the branch route. One major advantage to branching is that head office runs its own show and both the Canadian Imperial Bank of Commerce and Citibank have, until recently, exhibited a clear cut desire to control whatever business they engage in. During N. J. McKinnon's chairmanship of the Canadian Imperial Bank of Commerce this was certainly true but the picture has now changed somewhat. Fewer foreign branches are being opened and emphasis seems to be on participation in consortia. For example the Canadian Imperial Bank of Commerce recently took an equity position (20 per cent) in the Energy Bank of England along with three

other banking partners interested in financing the development of oil in the North Sea.¹²

While the expansion of foreign branches as an operating vehicle may slow down somewhat, it is safe to say that the existing branches will continue to make a significant contribution to foreign operations of Canadian and U.S. banks.

E. Subsidiaries and Affiliates

Both American and Canadian banks occasionally incorporate a subsidiary company to own and operate branches in a foreign country. The Commerce for example owns 100 per cent of the shares of the California Canadian Bank which operates twenty branches in California. Both The Royal Bank of Canada and The Bank of Nova Scotia have found it necessary to incorporate subsidiaries in the Caribbean to take over their branches there. This action was in direct response to host government pressures to allow equity participation in these operations. Equity participation by the parents is in the 75 per cent range so there is no question about control.

The top five U.S. banks have many subsidiaries operating throughout the world and engaged in a wide range of financial services.

The chartered banks also use subsidiaries as a vehicle for the operation of near banks in other countries. The big five banks have each incorporated trust companies in New York, U.K., and the Caribbean.

The affiliate route is also used by the banks of both countries. This form of entry into the foreign market is used when there are restrictions against branching or when local market conditions indicate this

method is preferable. An example would be the approach used by some chartered banks in Hong Kong. In this market there are limited advantages to branching. Says one Canadian banker:

In this part of the world, straight representatives of financial institutions from the West are considered outsiders to Asian businessmen. You've got to get into the ball game on the same level as the Asians to even hope to survive. You've got to buy into Asian business in order to even hear about the deals being planned. Its very much a closed society out here and, if you don't go to the right cocktail parties or sit on the right boards, you aren't privy to the kind of information that makes money for Canadian firms.¹³

In response to this type of market the Toronto-Dominion in 1970 purchased a 40 per cent interest in International Consolidated Investments Ltd., a holding company that controls two banks in Hong Kong (the Overseas Trust Bank and the Hong Kong Industrial and Commercial Bank).¹⁴ Together these banks have thirty-five branches in the Hong Kong area engaged primarily in retail banking.

The U.S. banks are engaged in investments through affiliates on a much broader scale than the chartered banks. Citicorp, for example, has consumer finance affiliates in Britain, Brazil, Belgium, Colombia, Hong Kong, the Philippines, and in Switzerland; factoring companies in Australia, Britain, Canada, Colombia, Panama, and Spain; and credit card affiliates in Costa Rica, Panama, and Venezuela.

F. Joint Ventures or Consortia

This vehicle has evolved since the 1960's as a method of entering merchant banking on a truly international scale. Basically, a joint venture is a partnership of (usually) three to six large banks who pool part

of their resources to enter a specific market. Domestic operations of the partner banks are always kept separate.

Merchant banking is difficult to define but it can be said that it includes almost every type of financing imaginable. Merchant bankers underwrite security issues; extend loans over short, medium, and long terms; take equity positions in companies; assist corporate mergers; sell advice, deal in foreign exchange; manage mutual funds; and underwrite insurance . . . and the list goes on. These banking practices have long been common in Continental Europe in contrast to the Anglo-Saxon tradition in which banks act chiefly as depositories and extenders of short term credit. During the past decade however the basic distinction between deposit and merchant banks has faded somewhat. Both the U.S. and Canadian banks have incorporated foreign affiliates that hold equities, assist in security underwritings, and provide long term venture financing.

An example of a large international joint venture engaged in merchant banking is the Orion Banking Group. The partners are The Royal Bank of Canada, The Chase Manhattan Corporation, National Westminster Bank, and Westdeutsche Landesbank Girozentrale. Members of the Orion group include:

- Orion Bank Ltd. which provides financial counselling, manages international underwritings, organizes consortium loans, and assists in mergers and acquisitions;
- Orion Termbank Ltd. which specializes in large scale Euro-currency loans; and

-- Orion Multinational Services Ltd. which conducts research and acts as the central planning agency for the partners.

The evolution of consortia serves to underscore the need for bigness in banking. As the credit demands of major multinational clients and governments increase it is likely that major banks will continue to meet the challenge at least partly via the consortia route.

SUMMARY

Based on the above discussion, the only type of international operation excluded from our definition of international banking is the correspondent relationship. The foreign representative office, while likely only representing a nominal investment, does qualify. Agencies, branches, and subsidiaries also qualify. Affiliates fit the definition provided the investing bank exercises effective control over the company. Participation in consortia presents a bit of a problem. Often no single bank has effective control. For example the Bank of Montreal, Australia and New Zealand Banking Group Ltd., Irving Trust Co. of New York, and Crocker Citizens Bank of California each put up \$13.75 million to launch the Melbourne-based Australian International Finance Corporation. Is this a direct investment by the three foreign partners? While the investment admittedly is in some 'grey' area between portfolio and direct investment, this writer would argue that because each of the companies have representation in management and take an active part in direction of operations, the investment should be classified as direct.

Support for this viewpoint is provided by the U.S. government:

Although definitions vary greatly from country to country, direct investment generally covers only investment in which business is controlled from abroad. The U.S. government defines this as an ownership interest in foreign enterprise of at least ten per cent.¹⁶

In summary, then, our definition of international banking is very broad in scope and includes virtually any international financial activity undertaken by the major banks. The key variable is only that a direct investment be involved. It should be noted that the definition of international banking that has evolved in this chapter is consistent with the self-image of the major international banks. The Chase Manhattan Bank, for example, thinks of itself as: "An aggressive, high quality international financial services corporation."¹⁷ The definition is also consistent with the concept of international banks of the future:

It is now apparent that the world bank of the future will range from property investment to handling companies' cash flow problems on a multinational basis, or from managing portfolios which are invested on a number of the world's stock exchanges to running retail branch networks in as many countries as possible round the globe.¹⁸

Figure 2-1 is presented to give the reader some idea of the organizational structure of the international operations of a large U.S. bank.

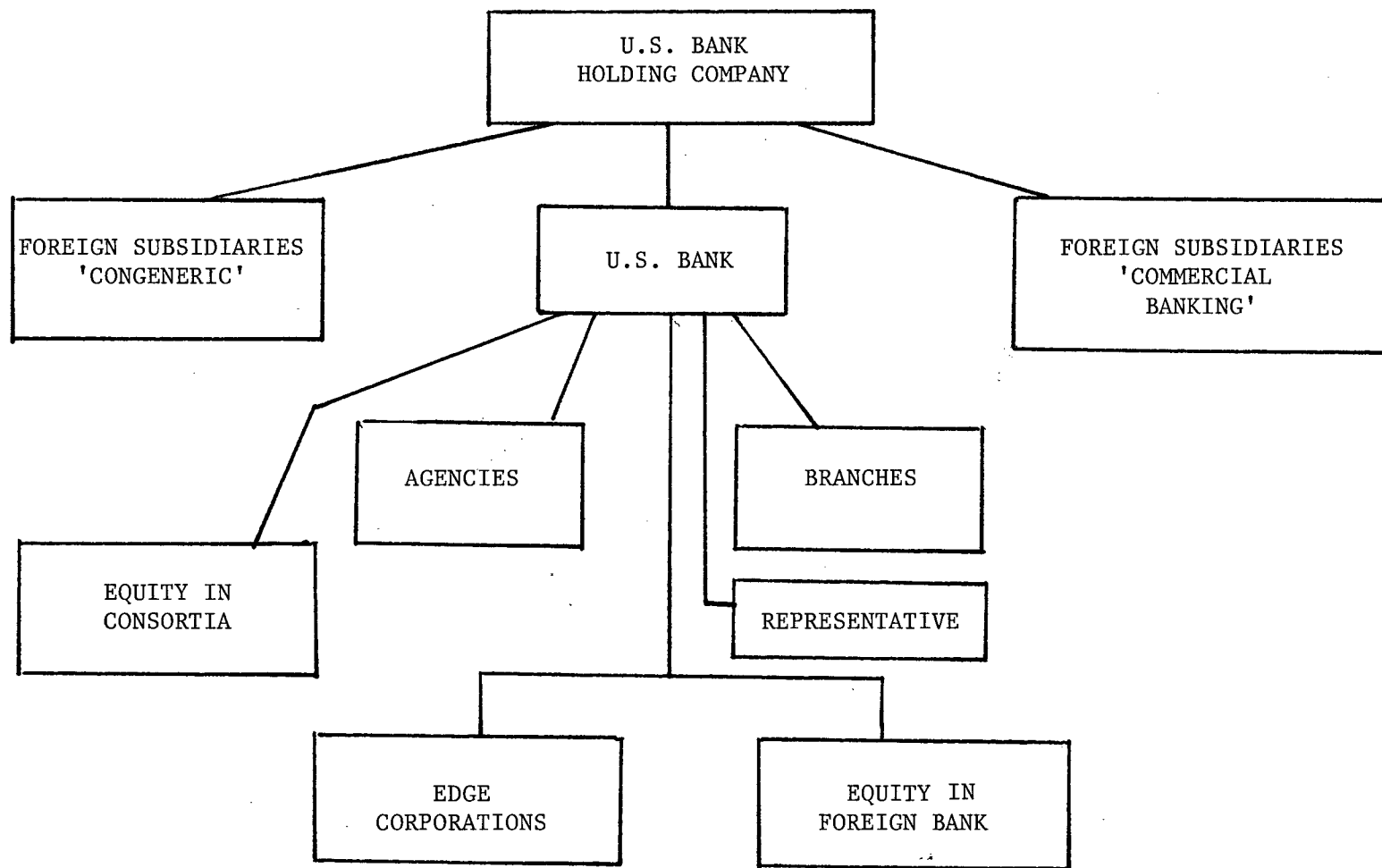


Figure 2-1

ORGANIZATIONAL STRUCTURE OF THE FOREIGN ACTIVITIES
OF A LARGE U.S. BANK

Notes for Chapter Two

- ¹ An Act Respecting Banks and Banking (Ottawa: Queen's Printer, 1967).
- ² D. R. Mandich, "International Loans: Profit Centre or Loss Leader?" Journal of Commercial Bank Lending (Sept. 1972), p. 39.
- ³ Canadian Business, 'From Ottawa' (January 1974), p. 6.
- ⁴ Quoted in The Canadian Banker and ICB Review, I-74, p. 21.
- ⁵ Bankers Trust New York Corporation, 1973 Annual Report.
- ⁶ BankAmerica Corporation, 1973 Annual Report.
- ⁷ Report of the Royal Commission on Banking and Finance, 1964, p. 373.
- ⁸ Bank of Canada Review (August 1974).
- ⁹ The Financial Post (December 28, 1974), p. 9.
- ¹⁰ "Banking Across Frontiers," The Economist (Nov. 21, 1964), p. 846.
- ¹¹ Quoted in "The Bankers Take the Plunge," The Executive (June 1971), p. 32.
- ¹² John Davidson, "Canadian Banks Think Globally," Canadian Banker and ICB Review, I-74.
- ¹³ Quoted in The Financial Post (October 13, 1973), p. 1.
- ¹⁴ Ibid.
- ¹⁵ "The Bankers Take the Plunge."
- ¹⁶ S. H. Robock and K. Simmonds. International Business and Multinational Enterprise (Georgetown, Ont.: R. D. Irwin, Inc., 1973), p. 40.
- ¹⁷ Chase Manhattan Corporation, Annual Report, 1973.
- ¹⁸ The Banker, 122 (1972), 777.

Chapter Three

IMPORTANCE OF INTERNATIONAL BANKING

The trend toward economic interdependence among nations of the world is evidenced by a dramatic expansion of world trade over the past decade. Total exports of all countries in 1973 grew 37 per cent to \$566 billion.¹ In constant dollars this increase amounted to 13 per cent--roughly double the real growth rate in world G.N.P.

Over the past decade, trade has been growing at an annual average of about 10 per cent compared with a global GNP growth rate of approximately 5 per cent.² The reduction in trade barriers including the General Agreement on Tariffs and Trade (GATT) has been an important contributing factor to the growth of trade.

One can legitimately ask of course what the above has to do with banking. The answer is that for almost all foreign trade transactions there are two monetary units involved--the currency of the exporting country and the currency of the importing country. Foreign traders become involved in what Binhammer calls a 'double sale' or 'double purchase.'³ That is, an importer desiring to purchase Japanese automobiles must first buy Japanese yen and then buy the automobile. The banks have long been the most important supplier of foreign exchange to facilitate trade between nations.

Canadian chartered banks maintain a world-wide network of correspondent banks to facilitate the financial flows that must accompany foreign trade. Basically the relationship between a Canadian bank and its

correspondent consists of reciprocal deposit accounts. The account maintained by a chartered bank with a foreign correspondent is usually denominated in the currency unit of the latter. The correspondent on the other hand often maintains a Canadian dollar account at the chartered bank. It has also become quite common for the chartered banks to maintain U.S. dollar denominated deposits with their foreign correspondents --partly to facilitate the large volume of trade in U.S. currency and partly for investment purposes. These deposits are referred to as 'Euro-dollars' which are simple U.S. dollars located outside the country.

There is no question that financing foreign trade is an important function of the banking industry. However it is a service that can be offered from a domestic base without direct foreign investment. The maintenance of transactions balances with foreign correspondents is really all that is required. In the circumstances, and in keeping with our definition of foreign banking developed in Chapter Two, financing trade flows does not qualify as an important contribution of international banking. This does not mean that financing foreign trade is not important per se. As important trading nations, it is vital that the United States and Canada each have a highly developed banking system which provides export-import financing and operates the foreign exchange markets. To reiterate, it is this writer's belief that the above functions can be fulfilled from a domestic base and without the necessity of direct foreign investment by the banks.

The banks of course also facilitate capital flows among the nations of the world. Here again this writer would argue that no great

impediment to capital flows would be encountered if a simple system of correspondent banks were used. One need only look at the experience of a nation such as Canada that has imposed severe restrictions on the entry of foreign banks for evidence that capital flows can indeed take place on a huge scale. It is not necessary for Citicorp of New York to have a branch in Toronto to allow one of its customers to make a direct or portfolio investment in this country.

It should not be inferred from the above that the writer is opposed to foreign branching. On the contrary: the discussion is merely intended to cast doubt upon the usually accepted explanation that the importance of foreign banking is in financing trade and capital flows.

From the point of view of the host country, the real importance of international banking is that it makes a very significant contribution to the creation of financial assets and the development of efficient financial markets.

There is no doubt that the transmission of financial technology, as well as the more far-reaching establishment of new types of financial institutions by foreigners has played a large part in the financial development of most countries.⁴

The development of financial markets is essential to economic growth--at least in 'western' economies.

Goldsmith has pointed out that every modern economy has a super-structure of financial assets that exist side by side with the infrastructure of national wealth composed of physical assets.⁵ Financial assets of course are largely a product of the banking system. A financial asset can be defined as a claim against some other economic unit.

Unlike a physical asset, the financial asset of one party is the debt of another. It follows that in a closed economy the net value of financial assets would be zero.

It has been found that in an advanced economy such as the U.S., financial institutions (primarily the banks) are connected as holders or issuers with a majority portion of all financial instruments outstanding.⁶ Furthermore this relationship has increased over time.

The following example is meant to illustrate the creation of financial assets:

- a) assume a firm purchases ten acres of industrial land for \$10,000 and wants to erect a warehouse costing \$90,000;
- b) bank A is willing to finance 100 per cent of the project secured by a mortgage bond of \$100,000;
- c) bank A in turn borrows \$10,000 via term deposits from each of ten customers;
- d) all ten bank A customers lever their investment by borrowing \$5,000 each from bank B; and
- e) bank B in turn borrows \$50,000 via term deposit from another depositor.

The end result is:

Real Assets:

Land & Building \$100,000

Financial Assets:

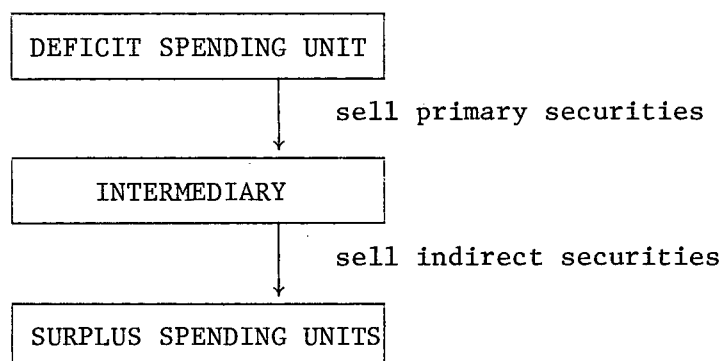
Mortgage Bond	\$100,000
Bank A term dep.	100,000
Bank B loans	50,000
Bank B deposits	<u>50,000</u>
	<u>\$300,000</u>

Goldsmith has argued that a measure of the level of economic development of a country can be obtained by its "financial interrelations ratio."⁷ The ratio is obtained by dividing the gross value of financial assets by the value of real assets or national wealth plus net foreign balance. In the hypothetical example above the ratio would be

$$\frac{300,000}{100,000} = 3$$

which in real life would indicate a very high level of development.

As a country develops, its financial superstructure grows more rapidly than its stock of real assets. The reason is that it has been necessary for the creation of financial intermediaries to facilitate flows of savings from surplus to deficit units. A diagrammatic illustration of the familiar process is as follows:



Adding a financial intermediary has the effect of increasing the financial interrelation ratio (in the simple case by a factor of 2).

The contribution of foreign banking to the financial superstructure can be in several areas. It may simply involve the creation

of a whole retail banking system for a country. An outstanding example of this is the Canadian banking system in the Caribbean. These banks have unquestionably aided in the development of a financial superstructure and thus in an attendant increase in national wealth.

It has been found that, until World War I, foreign banks held a dominating or at least a very strong position in virtually every country in which they operated. Up to this time then the main contribution would have been to create a retail banking system for a country.

Foreign banks may also focus on the development of a market segment neglected by indigenous financial intermediaries. A good example of this is the entry into medium term commercial financing by U.S. and Canadian banks operating in Europe.

On a broader scale, foreign banks can facilitate financing across national borders. This ability to supplement domestic funds with an outside source or mobilize surplus domestic funds for use abroad has enabled the banks to play a significant role in the economic development of many countries. In addition, Goldsmith reports that

Probably as important for the financial development of most countries as the flow of funds across international boundaries was the example provided by the more advanced countries. Transfer of technology and entrepreneurship have been easier to accomplish, and on the whole more successful, with respect to financial instruments and financial institutions than in many other fields.⁸

The latter sentence includes the assumption that firms in more advanced countries have some sort of market advantage to exploit in the host country. This is an important point which will be discussed in Chapters six and seven below.

One implication of the introduction of foreign banks is that it opens up a wider range of choice to holders and issuers of financial assets. This offers an advantage in that a closer fit should be possible in matching asset holdings with asset preference.⁹ Canadian bankers seem to recognize this contribution. Says Allen Lambert, Chairman of the Toronto-Dominion:

International business has been developing rapidly in the Asian-Pacific region, and Toronto-Dominion Bank was one of the earliest to participate in this. The development of new banking services has transformed the financial superstructure of the Asian/Pacific region and there now exists a much greater variety of financial instruments and a rapid growth of financial institutions.¹⁰

In addition it has been found that the introduction of a foreign bank often 'shakes up' the local market and results in lower interest costs and generally more efficient services to customers.

SUMMARY

The overriding importance of international banking then is that it assists in creating a financial superstructure in the host country. Goldsmith has found a parallelism between economic and financial development, however he cautions that:

there is no possibility of establishing with confidence the direction of the causal mechanism; i.e., of deciding whether financial factors were responsible for the acceleration of economic development or whether financial development reflects economic growth whose main-springs must be sought elsewhere.¹¹

Predominant thinking however supports the view that the causal chain runs from financial development to economic development. The

reason for this view is that it has been observed that financial institutions tend to facilitate the flow of funds to the best user in the system: i.e., to that economic unit that will generate the highest return on the funds employed.

Another important (but controversial) contribution of international banking is that it tends to weaken the boundaries set up to separate nation states. The big banks, like other multinationals have been described as:

a modern concept designed to meet the requirements of a modern age; the nation state is a very old fashioned idea and badly adapted to serve the needs of our present complex world.¹²

Nationalism is an outmoded concept and any contribution the banks, by their active expansion across national boundaries, can make to promote the growth of economic interdependence among nations can be considered worthwhile.

In summary, international banking makes a key contribution to the development of world financial markets. Furthermore there are indications that the trend toward international banking is here to stay. Accordingly it is probably time to develop some insights into the forces that have caused the banks to expand--but first a discussion of the relative size and growth of the foreign operations of the U.S. and Canadian banks.

Notes for Chapter Three

- ¹ Business Week (July 6, 1974).
- ² Ibid.
- ³ H. H. Binhammer, Money, Banking and the Canadian Financial System (Toronto: Methuen, 1968).
- ⁴ R. W. Goldsmith, Financial Structure and Development (New Haven, Conn.: Yale University Press, 1969).
- ⁵ Ibid.
- ⁶ Ibid.
- ⁷ Ibid.
- ⁸ Ibid., p. 47.
- ⁹ D. E. Bond and R. A. Shearer, The Economics of the Canadian Financial System (Toronto: Prentice-Hall, 1972).
- ¹⁰ The Toronto Dominion Bank, Annual Report, 1973.
- ¹¹ Goldsmith, p. 48.
- ¹² George Ball quoted in Fortune, 75, No. 6 (June 1, 1967), 80.

Chapter Four

GROWTH OF INTERNATIONAL BANKING

It is the primary purpose of this chapter to trace the growth over the past ten years of the international banking activities of U.S. and Canadian banks. The following chapter will then explore the more popular explanations offered for the rapid growth experienced.

To place the growth experience of U.S. and Canadian banks in perspective it may be worthwhile to discuss the overall growth of international banks in recent years. Since 1970, 'The Banker' has published an annual list of the top 300 commercial banks in the world (see Table 4-1 for a partial listing). Since banks perform somewhat different functions in various countries it is difficult to establish criteria upon which to base the annual rankings but it is clear that profits have never been considered.

Deposit taking and short term lending constitute typical banking activities and any companies performing this service are included in the list. However banks all over the world are diversifying wherever permitted by legislation and therefore the list includes several mixed banks who combine deposit taking and short term lending with other financial services. This policy is consistent with the broad definition of international banking developed in Chapter two. U.S. bank holding companies represent a good example of 'mixed banks' included in the annual list prepared by The Banker.

In 1964 the top ten banks of the world had deposits totalling

Table 4-1
THE WORLD'S MAJOR BANKS, 1973

Rank	Bank	Head office	Date of accounts	Assets less contra a/c	Total deposits	Capital & reserves
1	BankAmerica	San Francisco	31.12.73	48,772	41,453	1,550
			31.12.72	40,465	35,085	1,454
2	Citicorp	New York	31.12.73	44,018	34,942	1,770
			31.12.72	34,385	27,704	1,515
3	Chase Manhattan Corp	New York	31.12.73	36,790	29,913	1,348
			31.12.72	30,704	25,032	1,262
4	Banque Nationale de Paris	Paris	31.12.73	30,142	29,780	251
			31.12.72	21,034	20,732	205
5	Dai-Ichi Kangyo Bank	Tokyo	30.9.73	28,467	21,298	845
			30.9.72	20,969	16,815	594
6	Barclays Bank	London	31.12.73	28,304	24,748	1,586
			31.12.72	21,591	18,790	1,394
7	National Westminster Bank	London	31.12.73	27,555	24,802	2,095
			31.12.72	20,568	18,887	1,265
8	Fuji Bank	Tokyo	30.9.73	24,418	18,735	1,083
			30.9.72	17,636	14,551	784
9	Deutsche Bank	Frankfurt	31.12.73	24,389	22,847	836
			31.12.72	18,212	17,050	617
10	Sumitomo Bank	Osaka	30.9.73	23,905	18,233	879
			30.9.72	17,127	14,201	624
17	J.P. Morgan & Co.	New York	31.12.73	19,905	15,367	957
			31.12.72	16,128	12,839	881
18	Manufacturers Hanover Corp	New York	31.12.73	19,540	17,210	895
			31.12.72	16,163	14,150	846
28	Royal Bank of Canada	Montreal	31.10.73	17,737	16,816	491
			31.10.72	14,567	13,769	449
35	Canadian Imperial Bank of Commerce	Toronto	31.10.73	15,669	14,815	495
			31.10.72	13,133	12,414	466
41	Bank of Montreal	Montreal	31.10.73	13,988	13,304	390
			31.10.72	11,138	10,535	370
55	Bank of Nova Scotia	Halifax	31.10.73	10,462	9,769	340
			31.10.72	8,647	8,072	308
71	Toronto-Dominion Bank	Toronto	31.10.73	9,030	8,513	407
			31.10.72	7,354	6,953	306

Source: The Banker, June 1974.

\$73,407 million (including the two largest Canadian banks).¹ By the end of 1973 the ten largest banks in the world had total deposits of \$266,751 million.² This represents a compound annual growth rate of almost 14 per cent.

During the ten year period from 1964 to 1973 there were substantial changes in the top ten rankings:

1964 (1973 rank)	1973 (1964 rank)
1. (1) Bank of America	(1) BankAmerica Corporation
2. (3) Chase Manhattan	(3) Citicorp (1st National City)
3. (2) First National City	(2) The Chase Manhattan Corp.
4. (18) Manufacturers Hanover Trust	(31) Banque Nationale de Paris
5. (6) Barclays Bank	(41) Dai-Ichi Kangyo Bank
6. (21) Midland Bank	(5) Barclays Bank
7. (23) Chemical Bank	(17) National Westminster
8. (28) The Royal Bank of Canada	(20) Fuji Bank
9. (17) Morgan Guaranty Trust	(26) Deutsche Bank
10. (35) Can. Imperial Bank of Com.	(23) Sumitomo Bank

As was noted in Chapter One, several of the major banks now in the top ten have arrived there via mergers and acquisitions. In fact a common theme has emerged since the late 1960's in the international banking scene. It is that the large banks are striving for increasingly sophisticated ways to overcome the constraints on growth imposed by their environment.

Traditionally the share of the market was sustained or increased by direct competition between like institutions. But in recent years

rationalization and diversification into near banking areas of activity have become de rigueur for the big or medium sized banks seeking for something more than the natural growth arising out of increases in money supply and demand for credit.³

Of course the quickest way to move into the big leagues of banking is through a corporate merger. In 1970 Dai-Ichi and Nippon Kangyo Banks of Japan merged their operations to become the fifth largest bank in the world. Prior to the merger each bank ranked around fortieth in the Banker's list.

This merger touched off a wave of aggressive international expansion by Japan's major banks. In 1971 the Japanese banks began setting up international branch networks and they aggressively entered the Euro-currency markets on a substantial scale. This rapid expansion has recently been halted and there is some evidence that the Japanese may have been somewhat overeager in their expansionistic zeal. The Financial Post describes the banking 'invasion' this way:

Anyone who has ever been standing in a line invaded by a squad of Japanese tourists will understand the bruised feelings of the international banking community. The Japanese banks arrived with a typically large and co-ordinated bang. It hurt. And then they dramatically reversed direction last winter (1973). But this time they were the ones who were bruised.⁴

It appears that at the beginning of the 1970's the Japanese banks began to make substantial low rate, medium term Euro currency loans. "It was as if they [the Japanese] had a different message from the rest of us,"⁵ one banker commented in obvious reference to the general consensus of opinion that interest rates would soon rise. The Japanese banks were accused of using 'dumping' tactics in redeploying the country's foreign

exchange reserves to their primary loan outlet--resource rich developing countries.

The 1973 Middle East war and the resultant hike in oil prices forced a change in the Japanese posture almost overnight. Faced with a balance of payments deficit caused by higher oil prices, the Japanese had to borrow in the Euro market. By the second quarter of 1974, Euro dollar borrowings by the Japanese banks were six times the level of one year earlier, and at significantly higher rates of interest.⁶ The banks soon fell into the trap of having to borrow short at high rates of interest to fund long term loans at lower rates. By June of 1974 Japanese authorities had ordered their banks to cease making loans in the Euro currency market. This action effectively stopped the Japanese expansion and a reasonable guess would be that the Japanese banks have slipped considerably in 1974. (Ratings will be prepared (in June 1975) by The Banker.)

The year 1972 saw a further reshuffling of positions in the top 300 list due primarily to differing rates of economic growth in home markets discussed below. There are of course some factors outside the control of the banks that contribute to their relative growth rates. Re-alignment of currencies can have a substantial impact. For example, in 1972 the revaluation of the D-mark and the franc allowed major German and French banks to improve their world ranking. It should be noted however that the impact of a revaluation or devaluation of the local currency is largely dependent upon the degree to which a bank has gone international. The true international banks have assets and liabilities

in several currencies and the effect of a currency realignment may be diffused.

The rapid expansion of major international banks continued in 1973 with the Japanese banks again showing the fastest growth rates. Table 4-2 shows the comparative growth rates since 1971 of the top U.S., Japanese, and E.E.C. banks.⁷

Rapid growth in 1973 resulted in the Fuji Bank and Sumitomo Bank pushing into the top ten for the first time and the Dai-Ichi Kangyo Bank overtaking Barclays in fifth spot. Again, exchange rates played a role in the relative growth rates with Japan showing up well due partly to revaluation of the Yen.

In closing this section it is probably advisable to point out some of the weaknesses in the use of balance sheet data to compare the relative size and growth rates of the world's leading banks. The problem of exchange rate realignment has already been mentioned. However there are other potential problem areas. George Forrest of Barclays Bank has attempted to relate the size of major world banks to the ratio of the money supply to GNP in their home country.⁸ The approach is similar to that of Goldsmith (see Chapter Two) who found that a high ratio of money and near money to GNP is somewhat indicative of a lack of financial sophistication. This particular ratio should not be confused with Goldsmith's 'financial interrelations ratio' which is the ratio of the gross value of all financial assets to national wealth. A high value for the latter is indicative of a financially advanced country. On the other hand a high ratio of money to GNP often indicates that more

Table 4-2

COMPARATIVE GROWTH RATES OF MAJOR BANKS

	1973	% Change	1972	% Change	1971
TOP 10 U.S. BANKS (\$ millions)					
1 BankAmerica Corp	48,772	20.5	40,465	21.1	33,406
2 First National City Corp	44,018	28.0	34,385	16.8	28,713
3 The Chase Manhattan Corp	36,790	19.8	30,704	25.3	24,507
4 J.P. Morgan & Co. Inc.	19,905	23.4	16,128	18.7	13,871
5 Manufacturers Hanover Corp	19,540	20.9	16,163	13.8	14,347
6 Chemical New York Corp	18,364	19.8	15,324	21.5	12,702
7 Bankers Trust New York Corp	18,272	33.0	13,737	23.2	10,738
8 Western Bancorporation	17,751	17.6	15,088	14.8	13,138
9 Continental Illinois Corp	16,784	32.0	12,713	23.7	10,081
10 First Chicago Corp	<u>15,292</u>	<u>36.8</u>	<u>11,181</u>	<u>27.1</u>	<u>9,152</u>
	255,488	24.1	205,888	20.6	170,655
TOP 10 JAPANESE BANKS (\$ millions)					
1 Dai-Ichi Kangyo	28,467	35.8	20,969	32.9	15,774
2 Fuji Bank	24,418	38.4	17,637	37.5	12,823
3 Sumitomo Bank	23,905	39.6	17,127	38.2	12,393
4 Mitsubishi Bank	23,433	39.0	16,860	37.8	12,236
5 Sanwa Bank	22,373	42.1	15,747	35.1	11,658
6 Industrial Bank of Japan	18,550	40.4	13,212	10.8	11,927
7 The Tokai Bank	18,215	47.3	12,362	42.0	8,706
8 Mitsui Bank	16,845	41.8	11,877	45.6	8,158
9 Taiyo Kobe Bank	16,460	45.3	11,331	46.3	7,742
10 Bank of Tokyo	<u>16,298</u>	<u>51.3</u>	<u>10,771</u>	<u>55.3</u>	<u>6,936</u>
	208,964	41.3	147,893	36.4	108,353
TOP 10 EEC BANKS (\$ millions)					
1 Banque Nationale de Paris	30,142	43.3	21,034	34.0	15,698
2 Barclays Bank	28,304	31.1	21,591	15.6	18,680
3 National Westminster Bank	27,555	34.0	20,568	21.0	16,982
4 Deutsche Bank	24,389	34.0	18,212	20.0	15,168
5 Crédit Lyonnais	23,450	17.3	19,994	35.0	13,529
6 Société Générale	22,821	31.8	17,321	35.9	11,078
7 Banca Nazionale del Lavoro	22,651	20.4	18,819	27.6	14,754
8 Dresdner Bank	20,667	38.4	14,926	18.8	12,560
9 Banco di Roma	19,395	23.8	15,663	54.1	10,161
10 Westdeutsche Landesbank Girozentrale	<u>19,366</u>	<u>37.2</u>	<u>14,118</u>	<u>11.7</u>	<u>12,639</u>
	238,740	31.0	182,246	29.0	141,249

Source: The Banker, June 1974.

sophisticated financial assets and markets have not yet been developed. In these countries, banks are by far the most important financial institution and their size is often out of proportion (in relative terms) to the domestic economy. Thus it is not unusual to see a bank from a developing country included in the top 300 list.

In comparing the relative size of banks from developed countries one should be mindful of the appropriate government's view of the role of monetary policy. The governments of some countries, notably Germany, focus on the supply of money. Thus the growth of domestic deposits is restricted. Governments of other countries, Italy for example, use monetary policy primarily to stabilize interest rates. In recent months this has resulted in a very rapid rate of growth in the Italian money supply, primarily consisting of deposits at commercial banks. Italian banks are thus somewhat larger than one would expect they should be.

Another factor to consider in comparisons of the relative size of banks in various countries is whether the commercial banks are considered the major savings medium. Forrest argues that, in the United Kingdom, they are not.

The building societies dominate in the short term savings markets and the insurance companies the long term market. Thus the majority of savings do not come into the money supply and do not show on the books of the banks--resulting in 'smaller' banks than otherwise. In Germany, Switzerland, Japan, or Hong Kong, for example, the banks are the major savings mediums; 'near money' figures are dramatically boosted and the banks are greatly increased in size.⁹

In an effort to correct for the above problem, Forrest has prepared tables (Tables 4-3 and 4-4), which adjust the asset holdings of world banks by a coefficient based on the ratio of money supply to GNP.¹⁰

Table 4-3

MONEY EXPRESSED AS A PERCENTAGE OF GROSS NATIONAL
EXPENDITURE (RELATIVE TO THE UK IN BRACKETS)
ESTIMATED LEVEL AT JUNE 1973

	Money	Near- money	Money supply (Money + near-money)	
United Kingdom	21.2	24.5	45.7	(1.00)
Argentina	50.0	27.9	77.9	(1.71)
Australia	20.3	41.1	61.3	(1.34)
Austria	21.3	45.1	66.4	(1.45)
Belgium	37.9	18.2	56.0	(1.23)
Brazil	22.9	3.7	26.7	(.58)
Canada	21.7	23.2	44.9	(.98)
Denmark	28.7	24.9	53.5	(1.17)
Eire	24.3	32.5	56.8	(1.24)
Egypt	34.6	12.2	46.9	(1.03)
Finland	9.8	40.7	50.5	(1.11)
France	30.7	20.6	51.3	(1.12)
Germany	15.3	42.8	58.2	(1.27)
Greece	21.3	42.7	64.0	(1.40)
Hong Kong	48.8	64.2	113.0	(2.47)
India	24.7	13.6	38.3	(.84)
Iran	21.9	20.8	42.7	(.93)
Israel	21.8	40.7	62.4	(1.37)
Italy	69.3	33.9	103.1	(2.26)
Japan	39.9	59.5	99.4	(2.17)
Korea	12.3	21.9	34.2	(.76)
Kuwait	13.2	26.3	39.5	(.86)
Mexico	13.2	4.8	18.1	(.40)
New Zealand	20.3	11.1	31.4	(.69)
Netherlands	26.0	27.7	53.6	(1.17)
Norway	23.9	41.6	65.5	(1.43)
Pakistan	39.3	16.9	56.3	(1.23)
Peru	20.8	6.4	27.2	(.60)
Portugal	56.8	54.3	111.1	(2.43)
South Africa	20.2	25.8	46.0	(1.01)
Spain	38.2	69.1	107.3	(2.35)
Sweden	10.1	26.4	36.5	(.80)
Switzerland	48.0	66.2	114.2	(2.50)
Taiwan	23.7	37.6	61.3	(1.34)
Thailand	17.0	26.1	43.2	(.94)
Turkey	12.9	19.6	32.4	(.71)
USA	22.0	29.0	51.0	(1.12)
Yugoslavia	33.4	55.3	88.7	(1.94)

Source: The Banker, June 1974.

Table 4-4

ADJUSTED RANKING OF TOP TEN BANKS
(\$000 million)

	Adjusted Assets	Unadjusted Assets	Rank
1. Bank of America	43.7	48.8	1
2. First National City Bank	39.7	44.0	2
3. Chase Manhattan Bank	33.1	36.8	3
4. Barclays Bank	28.3	28.3	5
5. National Westminster Bank	27.6	27.6	6
6. Banque National de Paris	26.8	30.1	4
7. Credit Lyonnais	20.8	23.6	11
8. Societe Generale	20.4	22.6	12
9. Deutsche Bank	19.3	24.4	9
10. Midland Bank	19.1	19.1	20

Source: The Banker, June 1974.

Applying the Forrest coefficient to Canadian banks results in a significant upward adjustment in their ranking. The Royal Bank for example, would advance from twenty-eighth place to eleventh.

While Forrest's analysis is rather interesting, there is a potentially important flaw. The implicit assumption is that the major portion of a particular bank's assets are based in the home country and thus strongly influenced by the institutional and monetary arrangements in that country. As pointed out above, the truly international banks have assets located in several countries. For example, Citicorp of New York has 52 per cent of its total deposits in foreign countries. In this

case it is difficult to argue that the bank's assets should (for comparative purposes) be reduced by a coefficient based upon domestic (U.S.) economic data.

With the above qualifications in mind it can be said that, in the era of international banking, size and growth have taken on renewed importance.

In the past, size represented to a large degree status. In recent years, profitability has become much more important in banking, but increasingly volatile markets and greater involvement in economic development through monetary policy have made size more important again. The 1930's depression proved that big banks weather storms better than smaller banks.¹¹

GROWTH OF U.S. INTERNATIONAL BANKING

In the previous section we discussed the recent growth of the world's major international banks. No distinction was made between the domestic/foreign composition of their balance sheets. The intention rather was to give the reader some feeling for the 'growth cult' that has characterized the banking industry over the past decade.

We now switch our approach somewhat and focus on the ten year growth of the international operations of the U.S. banks. We have not limited our discussion to the growth experience of the five major U.S. banks but have chosen to discuss the international growth of the U.S. banking industry in general. Specific reference will be made occasionally to the experience of the major banks.

In an effort to illustrate the determination exhibited by the U.S. banks in penetrating foreign markets, we have singled out Canada as a case study.

We close this section with a brief discussion of the outlook for further growth of the international operations of U.S. banks.

As illustrated by Table 4-5, in March 1965, U.S. national banks had 144 foreign branches spread around the world.¹²

Table 4-5

FOREIGN BRANCHES OF NATIONAL BANKS, BY REGION AND COUNTRY,
March 31, 1965

Region & Country	Number	Region & Country	Number
Latin America	68	Africa	1
Argentina	17	Nigeria	1
Bahamas	1		
Brazil	15	Near East	4
Chile	2	Lebanon	2
Colombia	5	Saudi Arabia	1
Dominican Republic	1	Dubai	1
Ecuador	2		
El Salvador	1	Far East	36
Guatemala	2	Hong Kong	5
Jamaica	1	India	5
Mexico	5	Japan	10
Nicaragua	1	Malaysia	5
Panama	5	Okinawa	1
Paraguay	2	Pakistan	2
Peru	2	Philippines	5
Uruguay	2	Taiwan	2
Venezuela	4	Thailand	1
Continental Europe	12	U.S. overseas area	14
Belgium	1	Canal Zone	1
France	2	Guam	1
Germany	3	Puerto Rico	11
Greece	1	Truk Islands	1
Italy	1		
Netherlands	3	England	9
Switzerland	1	TOTAL	144

Consolidated assets and liabilities of foreign branches of U.S. banks at December 31st, 1964 were broken down as indicated in Table 4-6.¹³

Table 4-6

ASSETS AND LIABILITIES OF FOREIGN BRANCHES OF NATIONAL BANKS,
DECEMBER 31, 1964: CONSOLIDATED STATEMENT
(Dollar amounts in thousands)

Number of branches	138
ASSETS	
Loans and discounts	\$1,924,827
Securities	178,958
Currency and coin	31,331
Balances with other banks and cash items in process of collection	480,730
Due from head office and branches	320,858
Fixed assets	28,352
Customers' liability on acceptances	304,362
Other assets	<u>50,461</u>
Total assets	\$3,319,879
LIABILITIES	
Demand deposits of individuals, partnerships, and corporations	\$ 730,761
Time and savings deposits of individuals, partnerships, and corporations	1,178,987
Deposits of U.S. Government	190,932
State and municipal deposits	12,988
Deposits of banks	753,791
Other deposits (certified and officers' checks, etc.)	<u>21,468</u>
Total deposits	\$2,888,927
Due to head office and branches	8,591
Rediscounts and other liabilities for borrowed money	61,015
Acceptances executed by or for account of reporting branches and outstanding	305,481
Other liabilities	<u>55,865</u>
Total liabilities	\$3,319,879

In commenting on the 1964 results the U.S. Comptroller of the Currency noted that foreign branch assets had increased by 27 per cent over 1963, a rate well in excess of the growth rate of domestic banking operations.¹⁴ In addition to the foreign branches; in 1964 thirteen national banks had direct investment in eighteen subsidiaries engaged in

international banking and finance. The combined assets of these corporations exceeded \$750 million and their capital funds exceeded \$100 million.

While the 1964 annual growth rate of 27 per cent is certainly impressive, it does not come close to matching the phenomenal expansion over the following nine years. By December 31, 1973, assets of foreign branches of U.S. banks had reached \$121,866 million (see Table 4-7). This represents a nine-year average compound growth rate of almost 50 per cent.

Table 4-7

ASSETS OF FOREIGN BRANCHES OF U.S. BANKS
(In millions of dollars)

Location and Currency Form	Year	Total	Claims on U.S.	Claims on Forgners	Other
All Countries, All Currencies	1971	\$ 61,253	\$4,791	\$ 54,678	\$1,784
	1972	80,034	4,735	73,031	2,268
	1973	121,866	4,881	112,240	4,745
	Mar. 1974	136,983	7,986	123,823	5,174
United Kingdom 1) All Currencies	1971	34,552	2,694	30,996	862
	1972	43,684	2,234	30,430	1,020
	1973	61,732	1,789	57,761	2,183
	Mar. 1974	68,076	3,070	63,020	1,986
2) U.S. Dollars	1971	24,428	2,585	21,493	350
	1972	30,381	2,146	27,787	447
	1973	40,323	1,642	37,816	865
	Mar. 1974	46,062	2,967	42,212	882

Source: Federal Reserve Bulletin, June 1974.

The growth in branches and other financial outlets has not kept pace with asset growth, which has resulted in larger average branch size. By the end of 1973 (see Table 4-8) 125 Federal Reserve member banks had in active operation 699 branches in seventy-six foreign countries.

Table 4-8

FOREIGN BRANCHES OF U.S. BANKS

Location	No.	Location	No.
Abu Dhabi	1	Liberia	2
Argentina	38	Luxembourg	6
Austria	1	Malaysia	5
Bahamas	91	Mariana Islands	1
Bahrain	2	Marshall Islands	1
Barbados	4	Mexico	5
Brunei	2	Monaco	1
Belgium	9	Netherlands	6
Bolivia	3	Netherlands Antilles	3
Brazil	21	Nicaragua	3
Canal Zone	2	Okinawa	2
Cayman Islands	32	Pakistan	4
Colombia	32	Panama	33
Dominican Republic	16	Paraguay	6
Dubai	3	Peru	6
Ecuador	15	Philippines	4
El Salvador	1	Puerto Rico	22
Fiji Islands	4	Qatar	1
France	15	Saudi Arabia	2
Germany	30	Singapore	14
Greece	16	Switzerland	9
Guam	7	Taiwan	5
Guatemala	3	Thailand	2
Guyana	1	Trinidad and Tobago	6
Haiti	2	Trucial State of Sharjah	1
Honduras	3	Truk Islands	1
Hong Kong	23	United Kingdom	52
India	11	Uruguay	5
Indonesia	6	Venezuela	4
Ireland	4	Vietnam	3
Israel	2	Virgin Islands (U.S.)	21
Italy	8	Virgin Islands (British)	3
Jamaica	9		
Japan	23	Other (West Indies)	14
Korea	3		
Lebanon	3	Total	699

Source: 1973 Annual Report, Board of Governors of the Federal Reserve System.

Average branch size has risen from \$23 million in 1964 to \$174 million at the end of 1973. An important contributing factor to the growth in average branch size has been the rapid growth in size of branches in the United Kingdom as a result of their participation in the Euro dollar market. At December 1973, U.S. banks operated fifty-two branches in the United Kingdom with total assets of \$61,722 million for an average branch size of \$1,187 million, well in excess of the overall average.

In fact if U.S. branches and assets in the United Kingdom are removed, the remaining 647 foreign branches show assets totalling only \$53,790 million for an average size of \$83 million. It should be noted that the average size of foreign branches by any measure is still large in relation to the average size of U.S. domestic branches. At December 31, 1973, the 40,408 banking offices in the U.S. had assets totalling \$835,224 million which on average works out to \$21 million per banking office.¹⁵

Unfortunately it is not possible to compare the growth since 1964 in average size of the London branches. The Federal Reserve system only began collecting monthly data on the assets and liabilities of U.S. branches operating in foreign countries in September 1969.¹⁶ It does appear very likely however that, because of participation in the Euro dollar market, the London branches have expanded their average size at a considerably faster rate than other foreign branches.

In fact, assets of U.S. banks operating in London now constitute an important proportion of the entire United Kingdom banking industry.

Bank of England statistics indicate that reporting banks in the U.K. (including the major London clearing banks) held assets totalling £104,391 million at April 17, 1974.¹⁷ The London clearing banks, which include Barclays, Midland, Lloyds, and National Westminster, held £23,477 million or 22.4 per cent of the total. At the same time, U.S. banks operating in London held assets totalling £28,131 million or 27 per cent of the total.¹⁸

The expansion of U.S. banks into foreign markets has, like the Canadian banks, been by a variety of means. By 1972 (the latest date for which statistics could be located) the top ten U.S. banks had, in addition to an extensive foreign branch network, established sixty-five subsidiaries, 208 affiliates, and eighty-seven representative offices in various foreign markets.¹⁹

Canada is a case in point. Because of banking legislation which prohibits foreign banks from branching into Canada, the U.S. banks have created subsidiaries that offer many normal banking services but do not use the word 'bank' in their corporate title. During the past few years more than 100 foreign banks (primarily U.S.) have entered Canadian financial markets through a variety of indirect ways. The institutions created might be termed 'near banks' in that they offer a range of financial services that falls somewhat short of full service banking. Here is how J. A. Boyle, President of the Canadian Bankers Association described these operations:

Their Canadian operations are carried out mainly through subsidiaries and affiliates, covering almost all phases of what is generally understood to be 'banking.' By law in Canada such institutions may not describe themselves as 'banks' nor may they describe their

function formally as 'banking,' but this is really just a matter of semantics. They are very much here and are becoming increasingly important components of the Canadian financial scene.²⁰

The purpose of Boyle's comment was to make public the concern of Canadian bankers that the foreign operations are virtually unregulated and thus not subject to reserve requirements or diversification restrictions. The Bank of Canada reported that, as at October 31, 1974, assets of foreign owned financial institutions totalled \$1.1 billion.²¹

It should be noted that the reporting program is voluntary and this undoubtedly results in understatement of the figures. Another factor contributing to understatement of the figures would be the fact that assets of affiliates (less than 50 per cent foreign owned) are not included. For example, BankAmerica owns in excess of 20 per cent of Montreal Trust, a large Quebec based trust company with assets in the \$600 million range.²² These assets are not included in the Bank of Canada statistics.

Another method used by foreign banks to enter Canada has been by way of a resident representative. More than thirty foreign banks operate representative offices in Canada with the implicit blessing of government officials. The representative offices do place the name of the foreign bank above the office door so to speak which is technically in contravention of the Bank Act. There are indications however that the foreign representatives receive a friendly welcome from the chartered banks and "are given a warm reception from government officials and even an off-the-record apology that their office cannot have the status of a full operating branch."²³ The clear message that comes out of the

Canadian experience is that banks, especially the American ones, will not let restrictive legislation stand in the way of their growth requirements.

The growth rate of the overseas expansion of U.S. banks via affiliates, subsidiaries or consortia is not possible to measure because no statistics are available. However the suspicion is that growth has been rapid. A review of recent annual reports of the major U.S. banks indicates that considerable attention is paid to expansion by vehicles other than branching. It appears to be the case however that some major banks prefer to go it alone via the branch route. Citibank has, until recently followed this method. It now appears that Citibank may be changing their policy somewhat. In a recent address to a national convention of the Bank Administration Institute, S. C. Eyre, Comptroller of Citicorp stated:

The case of Citibank is perhaps illustrative of the altered economics of foreign expansion. Whereas in the late 1960's, we were frequently adding new overseas branches at the rate of about one new branch every two weeks, in 1972 we opened only eleven new branches, and we actually closed more branches, by a count of 16 to 11, than we opened.²⁴

At the same time Citibank is actively investigating further expansion via participation with foreign banks. One reason advanced for this somewhat altered policy is the spiralling costs of branch operation.

BankAmerica on the other hand has pursued a more balanced pattern of international growth. From 1964 to 1973 the bank expanded its international branches from twenty-seven to 103, an increase of 3.8 times. Over the same period the Bank's international subsidiaries grew from

three to twenty-one (seven times) and equity investments in other ventures grew from eighteen to eighty-one (4.5 times). The following excerpt from the 1973 annual report of BankAmerica seems indicative of its policy toward international expansion:

The bank continued to diversify its international investments in commercial banks, leasing firms, finance companies, and multi-speciality merchant banks. With the growing emphasis on the overseas potential of merchant banks, the bank participated in the operating of three such institutions in Southeast Asia and has plans for three more in 1974.²⁵

Chase Manhattan bank has expressed a similar policy toward overseas expansion:

In expanding our international business base, it has been our policy to employ a mix of branches, wholly owned subsidiaries, controlled but not wholly owned subsidiaries, and affiliates. The decision on which type of investment to initiate depends on our estimate of opportunities in each country.²⁶

The following table illustrates Chase's worldwide international network.²⁷

Table 4-9

WORLDWIDE INTERNATIONAL NETWORK--CHASE MANHATTAN BANK

	1969	1973
Overseas Branches:		
Canada, Caribbean, & Latin America	32	58
Europe and Africa	11	19
Asia and the Middle East	12	22
Total	55	99
Subsidiaries:		
Canada, Caribbean, & Latin America	10	21
Europe and Africa	5	11
Asia and the Middle East	0	2
Total	15	34
Affiliates:		
Canada, Caribbean, & Latin America	2	4
Europe and Africa	4	11
Asia and the Middle East	4	14
Total	10	29

In summary, the growth of foreign operations of U.S. banks has been spectacular. Over the five year period ending in 1972 the growth of foreign assets of U.S. banks clearly outstripped the growth of U.S. trade and direct investment as seen in the following table:²⁸

Table 4-10

EXPANSION OF BRANCH BANKING OVERSEAS COMPARED
WITH FOREIGN TRADE AND US DIRECT INVESTMENT
ABROAD, 1967-1972
(in bn \$)

Global	1967	1968	1969	1970	1971	1972
Assets of Overseas						
Branches of Member						
Banks Federal						
Reserve System	15.7	23.0	41.1	52.6	67.1	77.4
US Exports	31.5	34.6	38.0	43.2	44.1	49.8
US Imports	26.8	33.2	36.0	40.0	45.6	55.6
Bookvalue, US Direct						
Investments Abroad	59.5	65.0	71.0	78.1	86.0	94.0
Western Europe						
Assets of Overseas						
Branches of Member						
Banks Federal						
Reserve System	10.9	17.3	31.2	39.2	48.1	53.9
US Exports	10.3	11.3	12.4	14.5	14.2	15.3
US Imports	8.2	10.3	10.1	11.2	12.6	15.4
Bookvalue, US Direct						
Investments Abroad	17.9	19.4	21.7	24.5	27.6	30.7

As may be seen from the above table, foreign branch assets increased by 4.9 times while U.S. exports increased by 1.6, and direct investment by 1.6 times.

There appears to be a good possibility that U.S. international

expansion is at a crossroad. It has been argued that the physical expansion of U.S. banking offices abroad is waning and that asset growth may also slow down. There are a variety of reasons behind the above thinking. Firstly, spreads in the London market are very thin and it is unlikely that banks contemplating an office there could hope to earn an acceptable level of profits. Secondly, it can be argued that the major U.S. banks are now represented (where permitted by legislation) in every worthwhile nation and further physical expansion appears improbable. There are other problems currently muddying the water. "The devaluation of the dollar, a tighter competitive situation as evidenced by rate pressures in London, the uncertain effects of the emergencies, the administration's announced intention to phase out exchange controls by the end of 1974 [now done], all tend to make expansion through new offices a far less intriguing proposition."²⁹

A liquidity problem in the domestic U.S. banking industry may also have a repressive effect on foreign expansion (see Chapter Nine). Professor Paul Nadler of Rutgers University has stated that the liquidity problem is causing: "the worst crisis in confidence I've ever seen."³⁰ For reasons that will become clearer in later chapters, one cannot help thinking that, while some retrenching might take place, the pause in growth will be only temporary.

CANADIAN GROWTH

In this section we will follow a format somewhat similar to that presented for the U.S. case. After a brief discussion of the overall

growth of the major chartered banks (which can be compared to Table 4-2), we enter into a discussion of the growth of international operations. Both size of assets and number of banking installations are presented. In common with the U.S. case, it is considered preferable to use assets as the measure of international growth.

Perhaps the entry into international wholesale banking receives more emphasis in this section. This is primarily because the Canadian banks seem to be focusing more attention on this area than their American counterparts. While differences in preference for operating forms do exist within the U.S. banking industry, on the whole it appears that the U.S. banks have followed a more balanced expansionary process.

The following table shows the growth rate, since 1971, of the five largest chartered banks.

Table 4-11

GROWTH IN ASSETS OF CHARTERED BANKS

\$ Millions	1973	% Change	1972	% Change	1971
Royal Bank	17,737	17.8	14,567	17.1	12,430
C.I.B.C.	15,669	19.3	13,133	19.3	11,008
Bank of Montreal	13,988	25.5	11,138	12.7	9,897
Bank of Nova Scotia	10,462	20.9	8,647	26.7	6,823
Toronto-Dominion	9,030	22.7	7,354	17.7	6,246
	66,886	21.2	54,839	18.7	46,386

When compared to Table 4-2 it is apparent that the Canadian banking industry has been growing at a substantially slower pace than the banking

industries of Japan and the E.E.C., but at a comparable pace with the U.S. industry. However the above statistics do not tell the whole story. It is the case that domestic expansion of the chartered banks has been rather slow but foreign operations are growing at a considerably faster pace. Table 4-12 sets out the international network of the chartered banks as at December 31, 1973.

Table 4-12

BANK BRANCHES, AGENCIES, SUBSIDIARIES AND AFFILIATES
December 31, 1973

Country	Number	Country	Number
Argentina	5	Indonesia	3
Australia	2	Italy	2
Bahamas	47	Jamaica	90
Belgium	2	Japan	5
Belize	9	Lebanon	3
Brazil	3	Malaysia	1
Colombia	9	Mexico	3
Dominican Republic	19	Netherlands	4
Eire	2	Puerto Rico	10
France	6	Singapore	4
Germany (West)	9	Switzerland	1
Great Britain	27	United States	62
Greece	2	Venezuela	13
Guyana	12	British Virgin Is.	2
Haiti	2	U.S. Virgin Is.	6
Hong Kong	7	West Indies	104
India	1	TOTAL	477

Source: Factbook '74, The Canadian Bankers' Association.

It appears reasonable to assume that few people realize the extent to which the chartered banks have gone international in the past ten years. It is thought to be common knowledge that the banks operate the foreign exchange market and facilitate the financing of exports and imports. It is also fairly well known that a retail banking operation has been conducted in the Caribbean for the past 100 years. While these aspects of the foreign operations of Canadian banks continue to be important, the real growth area during the past few years has been in merchant and wholesale banking.

It may be well to identify three distinct, but interrelated areas of foreign currency business.³¹ The first area may be described as the operation of the foreign exchange market and export-import financing. The second area involves the operation of a retail banking business in a foreign market. The branch networks of the chartered banks in the Caribbean and in California are good examples. The third area may be described as international wholesale banking.

There are at least four ways of entering the wholesale market on the international level:

- a) branching;
- b) purchase of existing ventures (affiliate route);
- c) establishment of a foreign subsidiary; and
- d) participation in international consortia.

While the above distinction concerning types of foreign currency business may be useful in some respects, it should be remembered that the

boundaries are often fuzzy. For example a Canadian bank may have a branch in London that provides a foreign exchange service, a retail operation, and engages in wholesale banking.

Unfortunately the financial data available on foreign operations is not sufficiently disaggregated to allow precise comparisons of the growth rates of the three areas of foreign operations. Gross data only is provided by the Bank of Canada covering total foreign currency assets and liabilities (see Table 4-13), and this source will be utilized below when discussing the ten year growth rate of foreign currency business.

A comparison of the numbers of operating vehicles employed in foreign countries over the past ten years was considered as an indicator of the growth rates of the three areas of foreign currency business. The potential weakness of using this measure rather than some financial yardstick such as contribution to profits or asset growth is so great that the measure was rejected. For example the single Bankers Trust Office in London is very large and showing good growth. "Our London office, which was established in 1923 and by any measure would rank among the largest banks in the United States, continues to grow both in size and in profit contribution."³² Thus it would be possible for--say the Royal--to open several Caribbean 'mini branches' but just one major wholesale outlet operating in a financial centre might contribute far more to growth and profits.

A perusal of recent annual reports of the major chartered banks indicates that they all emphasize the importance of their wholesale operations and their participation in consortia. In the final analysis

Table 4-13

CHARTERED BANKS: TOTAL FOREIGN CURRENCY ASSETS AND LIABILITIES*

End of Period	A S S E T S						L I A B I L I T I E S			Net foreign assets
	Call loans	Other loans	Sec- uri- ties	Deposits with banks	Other assets	Total	Deposits of banks	Other deposits	Total	
1963	1,013	1,566	538	1,110	9	4,236	816	3,398	4,214	22
1964	1,017	2,011	587	1,597	-33	5,179	931	4,281	5,211	-33
1965	732	2,287	642	1,384	-8	5,037	1,260	3,822	5,083	-46
1966	892	2,622	621	1,516	-9	5,643	1,271	4,297	5,568	75
1967	744	2,658	788	2,326	-46	6,470	1,529	4,780	6,309	162
1968	712	2,943	814	3,263	75	7,806	2,134	5,243	7,378	429
1969	676	3,853	860	6,381	-138	11,632	3,240	8,390	11,630	2
1970	623	4,671	733	7,526	138	13,691	4,915	8,618	13,533	158
1971	715	5,315	516	7,669	254	14,469	6,419	7,743	14,162	307
1972	973	5,510	613	9,524	-48	16,572	8,411	8,607	17,018	-446
1973	537	7,082	546	14,759	375	23,298	13,323	11,255	24,577	-1,279
1974	526	11,692	726	14,885	796	28,626	15,284	14,117	29,400	-774

* Millions of Canadian dollars.

Source: Bank of Canada Review, August 1974.

however we are forced to discuss the growth of the international currency business of the chartered banks in gross terms.

As at June 30th, 1974, foreign currency assets of Canadian chartered banks totalled \$25,743,000,000 or about 30 per cent of total bank assets of \$87,194,000,000 compared to 1964 figures of \$5,179,000 and \$23,872,000 respectively.³³ Growth of foreign assets over the ten year period was at a compound annual rate of about 17 per cent compared to a U.S. growth rate of almost 50 per cent per annum over the same time period. Canadian dollar assets grew at about 11.75 per cent over the period. The growth in international business is clearly outstripping domestic expansion and, if the present trend continues, foreign operations will dominate (51 per cent) Canadian banking before 1990.

While the above statistics present a reasonably accurate picture, the full extent of the Canadian banks' international operations is somewhat understated. Under the Bank Act only wholly owned subsidiaries engaged in banking may be consolidated in the annual financial statements of a chartered bank.³⁴ The result is that a bank only records its investment in a subsidiary or affiliate and not the latter's total assets on a consolidated basis. For example, the Royal Bank of Canada owns 75 per cent of the capital stock of The Royal Bank Jamaica Ltd.³⁵ The latter company had total assets as at September 30th, 1973, of J\$75,215,144 (1 Jamaican = \$1.10 Canadian) which effectively constitutes foreign currency assets of the Canadian bank. However this investment was carried on the books of the Royal at \$2,532,005 and it is this figure that appears in the foreign currency data reported in the monthly Bank

of Canada Review. All of the 'big five' chartered banks have similar investments, which appear to be carried on the books following the cost rather than the equity method recommended by accountants. Other foreign currency assets not included in the available statistics include foreign investments in bank premises and equipment.

It is not possible to accurately determine the magnitude of the understatement of foreign currency assets owned by the Canadian banks but, based on sketchy information available, this writer would estimate that it is less than 5 per cent of the total.

As mentioned above it is not possible to obtain hard data to prove that international wholesale banking is growing faster than the other two areas of foreign banking. There is substantial soft evidence to support this contention however. The authors of the Porter Commission asserted that international wholesale banking was growing much more rapidly than the other areas.³⁶ The majority of comments concerning international operations by Canadian bankers focus on the wholesale area. The following are some samples from Canadian bankers:

John H. Coleman, formerly Deputy Chairman, The Royal Bank of Canada:

The world wide branch system is not the system of the future. We just pulled out of Peru for example. Some countries want us to incorporate our branches and offer some of the equity to the nationals. So now the thrust is to lessen our exposure to these forces (nationalism) by going into wholesale banking.³⁷

Bob Peel, General Manager, Corporate Accounts Development, Bank of Nova Scotia:

We've always been a hard core international operation. However we only really started to move into Europe in the late 1950's and, in

terms of wholesale banking, have been doing business internationally since that time.³⁸

F. H. McNeil, formerly President, Bank of Montreal:

The bank's international expansion in the past year (1973) has been primarily in the inter-bank (wholesale) market. Furthermore, the bank has taken steps to improve its ability to develop more corporate business abroad. London has been established as a regional office with responsibility for operations in Europe, Africa and the Middle East.³⁹

R. F. Harrison, President, Canadian Imperial Bank of Commerce:

A relatively large proportion of the bank's international business is in the wholesale money market field.⁴⁰

A significant part of the chartered banks recent growth has been the result of participation in the financial markets of Britain. As at April 17th, 1974, deposits of banks located in the U.K. totalled £104,391 million⁴¹ (see Table 4-14).

Table 4-14

ASSETS OF BANKS IN THE UNITED KINGDOM

BANKS IN THE UNITED KINGDOM: SUMMARY (£ millions)				All holders	
				Total	Other currencies
1973	Apr.	18	73,369	34,096	39,273
	May	16	73,158	33,930	39,227
	June	20	74,603	35,095	39,507
	July	18	78,730	36,363	42,367
	Aug.	15	82,386	36,755	45,631
	Sept.	19	84,932	38,383	46,549
	Oct.	17	88,002	38,942	49,060
	Nov.	21	92,724	40,536	52,188
	Dec.	12	95,490	41,125	54,364
1974	Jan.	16	99,260	41,735	57,525
	Feb.	20	100,777	42,454	58,323
	Mar.	20	101,049	41,576	59,474
	Apr.	17	104,391	42,472	61,919

(Source - all sections: Bank of England Quarterly Bulletin, June 1974.

A partial breakdown of the share in these deposits is as follows:⁴²

	(Millions) <u>Amount</u>	<u>%</u>
London Clearing banks	£23,477	22.6
Commonwealth banks	13,315	12.8
U.S. banks	28,121	27

The major set of banks (in terms of assets) making up the Commonwealth group are Canadian. The above figures include all currencies on deposit in the U.K. If sterling deposits are eliminated, then the share in holding foreign currency deposits (primarily \$ U.S.) breaks down as follows:⁴³

	(Millions) <u>Amount</u>	<u>%</u>
London Clearing banks	£ 2,411	3.9
Commonwealth banks	10,107	16.4
U.S. banks	24,034	38.9
All other	25,367	40.8
Total for U.K.	£61,919	100.0

In summary then a case can be made that a substantial portion of the very rapid growth in the international activities of the chartered banks has been in the wholesale banking area. This feature will have important implications when we explore the existing explanations for international banking growth.

SUMMARY

To give the reader some idea of the size of foreign operations of Canadian banks compared to large U.S. banks; foreign deposits of the five largest U.S. banks totalled approximately \$70,000 million at June 30th, 1974, compared to \$28,732 million for the whole Canadian banking industry.⁴⁴ In fact the combined foreign deposits of BankAmerica and Citicorp at some \$40,000 million exceeded the Canadian figure.

Both U.S. and Canadian banks have high propensities toward foreign assets although some interbank differences are evident. Strictly comparable data is difficult to locate because the chartered banks do not invariably disclose the domestic/foreign composition of their balance sheets. The Bank of Canada, of course, publishes only aggregate data. Occasionally the president or chairman of a bank will make some comment in the annual report to shareholders which indicates the size of the particular bank's foreign operations. For example the following are comments by R. W. Frazee, Executive Vice-President, Royal Bank, in his 1973 report to shareholders:

This is reflected in the significant increase in the bank's foreign currency deposits which grew by 44 per cent during 1973 to \$6,400 million at year end. At that date these deposits represented 38 per cent of our total deposit liabilities, which gives some indication of the importance to the bank of our foreign operation.⁴⁵

More recently the three smaller chartered banks have reported the foreign/domestic asset split in their annual reports. Available figures for the big five Canadian and U.S. banks are:

Per cent Foreign Deposits to Total Deposits

BankAmerica	42%	Royal	38%
Citicorp	52%	CIBC	about 24%
Chase Manhattan	42%	B/M	32%
Manufactures Hanover	28%	BNS	44%
J.P. Morgan	43%	T.D.	36%

Based on the above data and the previously mentioned fact that foreign business is growing at a faster pace than domestic, it is becoming very apparent that the home office location is only incidental to the big banks. They have become multinational corporations in every sense of the word.

In closing this section it should be reiterated that growth of foreign operations has been at a very rapid pace over the past ten years. All three areas of the U.S. and Canadian banks' foreign currency business has grown but the most rapid growth has occurred in the wholesale banking sector. It is the general failure to recognize this important point that has led the writer to question the validity of the most popular existing explanations for growth--the subject of the next chapter.

Notes for Chapter Four

- 1 Banks of the World (1964).
- 2 The Banker (June 1974).
- 3 Ibid., 121 (1971), 659.
- 4 Quoted in the Financial Post (Sept. 21, 1974), p. J12.
- 5 Ibid.
- 6 Ibid.
- 7 Adapted from The Banker (June 1973) and (June 1974).
- 8 G. Forrest, "How Comparisons Can Mislead," The Banker (June 1974).
- 9 Ibid., p. 613.
- 10 Ibid.
- 11 The Banker (June 1974).
- 12 Comptroller of the Currency, 1964 Annual Report.
- 13 Ibid.
- 14 Ibid.
- 15 Board of Governors of the Federal Reserve System, 1973 Annual Report.
- 16 Federal Reserve Bulletin (February 1972).
- 17 Bank of England: Quarterly Bulletin (June 1974).
- 18 Ibid.
- 19 H. V. Prochnow and H. V. Prochnow, Jr. The Changing World of Banking (New York: Harper and Row, 1974).
- 20 C.B.A. Bulletin, 17, No. 2 (June 1974).
- 21 Bank of Canada Review (October 1974).
- 22 Burrough's Clearing House (January 1974).

- 23 J. A. McMyn, "What Rules for Foreign Banking?" Canadian Banker and ICB Review, I-74.
- 24 S. C. Eyre, "Exploring Some Trends in International Banking," Burrough's Clearing House (February 1974).
- 25 BankAmerica Corporation, 1973 Annual Report, p. 7.
- 26 The Chase Manhattan Corporation, 1973 Annual Report, p. 4.
- 27 Ibid.
- 28 E. P. Imhof, "Rapid Expansion of Overseas Banking," Inter-economics, No. 8/74.
- 29 Eyre, p. 54.
- 30 Quoted in Business Week (September 21, 1974), p. 52.
- 31 Porter Commission, p. 137.
- 32 Bankers Trust New York Corporation, 1972 Annual Report.
- 33 Bank of Canada Review (August 1974).
- 34 The Bank of Nova Scotia, 1973 Annual Report.
- 35 The Royal Bank of Canada, 1973 Annual Report.
- 36 Porter Commission, p. 137.
- 37 Quoted in The Executive (June 1971), p. 32.
- 38 Quoted in The Canadian Banker and ICB Review (January 1974),
p. 9.
- 39 Bank of Montreal, 1973 Annual Report, p. 13.
- 40 Canadian Imperial Bank of Commerce, 1971 Annual Report.
- 41 Bank of England: Quarterly Bulletin (June 1974).
- 42 Ibid.
- 43 Ibid.
- 44 Business Week (September 21, 1974) and Bank of Canada Review (August 1974).
- 45 The Royal Bank of Canada, 1973 Annual Report.

Chapter Five

EXISTING EXPLANATIONS FOR THE GROWTH OF INTERNATIONAL BANKING

The role of a service industry in international business expansion has generally been thought of as a passive one. That is, some external or environmental variable is usually held out as the force 'pulling' a service firm to a foreign market.

Most service businesses limited the scope of their operations to a few foreign countries prior to the mid 1950's, but the tremendous volume of foreign activity by their traditionally domestic clients, beginning in the 1960's, induced--or perhaps 'forced'--the banks, accountants, advertising agencies, and so on, to go international themselves.¹

When commercial banks engage in international business they are typically thought of as operating the foreign exchange market and as a channel and/or source of financing for trade and capital flows. Here are two quotes, the first relating to the Canadian banks, the second to U.S. banks, that illustrates the popular explanation for international growth:

A major reason for Canadian bank expansion lies in the fact that Canada relies to a very large extent on export of raw materials, agricultural products, manufactured goods and engineering know-how. The banks provide a comprehensive network of facilities and services relating to foreign trade and financial transactions.²

There has been a close correlation between the high levels of international trade and investment on the onehand, and international activities of U.S. banks on the other.³

The clear implication that follows from these quotes is that the banks are followers in the international business arena.

The above comments are consistent with the earlier expressed motivation of the French, English, and German banks, who claimed their objective was to track the expansion of their respective countries' external trade and overseas investments.

The particular intent was to serve domestic customers in their colonial and foreign ventures, to provide them with the services they required, to finance their imports and exports, and to help finance their investments.⁴

It is not clear why banks would find it necessary to establish a foreign operation to serve domestic customers in their foreign trade and investment activities. Let us assume that a major Canadian corporation requires a chartered bank to look after its export and import transactions. In the first place all documents and collections (letters of credit, documentary bills, etc.) can be handled by a domestic bank branch whose only contact with the foreign market is through correspondent banks. Up to this point there is no need for a Canadian bank to establish overseas. An office set up in a foreign market just to handle the other end of trade transactions could hardly hope to survive.

The above discussion covers the handling of foreign exchange transactions. But what about financing foreign trade? In this area, why bank expansion abroad is a function of the growth of foreign trade is also unclear. The credit needs of the Canadian company are almost always provided in Canadian dollars. That is, no distinction is generally made in financing an account receivable, whether it be due from a company in

Tokyo or Toronto. J. A. Galbraith, formerly Chief Economist, Royal Bank of Canada, has noted:

Canadian banks, of course, have always played an important role in financing Canadian exports and imports. Much of their lending activity in Canadian dollars helps to accommodate the international trading transactions of their customers. Only a small proportion of bank financing of Canada's international trade is provided in U.S. dollars although much of Canada's trade is invoiced in U.S. dollars.⁵

In his 1969 M.B.A. thesis, Barry Bruce attempted to explain why the banks go abroad.⁶ Bruce conducted a field study in which bankers from the international divisions of the five major Canadian and five major U.S. banks were interviewed. All of the bankers interviewed stressed that the nature of the flow of trade was an important force directing the banks abroad.

It is interesting to note that the bankers interviewed by the writer continue to stress trade as an important motivating factor in international expansion of the chartered banks.

In summary, the 'foreign trade' argument to explain bank expansion abroad is open to criticism. Perhaps the argument has continued to prevail somewhat because it is not in the best interests of the banking community to dispell it. Facilitating foreign trade is a type of activity that receives fairly wide public acceptance---unlike some of the other banking services such as moving 'hot' money among various world markets.

In a speech presented to the Canadian Conference on Banking in September 1974, Page Wadsworth, Chairman of the Canadian Imperial Bank

of Commerce gave the impression that in the growth of international banking there are factors other than trade expansion. The following comment: "Trade expansion has therefore been a significant factor in the burgeoning of our international banking activities in the 1960's and 1970's"⁷ was followed, somewhat later in the speech, by:

the great increase in activity in international financial markets in recent years, and in the activities of international banks in these markets, can be characterized as wholesale banking--the fast efficient movement of high volumes of short, medium, and long term funds from lenders to borrowers by way of the international banking system.⁸

This writer would argue that the rapid growth of wholesale banking is good evidence that the banks are no longer simply tracking Canadian trade and investment around the world.

Bruce did uncover evidence that government regulation was a motivating force behind overseas expansion. We are in complete agreement with this finding and will develop the government variable further when we present our model of foreign bank expansion in Chapter Eight.

Bruce also uncovered some evidence that the 'bandwagon effect' influenced the decisions of at least some of the banks. This type of behavior which has been termed 'oligopolistic reaction' will be explored in Appendix II.

Several other reasons for the growth of the international activities of U.S. and Canadian banks have been suggested. S. C. Eyre, Comptroller of Citicorp, summarizes the reasons as follows:

The reasons for this rapid rate of growth are well known. Many banks were catching up with their corporate clients, who had expanded

abroad. Various exchange controls, imposed throughout the mid 1960's, encourage banks to develop deposit bases overseas. And, of course, after the credit crunches of 1966 and 1969-70 banks set up foreign branches to be able to tap the Eurodollar market for domestic use.⁹

Two distinct reasons seem to emerge from the above comment: the 'pull' of multinational clients and the 'push' of government interference in the market system.

It is somewhat difficult to argue that the pull of the multinational firm influences the Canadian banks. Canada's multinationals are few in number and the writer has been unable to uncover any evidence that the spread of these firms has been a significant influence in overseas operations of the banks. About 60 per cent of this country's foreign direct investment is in the U.S.--largely concentrated in breweries and distilleries due to the U.S. prohibition era which severely set back the domestic industry. Canadian banks only have branches in a few states--New York, California, Washington, and Oregon--and there is little correlation between the location of Canadian industry in the U.S. and the location of the Canadian banks.

One factor that may have some influence however is the experience the Canadian banks have gained in financing U.S. multinationals in Canada. Successful banking is very dependent on personal contact and favourable experience built up in Canada is thought by some to open up opportunities for the Canadian banks to serve major U.S. firms participating in overseas markets. While there may be some element of truth in this line of reasoning, it appears to this writer to be almost self-evident that the U.S. multinational would prefer to deal with its major U.S. bankers in the foreign market. This is based on the reasonable

assumption that the U.S. bank has located in the relevant foreign market.

There is more reason to believe that the expansionary foreign development of U.S. banks has been caused to some degree by the spread of U.S. based multinationals,

The overseas expansion of U.S. banking is, of course, a logical consequence of the prior expansion of American corporations, and of the predominant role of the dollar in financing the world's trade.¹⁰

An example of the advantages of being represented in several foreign markets, is evidenced by the experience of Citibank with a large U.S. based multinational.

Perkin-Elmer; a Connecticut based manufacturer of optical and scientific instruments, was looking for a blanket credit covering the short-term and medium term needs, in local currencies, of its European subsidiaries in seven countries. The company found that only Citibank, with branches in all seven countries, could handle the loan.¹¹

The strength of the 'pull' forces over--say the last five years--is open to some doubt however. A substantial part of foreign growth during the past five years has been in London. In 1953 there were ten U.S. banks in London. At this time the primary motivation was thought to be to acquire a sterling base and to serve U.S. industrial subsidiaries. Since the mid-late 1960's however the prime attraction to London has been the Euro-dollar market. As at March 31, 1974, assets of U.S. branches located in the United Kingdom totalled \$68,076 million.¹² This figure represented 49.6 per cent of total assets (\$136,983 million) of U.S. banks located in all foreign countries.

The magnitude of assets concentrated in one centre provides

reasonable evidence that the pull force of multinational clients might have been somewhat overplayed as a determinant of foreign expansion of the U.S. banks. Furthermore, we will argue later that the Euro-dollar market, rather than 'pulling' U.S. banks abroad, largely was spawned by domestic market interference from the U.S. government. Government interference will be a key variable in developing a theory of foreign bank expansion. The Euro-dollar market therefore will be seen to be the result (or victim if you will) of an aggressive outward 'push' by the U.S. banks--a push caused in part by government interference.

In summary, this writer has become somewhat dissatisfied with the rather stock explanations that have the banks playing a passive role in responding to the needs of their domestic customers--be it to facilitate a trade transaction or to finance the customer in a foreign market. There are good reasons to believe that the banks are considerably more aggressive than generally believed. The banks of course do very little to promote the idea that they have aggressively expanded--and for good reason. Maintaining a low profile and fostering the belief that a passive role is played is much more likely to result in less unfavourable comment from the wide variety of observers of the banking industry. Bankers are well aware that they are in an industry that is often the target of nationalistic opposition. Says C. Langston, Assistant General Manager, Canadian Imperial Bank of Commerce: "It's an extremely sensitive political situation when you move into a country. It is definitely not in your interest to step right in and make waves."¹³

Occasionally however some comment is made that indicates that

the chartered banks are more aggressively viewing the world as their market. For example, here is a quote from the 1974 annual report of the Bank of Nova Scotia:

Some of this growth in foreign currency loans reflected our efforts to meet the financing requirements of our domestic customers. But a larger proportion represented the expansion of our international lending activities.¹⁴

This writer does not claim to be the first to recognize the trend away from the passive role of the banks in foreign expansion. L. C. Nehrt, writing in 1967 reported:

A very recent, and most interesting development in the overseas expansion of U.S. commercial banks, however, is a tendency toward aggressive investments. Some banks are no longer passively (and often reluctantly) responding to the needs of their domestic customers; rather they are looking upon investments in an overseas branch in the same manner as the opening of another branch in their home state or city.¹⁵

Nehrt, however did not explore the underlying reason for the trend toward aggressive expansion. This would involve developing a theory of growth and to the writer's knowledge none has been developed for the banking industry to this date.

The growth and expansion of the foreign activities of Canadian and U.S. banks certainly qualifies them as multinationals. It therefore appears appropriate to examine the theoretical analysis that has been applied to other multinational firms in an effort to develop a theory that might be applied to the banking industry.

Notes for Chapter Five

- ¹ D. B. Zenoff and J. Zwick, International Financial Management (Englewood Cliffs, N.J.: Prentice-Hall, 1969), p. 10.
- ² James Montagnes, "International Banking Canadian Style," Burrough's Clearing House (September 1974), p. 73.
- ³ J. P. Koszul, "American Banks in Europe," in The International Corporation, C. P. Kindleberger (ed.), p. 276.
- ⁴ Ibid.
- ⁵ J. A. Galbraith, Canadian Banking (Toronto: Ryerson Press, 1970), p. 307.
- ⁶ B. D. Bruce, "International Banking Activities of Canadian and American Banks," M.B.A. thesis, University of British Columbia, 1969.
- ⁷ J. P. R. Wadsworth, "Why Do Canadian Banks Want to Establish Abroad?" from speech presented to the Canadian Conference on Banking, Toronto, September 16, 1974.
- ⁸ Ibid.
- ⁹ S. C. Eyre, "Exploring Some Trends in International Banking," Burrough's Clearing House (February 1974), p. 54.
- ¹⁰ J. Main, "The First Real International Bankers," Fortune (December 1967), p. 143.
- ¹¹ Ibid., p. 198.
- ¹² Bank of England: Quarterly Bulletin (June 1974).
- ¹³ Quoted in The Canadian Banker and ICB Review (January 1974), p. 12.
- ¹⁴ The Bank of Nova Scotia, 1974 Annual Report, p. 19.
- ¹⁵ L. C. Nehrt, International Finance for Multinational Business (Scranton, Penn.: International Textbook Company, 1967), p. 351.

Chapter Six

THEORIES OF THE CAUSES OF DIRECT

FOREIGN INVESTMENT

This chapter of the paper forms the foundation of what is hoped will be a sound micro-theory of international banking expansion. There is a considerable volume of literature, albeit of an inconclusive nature, dealing with the theory of direct foreign investment. The studies that this writer has been able to locate deal exclusively with U.S. industrial firms; however, as mentioned in the introduction, there is no obvious reason that a service industry such as banking should not be subject to some common objectives, opportunities, uncertainties, and risks when making a direct foreign investment.

What follows will be a rather rapid run through the field of investment theory. The chapter is organized as follows:

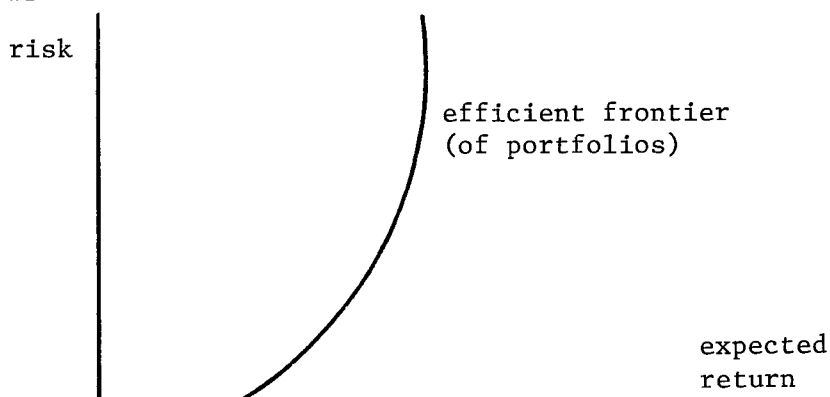
- a) definition of direct foreign investment (p. 80);
- b) distinction between direct and portfolio investment (p. 80);
- c) brief discussion of interest rate arbitrage (p. 81);
- d) introduction to direct investment theory (p. 83);
- e) Aliber's theory (p. 84);
- f) imperfections in capital markets (p. 88);
- g) monopolistic advantage (p. 90);
- h) oligopoly and need for growth (p. 94); and
- i) summary (p. 97).

The next two chapters will be devoted to applying the concepts discussed in this chapter to a theoretical model that might be applied to the banking industry.

(a) A direct foreign investment is defined as: "the amount invested by residents of a country in a foreign enterprise over which they have effective control."¹

(b) The distinction between direct and portfolio investment is that the former involves a net transfer of real capital to the host country together with entry into a host country industry by a firm established in some other country, whereas portfolio investment only involves the transfer of financial capital. Another distinguishing feature of the two types of foreign investment is that direct investment is virtually the exclusive domain of the corporation while portfolio investment includes substantial participation by individuals.

The pioneering work in portfolio investment theory was carried out by Markowitz.² Using a criterion called 'portfolio efficiency,' Markowitz confined his attention to selecting from a list of securities a sub-set that satisfied the dual investment criteria of (1) highest expected return for a given level of risk, and (2) lowest level of risk for a given level of expected return. The dual criteria can be illustrated as follows:



Unfortunately direct investment cannot be dealt with in a two parameter model. Many other factors beside expected return and perceived risk play a role in the investment decision process. These 'other factors' should become clear as we proceed through the next three chapters.

(c) Early theory simply grouped portfolio and direct investment together and assumed that both responded to differential rates of return. For example, if domestic interest rates are less than foreign interest rates for securities in a similar risk class, and the cost of hedging in the forward exchange market is less than the interest rate differential, then a flow of foreign investment should occur. By way of illustration let us assume the following situation:

Canadian 180 day T.B. rate	4%
British 180 day T.B. rate	8%
Canadian price of one pound	\$2.50 spot
	\$2.48 forward

A Canadian resident purchasing a £1,000 bond will go through the following process:

- 1) exchange \$2,500 Canadian for £1,000;
- 2) purchase British T.B. for £1,000;
- 3) engage in a forward contract to sell £1,040 at a rate of \$2.48;
- 4) receive cheque for £1,040 in 180 days; and
- 5) exchange £1,040 at \$2.48 for \$2,579.20 Canadian.

Alternatively the same Canadian may purchase a \$2,500 Canadian T.B. and at the end of 180 days will receive \$2,550 (\$2,500 principal and \$50 interest). The assumption is that rational investors will take advantage of the interest rate differential and invest their funds in the United Kingdom. This example assumes that the full force of interest arbitrage has not yet taken effect. If the above process were to continue for many transactions the forward discount of f should wipe out the interest rate differential as follows:

$$r_f = r_s \frac{(1 + i_d)}{(1 + i_f)}$$

$$r_f = 2.50 \frac{(1.02)}{(1.04)}$$

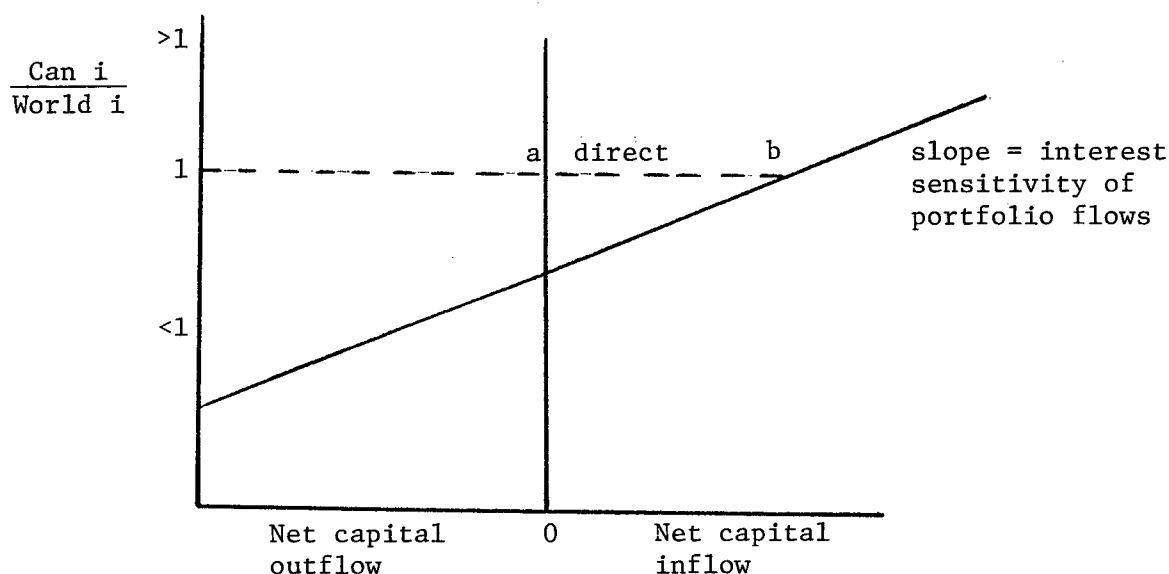
$$r_f = 250 (.980)$$

$$r_f = 2.45$$

At a forward rate of 2.45, the return in Canadian dollars from either investment would be the same.

Since at least the 1960's however there has been a growing awareness that not all capital flows are sensitive to interest rate differentials. That is, large capital flows have been observed even when the forward market has adjusted to remove any interest rate differential. A diagrammatic representation of Canada's case might be as follows:

The diagram implies that Canada, with a domestic interest rate just equal to the world rate, will still have an inflow of capital (direct investment). The determinants of direct investment must therefore be found in something other than market yields.



(d) As mentioned above, no conclusive theory of direct investment has been developed and accepted by economists. Ragazzi claims that the main theoretical focus is on the advantages of 'superior knowledge' which allows a foreign firm to earn a higher rate of return than indigenous firms.³ Aliber seems to agree:

the traditional theory of foreign investment--the Hymer-Kindleberger view--suggested that firms with a monopolistic advantage expanded into foreign markets to exploit their advantage abroad.⁴

Other authors, including Knickerbocker focus on the oligopolistic behavior of multinationals as providing the main motivation for direct investment.⁵ Kindleberger (who seems mainly in the 'superior knowledge' camp) argues that:

direct investment belongs more to the theory of industrial organization than to the theory of international capital movements.⁶

This statement certainly seems to indicate recognition that industrial

structure plays a role in direct investment. Perhaps there is more common ground than disagreement in the various camps. That is, superior knowledge and oligopolistic structure may be closely related and both serve to explain direct investment. In fact Stephen Hymer would probably object to the separation of the two theoretical approaches. While he is credited with being the first to develop the 'knowledge' theory,⁷ he later concentrated on oligopolistic behavior as a motivator of direct investment.⁸ The main purpose of this chapter is to review the existing theories of direct investment with a view to using certain concepts already developed to formulate a micro-theory of international banking. In the circumstances we do not feel obliged to fall into any particular 'camp.' There may be some useful insights provided by all of the approaches.

(e)

ALIBER'S THEORY

One theory that does not appear to have achieved wide acceptance but which is included here because of its possible relevance to banking is the one advanced by Aliber. He argues that:

The key factors in explaining direct foreign investment involve capital market relationships, exchange risk, and the market's preference for holding assets denominated in selected currencies.⁹

The latter part of this quotation is later developed by Aliber in his book, The International Money Game.¹⁰ Portraying the U.S. dollar as 'the preferred currency brand name' or 'currency at the top of the hit parade,' Aliber points out several advantages that accrue to companies

doing their main volume of business in U.S. dollars. Aliber's main research was conducted during a time when the U.S. dollar was clearly overvalued in terms of the currencies of most other developed countries. The implication that follows is that production costs should be higher in the U.S. than in countries with undervalued currencies and consequently there is an incentive for industrial firms to locate production facilities outside the United States.

Aliber also argues that the risk of exchange rate fluctuations work to the advantage of firms in the strong currency areas. His thesis is that the: "pattern of direct foreign investment reflects that source country firms capitalize the same stream of expected earnings at a higher rate than host country firms."¹¹ That is, Aliber would argue that a U.S. firm and a host country firm may well perceive an opportunity to exploit a market in the host country and both may come up with the same projected cash flow. Aliber argues however that, because of a definite bias in the securities markets, the U.S. firm will be able to obtain cheaper financing and thus be willing to pay more for the income stream (attach a higher capitalization rate) than the host country firm: "In Wall Street argot, everything else being equal, the P/E ratio is higher for U.S. firms than for non U.S. firms."¹² The bias in the securities market is caused by the tendency of investors in the source country to neglect to penalize projected earnings by some realistic coefficient representing exchange rate risk.

Aliber's theory has been challenged on empirical grounds by Ragazzi, who points out that U.S. direct investment continued to flow

into Europe in recent years when several European currencies were considered stronger than the U.S. dollar.¹³ Ragazzi also puts forth the normative argument that there is no reason for the market not to place a penalty on foreign income streams to allow for exchange risk. Based on this he then proceeds to show that Aliber's theory should be reversed:

In fact, it is possible to argue, contrary to Aliber, that firms in weak currency areas have an advantage investing in strong currency areas if the interest rate differential underestimates the exchange risk.¹⁴

On the other hand some support for Aliber's theory is provided by Dunning:

As far as it goes, I am fully persuaded that the factors he [Aliber] mentions--noticeably that the world market of investors may attach a different exchange risk premium to equities denominated in different currencies and hence evaluate investment opportunities differently--should be incorporated in any generalized theory of investment behavior.¹⁵

However Dunning goes on to make it clear that he does not view Aliber's theory as a substitute for the Hymer/Kindleberger 'superior knowledge' approach. Rather, he sees Aliber's work as providing an important additional contribution to the more popular approach.¹⁶

Aliber continues to hold his position however, although he admits that the various competing theories of foreign direct investments are inconclusive.¹⁷ Rigorous testing is required and apparently has not yet been carried out. It should be pointed out that Aliber's theory implies that, should the U.S. become a weak currency area (a possibility not too far fetched today) then there should be an increasing amount of 'cross

hauling'; that is direct investment in the U.S. by firms located in strong currency areas.

Other theories of direct investment fall roughly into three categories: (1) focus on imperfections in the capital market, (2) focus on monopolistic advantage, and (3) focus on oligopoly and need for growth. Ragazzi has conveniently placed the three approaches in perspective by pointing out that all of them focus on some deviation from perfectly competitive conditions in the international market.¹⁸ Ragazzi summarizes the main requirements for perfectly competitive conditions as follows:¹⁹

- 1) the rate of return and risk of foreign equities effectively reflect the rate of profit and risk of foreign enterprises;
- 2) enterprises of one country have no special advantage that allow them to operate subsidiaries in another country more profitably than local enterprises;
- 3) the objective of both individuals and enterprises is the maximization of profit in competitive markets; and
- 4) individuals and enterprises attach the same premium to exchange risks and are equally able to cover themselves against such risks.

It can be argued that, under perfectly competitive conditions, there will be portfolio investment only. No direct investment will take place because it can reasonably be assumed that a foreign subsidiary will incur higher costs than indigenous firms in the same industry. The reasons include transportation and communication costs with the

parent, and lack of knowledge about local culture and institutions. Under conditions of perfect competition then, funds would flow between countries in response to temporary yield differentials in given risk classes and the need for investors to diversify portfolios. However the world markets are not perfectly competitive as the following discussion illustrates.

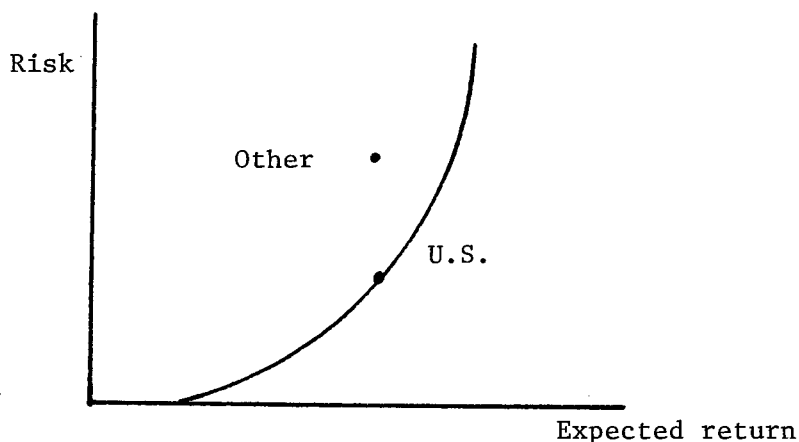
(f)

IMPERFECT CAPITAL MARKETS

Ragazzi argues that imperfections in the market for securities may be an important determinant of foreign direct investment.²⁰ By relaxing the assumption that the rate of profits from a foreign enterprise in a given risk class is accurately reflected by the rate of return on its outstanding shares one may arrive at a motivating factor for direct investment. If securities markets are poorly developed (lacking depth and breadth) the return on a portfolio investment in a particular company may be substantially lower than the return available if control is obtained. This is particularly true in Europe where lack of information or downright misleading information seems to have developed into a market norm. In the circumstances, equities trade at relatively low P/E multiples. The situation is so bad in Europe that some major banks have established 'intelligence' units to sift through the bits and pieces of information available about companies. One example is 'Eurofinance,' a company operated by sixteen major banks including the Bank of Nova Scotia. Operating out of Paris, "It was born in 1961 when an investment analyst with the merchant banking firm of Lazard Freres got fed up with corporate

secrecy and down-right financial lying practised by many of Europe's largest companies."²¹ The company provides information to its shareholders primarily, but also sells research to investors.

Ragazzi has shown that while the rate of return on U.S. securities corresponds roughly with that of other industrialized countries, the standard deviation of past annual rates of return has in general, been lower in the U.S. than in most economically advanced countries.²² According to Markowitz's portfolio theory, the investor, given a choice between securities of equal return but different risk classes will always select the lower risk assets.



This should provide investors all over the world with a strong incentive to seek out the developed securities markets of New York and London.

However while market imperfections may cause portfolio flows, this writer is of the opinion that Ragazzi takes a rather large step in assuming that these imperfections cause a reverse flow of direct investment. There seems to be little reason to assume that because the rate of return on equities is lower than corporate profit returns that investors

will seek another market. If this phenomenon were to occur in the U.S. then one would expect a large number of investors to seek control of the U.S. company rather than looking to some foreign markets for a better portfolio return. Ragazzi's example of course--European portfolio investment in the U.S. and U.S. direct investment in Europe--cannot be disputed. The facts are clear but there may be some underlying psychological differences (liquidity preference, risk avoidance, entrepreneurship) that provide more important motivation for direct investment.

(g)

MONOPOLISTIC ADVANTAGE

Within this broad category of monopolistic advantage we include:²³

- 1) departures from perfect competition in goods markets including product differentiation and special marketing skills;
- 2) departure from perfect competition in factor markets including technology, access to capital and proprietary managerial skills;
- 3) internal and external economies of scale.

The theory is based on the assumption that indigenous firms have definite advantages in operating in the home markets (knowledge of local market, culture, and shortened communication lines) and therefore foreign firms must have some other advantage that allows them to earn higher profits than local firms. At least one author^{*} has questioned this assumption: "I would not accept that host country firms have an inevitable advantage over foreign firms. This implies that *ceteris paribus* the two groups of firms are equally efficient and this need not be the case."²⁴

^{*} J. H. Dunning.

Kindleberger puts the argument in simple terms as follows:²⁵

$$C = \frac{I}{i}$$

C = value of asset

I = income stream

i = discount rate

He argues that foreign firms operating abroad have some special advantage that allows them to generate a larger 'I' than indigenous entrepreneurs and therefore the foreign firm will be willing to pay more for the income stream than the indigenous entrepreneur. A key feature of this formulation is the assumption that the foreign firm and the local firm use the same rate of interest (i). If different rates were used of course it would be possible to produce the same asset value with different income streams. It is just at this point that Aliber departs from the main body of work by arguing (as discussed above) that source country firms do use a lower 'i' and thus have a higher capitalization rate than indigenous firms. Kindleberger considers this possibility:

It will happen, to be sure, that international capital markets are less than perfect, and that differences in i contribute to the flow of capital. But the behavior of direct investment,--the readiness of investors to borrow in the host country at the same i as residents face . . . --indicate that it is capital I not small i which dominates.²⁶

A unique feature of superior knowledge is that it takes on the character of a public good. The company that has developed the knowledge may have incurred considerable costs which are now 'sunk' and therefore the marginal costs of exploiting the knowledge in an overseas market is negligible in comparison to the development cost that probably faces an

indigenous firm. Up to this point the theory is incomplete. As pointed out by Aliber:

The industrial organization approach to direct investment did not explain why the firm chose to exploit the foreign market through investment rather than through exporting or licensing.²⁷

On the surface it might seem reasonable to expect that exporting or licensing should occur if we stick with the assumption that host country producers have advantages in their home market.

A further potential problem however is the implied assumption that the objective of the firm is to maximize profits rather than growth. As will be seen when we discuss the theory focusing on oligopoly this assumption may not be valid. In other words the firm may prefer direct investment even when the return on--say licensing--is higher than on direct investments. The reason is that direct investment shows up in consolidated sales and asset figures.

Believers in this approach have offered an alternative response however: the market for 'advantage' is imperfect.²⁸ If we set aside for now the above goal of profit maximization, the decision to license or invest directly should simply involve comparing the net present value of the two separate projected cash flows discounted at the company's cost of capital. The alternative with the greater NPV would then be selected. The implication of the notion that the market for 'advantages' is imperfect is that an adequate price cannot be obtained via licensing therefore direct investment is often the preferred alternative even though a large capital outlay and the acceptance of increased risk is often required.

The authors reviewed seem to miss another important point however and that is that the recipient of the license may come back to haunt the licensor in its home market. The dangers of trading a football quarterback to another team in the same league are well known. The same can be said in selling 'advantages,' in fact it has often been said that U.S. firms made a major mistake in exporting technology to Japan which soon enabled that country to compete in the domestic U.S. market.

Ragazzi has pointed out--and this may be particularly relevant for banking--that many types of advantage cannot be sold because they cannot be embodied in a license.²⁹ Managerial expertise, knowledge of markets, and industrial organization are cited as examples. Another possible example is a form of 'corporate spirit' or a business philosophy that could probably not be sold to another company. An example that comes to mind is the American 'gung ho' marketing outlook versus the European 'status quo' or 'clubby' approach.

Economies of scale were cited above as one of the factors leading to monopolistic advantage. Scale economies may be either internal or external. The latter typically involves vertical integration and, because of its obvious inapplicability to banking, we will not discuss it here. Internal scale economics on the other hand usually involve horizontal investments and this is relevant to banking. Increased output of relatively standard products may spread certain fixed costs (financing, marketing, head office administration) over a wider area and thus reduce unit costs. Kindleberger warns however that, beyond some point there are counterbalancing diseconomies of scale in administration which set limits on the optimum scale of operations.³⁰

In closing this section on monopolistic advantage it should be pointed out that an important theoretical contribution developed by Raymond Vernon and known as the 'Product Cycle Theory' has been omitted from the above discussion.³¹ The theory deals exclusively with manufacturing companies. On the grounds that it is not realistic to think of money (a bank's product) progressing through some form of life cycle, the main thrust of Vernon's work has not been included. However Vernon does contribute some ideas that will have a bearing on our upcoming development of a micro-theory of international banking. The key contribution is: "The decision-making sequence that is used in connection with international investments, according to various empirical studies, is not a model of the rational process."³² In this connection Vernon sees investments occurring more in response to a threat to an established position rather than in response to an opportunity for profits. This view puts him at least partly in the camp of those who take the oligopoly approach which is the subject of the next section.

(h)

OLIGOPOLY AND NEED FOR GROWTH

Terms such as 'bandwagon effect' and 'follow the leader syndrome' have been used to describe the often observed fact that when one industry member located a subsidiary in a foreign country, industry rivals felt compelled to follow. The implication of this observation is that growth and retention of market share are the determinants of direct investment rather than the profit motive. This observation has recently been subjected to quantitative analysis by F. T. Knickerbocker in his award

winning doctoral dissertation entitled "Oligopolistic Reaction and Multinational Enterprise."³³ Oligopolistic reaction is defined as an interactive kind of corporate behavior by which rival firms in an industry composed of a few large firms counter one another's moves by making similar moves themselves. Utilizing facts and figures from the data bank of the Harvard Multinational Enterprise Study, Knickerbocker has produced statistical evidence that U.S. manufacturing industries have consistently illustrated that foreign direct investment decisions are made with an eye on what industry rivals are doing. Oligopoly theory's notion of interdependency would of course predict this behavior.

Knickerbocker's methodology centered around development of an 'entry concentration index' which is a measure of the extent to which, in the 1948 to 1967 period, 187 major U.S. corporations bunched the establishment of their manufacturing subsidiaries together in twenty-three countries.³⁴ His key preliminary finding is that of approximately 2,000 foreign subsidiaries, almost 50 per cent were established within three year peak clusters. "Industry by industry, country by country, U.S. enterprise invested abroad in lock-step-like fashion."³⁵

Two possible conclusions that might be drawn from the above should be dispelled:

- 1) that the observed sheeplike strain is economically irrational;
and
- 2) that oligopoly can only lead to 'bad' results for the consumer.

First there is no a priori reason to conclude that the observed 'follow

the leader syndrome' is irrational in an economic sense. H. A. Simon in his well known book, Administrative Behavior, argues that:

the limits of rationality have been seen to derive from the inability of the human mind to bring to bear upon a single decision all the aspects of value, knowledge, and behavior that would be relevant.³⁶

Decisions often become based more nearly on a stimulus-response pattern than a choice among alternatives. The stimulus in the issue at hand of course is the penetration of a foreign market by a competitor in the industry: the response is to follow.

Most firms in the Western world are very reluctant to lose markets to competitors and consequently it makes some sense for others in the industry to checkmate moves abroad.

The second conclusion (that oligopoly is 'bad') can be disputed. Knickerbocker suggests that non-collusive behavior has in fact been documented among most international firms. In fact, in many cases, the arrival of foreign firms sparks a renewal of competitive vigor among firms in a particular industry located within the host country. Caves provides some support for this view:

Whatever the market structure that results from the influence of direct investment, it can be argued that entry by a foreign subsidiary is likely to produce more active rivalrous behavior and improvement in market performance than would a domestic entry at the same initial scale.³⁷

Balassa and Caves have taken a different approach than Knickerbocker in that they focus on the need for growth rather than profit as a motivation of direct investment. Galbraith has put forth a persuasive

argument that growth is indeed a major objective of the large corporation:

Once the safety of the technostructure is ensured by a minimum level of earnings, there is then a measure of choice as to goals. Nothing is so compelling as the need to survive. However, there is little doubt as to how, overwhelmingly, this choice is exercised; it is to achieve the greatest possible rate of corporate growth as measured in sales.³⁸

Balassa's hypothesis is that a firm belonging to an oligopolistic industry may find it easier to invest abroad since any action to increase its share of the domestic market can be expected to meet with retaliation from other participants in the industry.³⁹ Thus, although the cost of entry into the foreign market may be high, it could well be cheaper than stirring up a trade war at home.

Caves on the other hand hypothesizes that firms in oligopolistic industries in each country encounter limits to increasing the sales of their traditional product in the domestic market.⁴⁰ In order to continue their growth rate, they must choose between expanding across a product boundary in the domestic markets or expanding across a national border with their traditional product.

(i)

SUMMARY

It has been the purpose of this chapter to review various theories offered to explain foreign direct investment as it applies to industrial firms. No single theory seems to be entirely valid although each offers points that have a ring of truth about them. Indeed this writer sees no great conflict between any of the theories.

It may be that Aliber's theory highlights primarily a special type of monopolistic advantage--favourable access to capital markets. The oligopoly theories may also relate closely to the Hymer/Kindleberger approach--if one takes the view that the pursuit of growth is really just the pursuit of long term profits in disguise. Some practitioners in the field believe that growth may be the best long term strategy for maximizing profits.

In any event, the theories reviewed do provide a rich source of information from which to build a theory applicable to the expansion of foreign banking.

Notes for Chapter Six

¹ G. Ragazzi, "Theories of the Determinants of Direct Foreign Investment," IMF Staff Papers (July 1973), p. 471.

² H. M. Markowitz, Portfolio Selection: Efficient Diversification of Investments (New York: John Wiley and Sons Inc., 1959).

³ Ragazzi, p. 472.

⁴ R. Z. Aliber, "The Multinational Enterprise in a Multiple Currency World," in The Multinational Enterprise, J. H. Dunning (ed.).

⁵ F. T. Knickerbocker, Oligopolistic Reaction and Multinational Enterprise (Boston: Harvard University Press, 1973).

⁶ C. P. Kindleberger, American Business Abroad: Six Lectures on Direct Investment (New Haven: Yale University Press, 1969), p. 11.

⁷ S. H. Hymer, "The International Operations of National Firms: A Study of Direct Foreign Investment," cited in American Business Abroad, by C. P. Kindleberger.

⁸ S. H. Hymer and R. Rowthorn, International Big Business 1957-67: A Study of Comparative Growth (Cambridge: Cambridge University Press, 1971).

⁹ R. Z. Aliber, "A Theory of Direct Foreign Investment," in The International Corporation, C. P. Kindleberger (ed.).

¹⁰ R. Z. Aliber, The International Money Game (New York: Basic Books Inc., 1973).

¹¹ Aliber, "A Theory," p. 28.

¹² Aliber, Money Game, p. 187.

¹³ Ragazzi.

¹⁴ Ibid., p. 493.

¹⁵ J. H. Dunning, The Multinational Enterprise, p. 57.

¹⁶ Ibid.

¹⁷ Aliber, Money Game.

¹⁸ Ragazzi.

- 19 Ragazzi, p. 478.
- 20 Ibid.
- 21 "The Bankers Take the Plunge," Executive (June 1971), p. 33.
- 22 Ragazzi.
- 23 Kindleberger, American Business, p. 14.
- 24 Dunning.
- 25 C. P. Kindleberger, International Economics (Homewood, Ill.: R. D. Irwin Inc., 1968), p. 393.
- 26 Ibid.
- 27 Aliber, Multinational Enterprise, p. 50.
- 28 S. H. Hymer, "The Multinational Corporation: An Analysis of Some of the Motives for International Business Integration," cited in The Multinational Enterprise, J. H. Dunning (ed.).
- 29 Ragazzi, p. 485.
- 30 Kindleberger, American Business.
- 31 R. Vernon, "International Investment and International Trade in the Product Cycle," Quarterly Journal of Economics, 80 (1966), 190-207.
- 32 Ibid.
- 33 Knickerbocker.
- 34 Ibid.
- 35 Ibid.
- 36 H. A. Simon, Administrative Behavior (New York: MacMillan and Co., 1951), p. 108.
- 37 R. E. Caves, "International Corporations: The Industrial Economics of Foreign Investment," Economica, 38 (1971), p. 15.
- 38 J. K. Galbraith, The New Industrial State (New York: Signet Books, 1967).

³⁹ B. Balassa, "American Direct Investments in the Common Market,"
Banca Nazionale Del Lavoro (June 1966).

⁴⁰ Caves.

Chapter Seven

TOWARD A THEORY OF INTERNATIONAL BANKING EXPANSION

BANKING: AN OLIGOPOLISTIC INDUSTRY

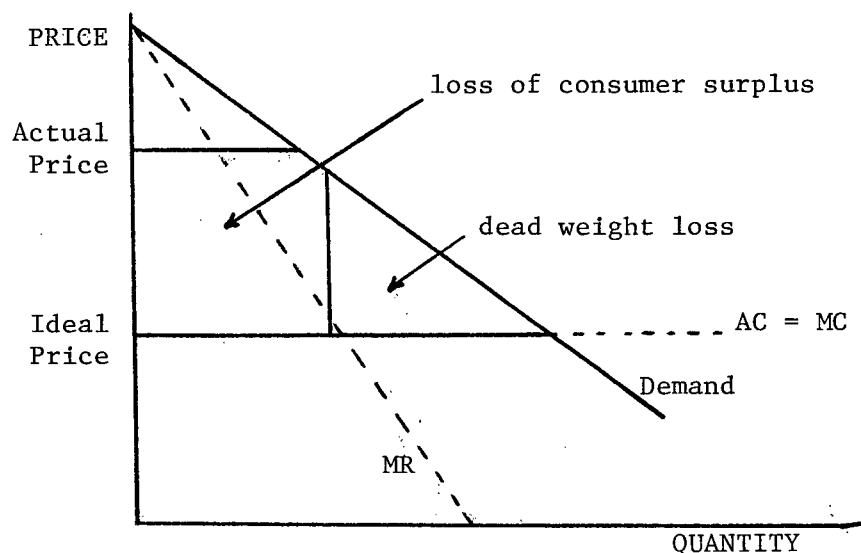
Throughout the above discussion of the various theories of foreign direct investment, one common feature emerged: all theories assume some deviation from perfectly competitive market conditions. In fact Kindleberger argues that:

for direct investment to thrive there must be some imperfections in markets for goods, or factors, including among the latter technology; or some interference in competition by government or by firms, which separates markets.¹

The argument is based on the presumption that if perfect markets did in fact exist then there would be no direct investments. The only type of capital flow possible would be portfolio investment. This writer can find no fault with the above line of reasoning and it follows therefore that the starting point in development of a theory to explain foreign banking expansion should be a search for market imperfections in the banking industry.

It is well known that the Canadian banking industry fits the textbook description of an oligopoly---a horrible sounding word derived from the Greek word "oligos" meaning few.² An oligopolistic industry is characterized by a few sellers who produce an almost identical product. Economic theory states that firms in this type of industry recognize their mutual interdependence and thus end up administering prices. It

is argued that there is a certain amount of waste to society involved in this type of industry because prices are certain to exceed marginal costs. In addition to loss of the familiar consumer surplus there is also a "dead weight loss" that results from too little of the product being produced. Samuelson graphically illustrates the foregoing as follows:³



There is an implicit assumption throughout this type of analysis that a number of small firms in an industry could supply their product at a lower 'ideal price.' In the banking industry a case can be made that there are economies of scale which could well mean that the marginal cost/marginal revenue intersection for small banks is well above the ideal price. It may even be very close to the actual price charged for loans and services. While this brief discussion is somewhat of a diversion from the issue at hand, the writer considers it important to make it clear that there is nothing necessarily evil or sinister about

oligopoly and, further, that the case for high administered prices is not proven.

There are currently ten chartered banks in Canada. As at October 31st, 1973, the five largest controlled 91.5 per cent of industry assets totalling \$75,021 million. Concentration is definitely a fact in Canadian banking. The situation in the U.S. is somewhat different. At June 30th, 1974, there were 14,338 banks in the U.S. with total assets of \$853 billion.⁴ On the surface it would appear that the industry is in no way characterized by oligopoly. However there is in fact a considerable amount of concentration in U.S. banking and the degree of concentration is growing. One quarter of all deposits and 22 per cent of total loans belong to the five largest banks. The top ten banks hold 35 per cent of industry assets. Furthermore the nature of U.S. banking law serves to promote concentration. Laws preventing banks from branching across state lines result in the domination of the many regional markets by a few large banks. For example the California market is dominated by BankAmerica (\$57,351 million), Western Bankcorp (\$14,740 million), Security Pacific (\$12,571 million), Wells Fargo (\$8,880 million), and Crocker National (\$8,326 million).

Perhaps more important for the purposes of this study the top banks centered in New York (and BankAmerica in California) are the primary participants in foreign markets. The top ten banks hold an average of 36.3 per cent of their deposits with foreigners while the vast majority of deposits with the fiftieth through two hundredth largest U.S. banks are domestic. In fact 150 of the nations 200 largest banks have

negligible holdings of foreign deposits (less than 10 per cent).

The first and most obvious deviation from perfectly competitive markets then is industry concentration--or oligopoly. One of the implications that falls out of an oligopolistic industry structure is that it is very difficult to significantly alter one's share of the domestic market. The banking industry has one rather unique additional feature about it that is not common to other industries--total domestic market size is controlled by central monetary authorities. That is, by controlling the supply of reserves, the central bank sets an upper limit on the amount by which banks can expand their domestic assets. If the total market is growing by 10 per cent per year, the only way a particular bank can grow more rapidly is at the expense of some other bank. This can be very expensive and in fact may not be possible since other banks will likely retaliate. A good example is the introduction of the 'Western Account' by the Bank of British Columbia, a small regional bank with about one per cent of total market share. The 'Western Account' is a package of usual retail banking services sold to customers at a flat monthly rate. The idea caught on quickly and, as soon as the major banks perceived even a minute shift in market share, they all came out with essentially the same plan.

NEED FOR GROWTH

Protection of market share is a fact of life in banking (as it is in other oligopolistic industries) but this does not in itself provide a motivation for foreign direct investment. The motivation is more

likely to be an almost innate need for growth. There are a variety of good reasons for a bank to set growth as an objective. The most obvious is that there are economies of scale in banking. Three areas can be singled out where a large bank can operate more efficiently than a smaller bank:

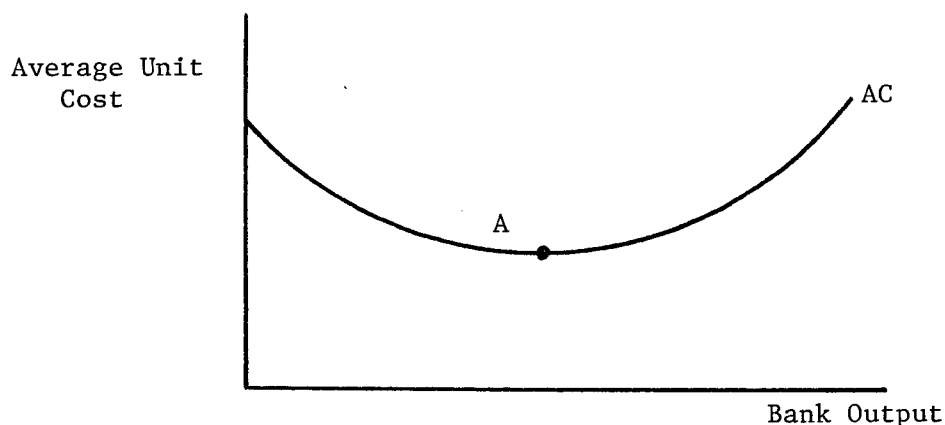
- a) acquisition of deposits;
- b) asset management; and
- c) clearing mechanism.

The use of computers can lower the costs of all three of the above functions. The growth of branch banking is also a good indication that economies can be achieved in the internal transfer of funds. The most obvious example is facilitating the flow of funds from surplus units (households in rural areas) to deficit units (business firms in industrialized areas).

At least one author has questioned the assumption that larger banks are more efficient. G. J. Benston has conducted a study of U.S. banks which he claims casts some doubt on the accepted truism that economies of scale exist in banking.⁵ His findings were that a doubling in size of a bank was associated with something in the order of a 7 per cent decrease in unit costs which the author claims is relatively insignificant. Benston also argues that if growth is achieved by branching then economies are not achieved.⁶ There were some serious problems associated with the study however--the most important being the extreme difficulty in measuring the output of a bank. Benston himself admits

that his methodology did not measure the ability of a bank to make large loans to valuable deposit clients nor the economies that might be expected from more efficient funds management.⁷

A more rigorous study of the economies of scale question has been carried out by L. Kalish and R. Gilbert.⁸ Using a sample consisting of 898 U.S. commercial banks the authors attempted to obtain a measure of the relationship between size and average unit cost as follows:



The objective was to locate point A on the above average cost curve. As was the case in the Benston study, there was difficulty in measuring bank output, however the authors did agree that the average cost curve took on a positive slope at a relatively low level of output. Specifically, the Kalish and Gilbert study found a bank with assets in the \$5 to \$15 million range to have the lowest per unit average cost.⁹ These results were compared to two other studies (Alhadeff and Gramley) as follows:¹⁰

Comparison of Long Run Average Cost Curves

<u>Bank Size</u> (thousands)	<u>Alhadeff</u> (cost per unit of output)	<u>Gramley</u>	<u>Kalish/ Gilbert</u>
under \$2,000	\$.0438	\$.0278	\$.0401
2,000 - 5,000	.0289	-	.0349
5,000 - 15,000	.0256	.0239	.0304
15,000 - 50,000	.0282	-	.0307
50,000 - 150,000	.0255	.0200	.0318
150,000 - 1,000,000	.0199	.0196	.0323
1,000,000	N/A	N/A	.0457

There are a couple of points to note about the above data. The first is that the studies are not in agreement. Both the Alhadeff and Gramley studies indicate no positive slope in the average cost curve. The second point is the absence of data on major banks--say with assets above \$10 billion. There were no major banks included in the Alhadeff and Gramley studies and the largest bank in the Kalish/Gilbert study had assets of only \$1 billion. This leaves open the distinct possibility that the authors have concentrated on much too narrow an asset range in their samples. It could well be the case that the average cost curve of major banks is indeed lower than those of the smaller banks.

While the case for economies of scale in banking remains unproven, predominant opinion seems to be in favour of the hypothesis. The recent trend toward state-wide, multiple-branch banking in the United States may be evidence that bankers believe that this form of expansion achieves scale economies. Roger E. Anderson, Chairman of the Board of Continental Illinois National Bank has recently stated: "An internal advantage for the branch bank itself is felt to be increased operating efficiency and lower costs, since a bank could offer the same services at many establishments."¹¹

For our purposes it is not important to prove the existence (or otherwise) of economies of scale. What might be important is that bank management believe that there are scale economies or that they want "scale" for some reason other than for economies. Baumol suggests that:

Though businessmen are interested in the scale of their operations partly because they see some connection between scale and profits, I think management's concern with the level of sales goes even further.¹²

The clear implication here is that growth would continue to be important even though further scale economies were not achieved.

We have uncovered some sketchy evidence that indicates Baumol may be correct. The U.S. Federal Reserve Board annually publishes income, expense, and dividend data broken down by size of member bank. It is interesting to note that the major international banks do not generate profit ratios that compare favourably to smaller regional U.S. banks. Tables 7-1 and 7-2 summarize the data.¹³

Table 7-1

PROFIT RATIOS BY SIZE OF U.S. BANK

Net Income as % of Gross Revenue	Size Group by Deposits 000's omitted							
	\$1- 2000	2000- 5000	5000- 10000	10000- 25000	25000- 50000	50000- 100000	100000- 500000	500000 & up
1973	13.9	15.1	15.1	15.4	14.3	13.3	12.0	11.3
1972	13.9	12.8	14.3	14.8	14.7	14.3	14.0	13.8

Table 7-2

PROFIT RATIOS OF SELECTED BANKS

Net Income as % of Gross Revenue	BankA- merica	Chase	Man/Han	Chemical	Morgan	Bankers Trust
1973	10.0	6.9	8.0	5.8	11.4	5.2
1972	11.6	10.2	10.8	9.3	16.0	9.9

Another advantage that is offered by growth is that bigness is associated by the banking public with safety, efficiency, and service. Evidence of this is provided by recent events in the U.S. banking industry. U.S. banks are currently undergoing a liquidity crisis. Compounding the problem is the fact that the large New York banks continue to experience rapid growth while the small regional banks are in trouble. To quote Professor Paul Nadler:

When bad news about one bank gets out, people panic, figuring that if it can happen to one bank it can happen to another. So they withdraw their money from regional banks and ship it all off to the 'biggies' because people equate bigness with soundness.¹⁴

The banks are well aware of the importance of size so growth becomes a very real objective.

Growth is also important for another reason--generation of employee enthusiasm. Banking is unquestionably a 'people' business and it is vital to retain aggressive young employees. One way to do this is to grow. Growth of any organization increases opportunities for the upward mobility of its employees. This process appears quite logical to this

writer and indeed seems essential to ensure the continued health of an organization.

Galbraith however has a different interpretation of the process. While acknowledging that growth is in the self-interest of the technostructure (defined as those who participate in corporate decision making), Galbraith views the growth process as being inherently in conflict with the preferred goal of profit maximization:

The paradox of modern economic motivation is that profit maximization as a goal requires that the individual member of the technostructure subordinate his personal pecuniary interest to that of the remote and unknown stockholder. By contrast, growth, as a goal is wholly consistent with the personal and pecuniary interest of those who participate in decisions and direct the enterprise.¹⁵

The case for growth is widely accepted within the banking industry. The focus is on expanding markets but the assumption is that, eventually, profits will justify the growth. Theorists find this a tough pill to swallow. In fact, Kindleberger, in response to this type of statement, stated:

But the explanations which businessmen give of their thought processes must not be taken with literal seriousness. Like Monsieur Jourdain in Moliere's *Le Bourgeois Gentilhomme* who spoke prose all his life without having been aware of it, they doubtless maximize profits rather than merely follow markets.¹⁶

This is a rather brave statement to make especially since the author provided no supportive evidence. The comment indicates Kindleberger's staunch resistance to relaxing one of the critical economic assumptions underlying the theory of the firm: profit maximization. At least some other economists seem more prepared to alter their position. After

observing the behavior of oligopolistic firms for several years (always with the profit maximization assumption firmly entrenched in his thought processes), W. J. Baumol finally concluded that:

This (difficulty forming a theory of the firm) is largely the result of my stubborn reluctance to part company with the universal applicability of the profit maximization hypothesis. Only after a number of unsuccessful attempts to force its implications down the throats of otherwise highly cooperative firms for which I was consulting did it occur to me that something might be wrong with the central tenets of my position.¹⁷

Here is a comment from a British observer of international banking that lends some support to Baumol's observation:

Economists might wonder what has happened to the theory which explained everything a firm did in terms of profit maximization. The order of the day on the international banking scene now seems to be business maximization irrespective of profits, though it is hoped, of course that one will follow from the other.¹⁸

PROFIT CONSTRAINT

Bigness and the need for growth is not all that counts in banking however. There is a profit constraint imposed by the shareholders and by the need to finance further growth. There are good reasons to believe however that the constraint imposed by shareholders is something less than profit maximization. Profit norms for the banking industry have evolved over time and as long as a bank generates sufficient revenue to make normal dividend payments, it is extremely unlikely that the position of management will be threatened. On the other hand if growth is not up to the industry norm and the bank starts to slip in relative size it is likely that shareholders, through the board of directors, will begin to

ask questions about the efficiency and competence of management.

The above phenomena are not unique to Canadian and U.S. banking. A British magazine, "The Banker," publishes an annual survey of the top 300 commercial banks. This publication recognizes and defends the need for growth of banks.

There are many reasons why bankers, especially chairmen and senior managers, are concerned about the size of their bank, quite apart from any guide that listings give them. Now that traditional distinctions of status based on class at birth or inherited wealth have largely disappeared in advanced societies and there is a fast growing, multinational, multilingual financial community comprising men of most diverse origins, the relative rise of the institution they work for goes some way to determine their status generally.¹⁹

"The Banker" goes on to point out that the goal of size itself can help management define at least one readily understandable corporate goal for the organization. In an industry that essentially deals with a homogeneous product a growth goal subject to a profit constraint has become accepted worldwide.

MAINTENANCE OF MARKET SHARE

A very important offshoot of the inherent need for growth is the need within the banking industry to (as a minimum) maintain one's size relative to competitors. Bankers may well reflect adherence to the Red Queen's dictum: "Now, here, it takes all the running you can do to keep in the same place. If you want to get somewhere else, you must run at least twice as fast as that."²⁰

From the point of view of the Chase Manhattan Bank it was a disaster to slip from the world's second largest bank to third largest within

the past few years. For Citicorp on the other hand it was a major victory to move into second place.

It is interesting to note that there is no evidence that Chase was being criticized by its shareholders for not maintaining profits at the same level as its main competitors. For the ten year period ended December 31st, 1973, the Chase had experienced an average growth in earnings per share of $7\frac{1}{2}$ per cent, well under the growth rates of BankAmerica (8.9 per cent), Citicorp (10.5 per cent), and J. P. Morgan (10.9 per cent).²¹ However it was not until the Chase slipped into third place that managerial competence was questioned. In response to critics, David Rockefeller, Chairman, is reported to have embarked on a personal crusade to rid Chase Manhattan "of its image as the slumbering giant of international banking."²² This involved several top management changes including the resignation of the president in 1972. It is apparent that Rockefeller's crusade is still going on.²³

The same pressure is in evidence in Canadian banking. W. E. McLaughlin, Chairman and President of the Royal Bank of Canada has observed that his bank is Canada's largest and fully intends to remain number one. The comparison has been on the basis of assets not profits.

The need to maintain one's position in the industry manifests itself by the practice of the banks matching each others moves into foreign markets. This practice has been observed in other industries and is more a function of industry structure than type. Kindleberger says:

Indeed, in concentrated industries there is pressure for each firm to develop a position in each important or potentially important

market--regardless of the rate of profit obtainable in absolute terms--to prevent any of its few competitors from obtaining a substantial advantage which it could put to use over a wider area.²⁴

This observation has been supported by Vernon²⁵ and investigated in depth by Knickerbocker,²⁶ who provides empirical support for the argument.

GOVERNMENT INTERFERENCE

The acceptance of growth as a goal in banking does not in itself explain why the banks would expand abroad. There may well be attractive opportunities in domestic financial markets. We have already argued that expansion of a share of the domestic banking market is very difficult for a single bank. However we are now talking about expansion into near banking operations or 'congeneric services' (meaning banking related services). There is a lucrative market to be exploited in Canada, however, the chartered banks have taken only very tentative steps in this area. The reason is another 'market imperfection,' this time in the form of government interference. The Bank Act of 1967 is very 'iffy' on the subject of diversification by the banks into other financial service areas. Prior to 1967 the chartered banks had been prohibited from owning the shares of another chartered bank and it has also been ruled that owning more than 50 per cent of the shares of any other corporation, whether financial or not, would be beyond the powers of a bank.

The 1964 Royal Commission on Banking and Finance looked closely at this issue and recommended that existing provisions be tightened. Most of the restrictive Porter recommendations were not heeded but the following ownership provisions were included in the new Bank act:²⁷

- a) a limit of 10 per cent was placed on the ownership of a trust or mortgage loan company or other deposit taking institution; and
- b) a limit of 50 per cent applies to all other companies unless the cost of shares is over \$5 million in which case the limit is 10 per cent.

The above regulations certainly inhibit the ability of the banks to expand in Canada.

An interesting side issue is the fact that American banks are not barred from the Canadian congeneric market. Several major U.S. banks have entered Canadian financial markets and Canadian bankers are publicly expressing disapproval of the present permissible posture in Ottawa.

An example is the Bank of America which is closely related to Power Corporation in Canadian financial markets. BankAmerica now controls 20 per cent of Montreal Trust, 5 per cent of Investors Group, and about 49 per cent of North Continent Capital (a Vancouver based industrial leasing firm).

Diversification into Canadian financial markets is going to be a hotly debated subject during the 1977 decennial revision of the Bank Act. The point of relevance to this study is that chartered banks, given that they want to expand and grow, have chosen to seek growth abroad.

Until recently there has been similar interference in U.S. banking. Up until the passage of the new Bank Holding Company Act in 1970, expansion of U.S. banks into near banking areas was difficult. Since 1970 however, acquisition of non-bank affiliates by bank holding companies has been on firmer legal ground. This has predictably led to a rapid

expansion by the U.S. banks into a wide range of financial activities, from finance companies to general insurance underwriting. The list of permissible non-bank activities for U.S. bank holding companies has grown rapidly in the three years since the 1970 Amendments were passed. The current list of approved activities as at June, 1974, includes:²⁸

- a) finance companies;
- b) mortgage companies;
- c) factoring companies;
- d) dealers in banker's acceptances;
- e) credit card companies;
- f) operating an industrial bank;
- g) trust companies;
- h) servicing loans;
- i) providing portfolio investment advice;
- j) furnishing general economic information and advice;
- k) investment adviser to Real Estate Investment Trusts and to investment companies under the Investment Company Act of 1940;
- l) full pay-out leasing of personal and real property;
- m) investments in community welfare projects;
- n) providing bookkeeping or data processing services;
- o) acting as insurance agent or broker--primarily in connection with credit extensions;
- p) underwriting credit life, accident, and health insurance;
- q) dealing in gold and silver bullion and coins; and
- r) courier services for investments of a banking or financial character.

The McFadden Act passed in the 1920's which prohibits branching across state lines represents a major form of government interference. It is this type of legislation, based upon populist fears of a conspiracy of giant banking groups against small business interests and the rural community (especially the farmer), that led to the unit banking structure in the U.S.

The above legislative framework would suggest that U.S. banking growth would have to occur in the foreign sector. The following comment by Kindleberger (surprisingly) provides support:

Indeed so restrictive of spatial expansion by American banks is populist sentiment inside the United States that it may force expansion abroad by blocking it at home, just as antitrust laws are believed to do in industry.²⁹

This comment contains an underlying assumption that banks need to grow which is consistent with the views of this study.

U.S. banking laws are slowly being liberalized and it will be interesting to see whether a removal of the barrier to domestic expansion and diversification will divert attention away from the international sector. This possibility will be explored in Chapter Nine below.

At the present time however there remains significant barriers to the expansion of U.S. banking at home. Under the Bank Holding Company Act the Federal Reserve Bank has the power to turn down acquisitions. Business Week reports that the BankAmerica, Citicorp, Bankers Trust, and First Chicago (all among the top ten U.S. banks) have had planned acquisition turned down in recent months.³⁰

The various attempts in the mid-1960's by the U.S. government

to deal with a continuing balance of payments deficit represents another form of 'interference' that influenced the growth of foreign banking. In 1963, the Interest Equilization Tax was introduced. Designed to reduce private capital outflows, it placed a prohibitive tax on the purchase of foreign stocks and bonds by U.S. citizens. The effect of the tax was to substantially reduce the ability of foreign institutions and corporations to sell securities in U.S. financial markets. Faced with a closure of this market, the foreign borrowers turned to the U.S. banks. "It has been estimated that possibly as much as two-thirds of all new commercial and industrial loans in New York during the 1963-64 period were made to foreigners."³¹ Thus in closing one source of capital, government interference had swiftly opened another. In 1965 the government introduced a new balance of payments program designed to curb the granting of bank loans to foreign borrowers. Banks in effect voluntarily pledged to limit the volume of credit that they extended abroad to 109 per cent of the 1964 total. Effectively cut off from serving a world market from a domestic base, the banks soon realized that, if they wished to continue this activity they would have to tap the Eurodollar market. "Since, by definition, Eurodollars are held outside the United States, there was a major incentive to open offices overseas in order to participate directly in this active market."³²

One American banker has expressed what could well be the predominant banking view of government interference.

It is not out of place here to recall that one of the determining factors for the existence of the Euro dollar market is the regulation

that prevents banks in the United States from paying for money the price that market conditions warrant.³³

This comment reflects the view that yet another act of interference, Regulation Q, was partly responsible for the development of the Euro-dollar market. Under Regulation Q the U.S. banks are subject to an interest ceiling on time deposits and are prohibited from paying interest on chequeing accounts. Evidence that U.S. Government interference influences foreign operations is often provided by senior bankers. The following comment, from the 1971 annual report of J. P. Morgan and Company is illustrative:

As has been the case for several years, restrictions imposed by U.S. authorities for balance of payments reasons strongly influence the pattern of our activities in this (international) field.³⁴

Foreign expansion was also spurred on by the Federal Reserve imposed 'credit crunch' of 1969-70. At a time when U.S. banks were experiencing liquidity problems in their domestic operations it was important to be able to tap the Eurodollar market. Thus foreign branches of U.S. banks were able to borrow in the Euro dollar market and re-lend to the U.S. head office to ease liquidity pressure. At least one author has claimed that the Euro dollar market provided, "the motivation behind the setting up of most branches opened by American banks in London in the last 10-12 years."³⁵

U.S. legislation has also interfered with the ability of banks to select the geographical location of banking outlets. Under the provisions of the Federal Reserve Act (Sec. 25), permission from the Board

of Governors must be obtained before a bank branch may be established in a foreign country.³⁶ This authority also extends to the investment by member banks in the stock of corporations engaged principally in international or foreign banking. Through the use of this power the Federal Reserve Board has been able to influence the direction of banking expansion. In 1968 the Board was clearly discouraging expansion in developed countries, preferring instead that the banks establish in developing economies.

Equity investment in developed countries of continental Western Europe will not, while the new provisions remain in effect, be approved by the Board, unless circumstances clearly demonstrate that the transaction will not be detrimental to the U.S. balance of payments. But, applications to make equity investments elsewhere will be considered on their merits.³⁷

It is an interesting fact that the various U.S. government restrictions on capital flows have had an indirect influence on the foreign activities of the Canadian banks.

In March 1968 the Canadian government was able to obtain almost complete exemption from the U.S. capital restraint program. However as part of the price for obtaining exemption, the government agreed to impose restrictions designed to prevent the 'flow through' of U.S. funds to third countries. The guidelines read as follows:³⁸

1. The total of a bank's foreign currency claims on residents of countries other than Canada and the United States should not rise above the level of the end of February 1968 unless the increase is accompanied by an equal increase in its total foreign

currency liabilities to residents of countries other than Canada and the United States.

2. If there should be a decline in the total of a bank's foreign currency liabilities to residents of countries other than Canada and the United States from the level at the end of February 1968 the bank should achieve an equal reduction in its total foreign currency claims on residents of countries other than Canada and the United States as quickly as the liquidity of such assets will permit.
3. Each bank should allow an increase in its U.S. dollar liabilities to residents of the United States from the level at the end of February 1968 only to the extent that the increase is fully matched by the sum of (1) the increase from that date in the bank's U.S. dollar claims on residents of Canada, (2) the decrease from that date in the bank's U.S. dollar liabilities to residents of Canada, and (3) the decrease from that date in the bank's own spot position in U.S. dollars.

Freedman has argued that the above guidelines strongly influenced the conduct of the chartered banks.³⁹ The first two guidelines prevented the chartered banks from soliciting deposits from U.S. residents and investing the funds outside North America. Thus the banks could no longer expand their Euro dollar activities from a domestic base. If continued growth was to be achieved it was necessary to establish foreign branches in order to solicit an adequate deposit base. Thus it can be argued that U.S. government 'interference' had an indirect effect on the ability

of the chartered banks to continue their growth. The effect of this interference was to encourage the chartered banks to expand their operations in Europe in order to tap the Euro dollar market.

SUPERIOR KNOWLEDGE THEORY

We have thus far established that there are grounds for believing that there are links between the expansion of foreign banking and direct investment theories that focus on oligopolistic behavior and the maximization of growth.

However, the main line of direct investment theory focuses on superior 'knowledge' and accordingly, we will now look for some similarities in the 'knowledge' area that apply to banking. It should be remembered of course that superior knowledge also represents a deviation from perfectly competitive market conditions.

The fundamental argument advanced by the 'knowledge' theorists is that some form of advantage must exist that allows a foreign firm to operate more profitably than a domestic competitor. The banking evidence in this area is mixed to say the least. Canadian chartered banks are not required, nor do they deem it necessary, to report earnings from foreign operations. The references to profits are always veiled in generalities. Witness the following quote from the Canadian Bankers Association:

The banks' international operations have become increasingly important to their balance of revenue. In 1955, only about 11% of total assets consisted of foreign currency assets; whereas by 1960 this had increased to 16%; and by 1970 to 30%.⁴⁰

The statement certainly leads one to believe that foreign operations are profitable; but the evidence is not conclusive.

As part of our field study, we explored the profitability question with senior executives in the international divisions of the five major chartered banks. No one was willing to reveal actual figures but there were indications that foreign operations were about as profitable as domestic. In this connection it was mentioned that there are major difficulties in allocating costs and measuring the actual profit split between domestic and foreign operations.

There appears to be good reason to assume that Canadian and U.S. banks do in fact have some competitive advantages in operating in certain foreign markets. We asked international operations' executives in Canada's five large chartered banks if they thought that the chartered banks had any 'advantage' that allowed them to operate more profitably in foreign markets than indigenous banks. The answer was: "yes, in some cases." In certain foreign markets the size and reputation for conservative management was thought to represent an advantage. However it was unanimously agreed that this advantage did not carry over into major world markets. New York and London were identified as two examples of markets where the chartered banks had no advantage.

Whether or not the size advantage is translated into superior profits remains open to question. The evidence is again conflicting. Here is a comment concerning the profits issue by J. P. Koszul, Vice-President, Citicorp: "The result of all this (lack of a local deposit base) is that their (U.S. bank's) profit margins tend to be more limited

than those of their indigenous competitors."⁴¹ This comment appears to be somewhat at variance with a recent report that Citibank earns a higher than proportional share of its profits from overseas operations.⁴²

Much of the foreign business of the U.S. and Canadian banks is centred in the Euro-dollar market and there is good evidence that spreads are very thin in this highly competitive market. On the whole it is difficult to see how the Kindleberger/Hymer thesis has much explanatory power with respect to behavior in the banking industry. The crux of the theory depends on a superior 'I' in the formulation:

$$C = \frac{I}{i}$$

There is no convincing evidence available that it applies to banking. On the other hand this writer concedes that, because of the absolute unavailability of data it is probably not possible to build a convincing empirical case against the theory.

While it is not possible to obtain conclusive profit figures from the foreign operations of U.S. banks, there are scattered bits of evidence. Walter Wriston, Chairman of Citicorp reports that foreign earnings as a percentage of total earnings in 1972 and 1973 totalled 50 per cent and 60 per cent respectively.⁴³ Given that less than 50 per cent of Citicorp's assets are invested abroad it appears that foreign operations were more profitable than domestic operations, at least in 1972 and 1973.

Some of the major U.S. banks now voluntarily offer more information about their foreign operations. The Chase Manhattan Bank, in

particular, appears to have adopted a policy of more adequate disclosure.

In September, recognizing the desire by investors and others for more information about Chase, we gave a presentation to the investment community with unprecedented detail about our operations and policies. This year's annual report underscores our continued determination to provide broader information to shareholders and the public--including many new facts in the financial review and elsewhere.⁴⁴

Based on information provided by Chase it now appears that the rate of return on foreign assets approximates the rate of return on domestic assets:⁴⁵

	<u>1973</u> %	<u>1972</u> %	<u>1971</u> %	<u>1970</u> %
foreign profits as a % of total profits	41	34	21	17
foreign assets as a % of total assets	39	34	28.9	27.5

Furthermore, a geographical breakdown of assets and net income reveals the following:

	<u>U.S.</u>		<u>Europe/Africa</u>		<u>Asia/Middle East</u>		<u>Caribbean/Latin America/Canada</u>	
	1972	1973	1972	1973	1972	1973	1972	1973
assets as a % of total	66	61	17	18	6	9	11	12
net income as a % of total	66	59	12	17	9	11	13	13

The following are the contributions of foreign operations to other major U.S. banks:⁴⁶

	BankAmerica		Manufacturers Hanover		J.P. Morgan		Bankers Trust	
	1972	1973	1972	1973	1972	1973	1972	1973
% foreign profits	28	32	33	33	35	46	35	45
% foreign assets	31	36	29	34	N/A	N/A	N/A	N/A

In summary, it appears fair to say that foreign operations of the U.S. banks have not generated 'excess' profits nor have they harmed the overall profit performance of the U.S. banks. From the point of view of U.S. bankers this is the relevant variable.

However, the truly relevant figures in this issue are definitely not available; that would be a comparison not of foreign/domestic profit ratios of the Canadian or U.S. banks but a comparison of the profit ratio of an indigenous bank in--say France--with the profits generated by a Canadian or U.S. bank operating in France. In order for the Kindleberger/Hymer analysis to hold, it is necessary to illustrate that a foreign bank can make sufficient profits in the host country to exceed the regular profits of an indigenous bank after allowing for the cost of the inherent disadvantage of operating in an unfamiliar market.

Some authors (including Aliber) argue that the U.S. banks have a competitive edge in international markets.⁴⁷ The reasons given are size, leaner cost structure and use of more advanced technology. In addition the U.S. banks are accustomed to a competitive atmosphere at home unlike the 'clubby' arrangements of some European bankers. Some of these advantages also apply to the Canadian banks. The size qualification is certainly met. There is also not much difference between the interest rate spread (markup) in Canada and the U.S. A comparison between the prime

lending rate and interest rates paid on deposits has often been used by analysts in determining the 'leanness' of a bank's cost structure. Canadian and U.S. banks show up well in these comparisons. While admittedly well behind the U.S. in the use of computer technology, Canada probably has an advantage in this field over banks in other countries.

The requirement of the Kindleberger/Hymer theory that profits from direct investment be higher than all alternative methods of penetrating the foreign market would not seem to apply in general to the banking industry. Vernon has pointed out that direct investment is the only route for service industries. "When skill in purveying services is involved, it is especially difficult to use the export route in order to test the marketability of what one has to offer. Here again one has to test one's marketing advantage by setting up a subsidiary abroad. This is what lay behind the bold expansion of . . . U.S. banking organizations after W.W.I."⁴⁸

This comment however does not deal with the more difficult question of why the banks do not sell their superior knowledge via a licensing arrangement. Perhaps an example of the Canadian and U.S. penetration of the medium term loan market will shed some light on the difficulty involved in licensing. Walter Wriston (Chairman of Citicorp), once observed that European bankers thought medium term loans were 'naughty.'⁴⁹ This observation led to an advantage by U.S. and Canadian banks who were familiar with medium term financing.

Prior to the 1960's European industry seemed to have no need for medium term bank credit. However for a variety of reasons in the mid

1960's traditional sources of financing were inadequate to support expanding European business. European bankers were unwilling to fill the gap so U.S. and Canadian bankers stepped in. Within a very short period of time the market was booming. One question that falls out of this experience is: Why did the U.S. and/or Canadian banks not approach European bankers with a package designed to allow the latter to establish a market for medium term bank loans? Could not a satisfactory licensing arrangement be established that would generate profits for both parties? From the point of view of the licensors the necessity of making a direct investment in an unfamiliar foreign market could be avoided. On the other hand, the licensees had a well established local branch network that generated a good source of funds. So why was licensing not the solution?

PREFERENCE FOR DIRECT INVESTMENT

This writer would suggest that there are at least three important factors that contribute to the preference for direct investment:

(a) The first is the difficulty in placing a price on some ill-defined technology possessed by the licensor. The concept of technology encompasses technical and managerial know-how which is embodied in physical and human capital and in published documents.⁵⁰ (b) In banking, technology is relatively less important than in--say the manufacturing industry. In the medium term loan field for example, there are no special 'secrets' that could be sold to European bankers. The problem was one of differing management philosophies.

European bankers have usually been asset lenders; they would go around a company's plant, kick the walls, look at the deed and the mortgage, and, then, on the basis of physical assets, make their decision on how much to lend and on what conditions. American bankers look at cash flow and lend on prospects.⁵¹

The difference in lending philosophies is obvious. Based on this observation it is difficult to conceive of a situation where U.S. or Canadian bankers could have sold European bankers on the idea of medium term credit. Furthermore, that European bankers should pay for the idea (which is really all it is: it is not technology) is unthinkable. The problem is based on differences among management men in Europe and the United States. It is a management gap and this management is not a commodity that can be sold via a licensing arrangement. Perhaps one of Servan Schreiber's observations about the U.S. manager is relevant to that country's bankers:

Americans are not more intelligent than other people. Yet human factors--the ability to adapt easily, flexibility of organizations, the creative power of teamwork--are the key to their success.⁵²

It is the 'human factor' or managerial philosophy that allows U.S. and Canadian bankers to profitably exploit the medium term loan market in Europe. Here is one U.S. banker's perception of his advantage:

American banks are deeply convinced that they bring something with them (to the foreign market): new methods and sometimes a new spirit, which is an asset in itself, and this belief is supported by success achieved in all parts of the world.⁵³

This 'new spirit' cannot be sold; it must be transferred via direct investment.

The bankers interviewed unanimously agreed that no consideration had been given to entering foreign markets by any route other than direct investment. All banks wanted some element of control over their investment. In cases where the equity investment was less than 100 per cent, the banks seemed to emphasize the importance of 'having a team of their own men on the scene.'

(c) The other important reason for preferring direct investment over licensing is that the primary objective of the banks is not profit maximization; it is growth of assets. It is the writers hypothesis that, given the opportunity to penetrate a foreign market that would yield identical profits through either direct investment or licensing, the bank would choose direct investment every time. The reason of course is that gross revenues and assets would show more growth if the direct investment were undertaken. While the licensing arrangement would (under the assumption) result in the same net profit figure, there would be no appreciable effect on the balance sheet. Given what is said about growth (above) it is clear that direct investment is preferable to licensing. This finding is not unique to the banking industry. Other multinational firms pursue multiple objectives which include growth of sales and assets subject to some 'acceptable' profit constraints.

CROSS HAULING

A major requirement of a theory of foreign banking is that it explain the preponderance of 'cross hauling' in the industry. There is absolutely no doubt that foreign banks would establish in Canada if the

banking legislation were liberalized. The same would be true in the U.S. and in fact is being observed in some states that have opened the doors to foreign banks. Both California and New York have several foreign banks competing against domestic banks in the retail and wholesale markets. According to the Hymer/Kindleberger theory these foreign banks must have some 'knowledge' advantage that they can exploit. It is somewhat difficult to believe that these foreign banks have some advantage that would allow them to generate larger profits than the well established domestic competitors, especially in the U.S. However the wide range of the market might provide a partial answer. For example Japanese banks could concentrate on providing service to Japanese firms operating in Canada while European banks might focus on funneling European funds into real estate and equity investments in Canada. The type of 'knowledge' advantage in this case would be better 'connections,' a variable that has always been important in banking.

It appears to this writer however that a more general explanation of cross hauling is provided by industry structure. If banks in most countries are located in oligopolistic markets the tendency for them would be to expand outside national borders. Thus we would expect that, given the need for growth, Lloyds Bank may be attracted to the U.S., while BankAmerica would be attracted to Britain.

Entry into the foreign market frees a bank somewhat from the necessity of 'joining the local club.' Market share can be fought for without as much fear of retaliation. Support for this line of reasoning is provided by Stephen Hymer who argues that all dominant oligopolists

have a similar world wide market.⁵⁴ Cross hauling is a natural extension of oligopoly and the need for growth. A somewhat paradoxical implication of cross hauling is that it introduces a competitive element to banking that would not exist if domestic markets were served only by indigenous banks.

ALIBER'S THEORY

Aliber's theory may contain some features that apply to banking. As mentioned above, his theory focuses on capital market relationships, exchange risk, and the market's preference for holding assets dominated in U.S. dollars. The first feature, involving a bias in the securities market that enables U.S. firms to obtain cheaper financing, is definitely not relevant. The U.S. and Canadian banks obtain their funds essentially from depositors at going market rates, and thus obtain no advantage in this area. In fact in Europe, the Canadian and U.S. banks often must obtain their funds in the interbank market at rates higher than the indigenous banks pay for deposits.

The relevant part of Aliber's theory is the market preference for certain currencies. The U.S. dollar has long been the 'preferred currency brand name' and it appears logical to associate the U.S. banks with the U.S. dollar. This could represent a significant advantage. This advantage is also thought to have 'rubbed off' on the chartered banks:

World trade--facilitated by payments in overseas U.S. dollars even between countries with strong currencies of their own--and the need of multinational companies to obtain arm's length financing have given Canadian banks the opportunity to participate in overseas

markets on a large scale. Moreover since these same banks have had long experience dealing with U.S. multinationals and overseas U.S. dollars, they have built up a series of contacts that rank high in world banking circles.⁵⁵

This advantage could well lead to the U.S. and Canadian banks capturing a large share of the world market for dollar deposits. Some support for this line of reasoning was obtained from the bankers interviewed. This type of advantage is to be distinguished from the Kindleberger/Hymer type which translates directly into an increased profit margin. The advantage that Aliber has in mind does not imply that the capture of a large market share of deposits leads to superior profit margins. It may however lead to an increase in absolute profit levels and certainly leads to growth in assets.

SUMMARY

We opened this chapter by pointing out that a common feature of all theories of direct investment is that they incorporate some departure from perfectly competitive market conditions.

In this sense the various theories are not in great conflict with each other. It is this writer's opinion that all of the theories add something to an understanding of foreign banking. The predominant forces however are oligopoly, need for growth, and government interference. Advantages reaped from superior knowledge apply in certain specific cases and association with the preferred currency brand is a favourable factor for U.S. and Canadian banks. The next chapter will attempt to draw these observations together into a theory of international banking expansion.

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- 54 S. Hymer and R. Rowthorn, "Multinational Corporations and International Oligopoly: The Non American Challenge," in The International Corporation, C. P. Kindleberger (ed.).
- 55 J. Davidson, "Canadian Banks Think Globally," Canadian Banker and ICB Review, I-74, p. 9.

Chapter Eight

A THEORY OF INTERNATIONAL BANKING EXPANSION

It is our hypothesis that the financing of foreign trade and capital flows no longer represents the primary explanation for the growth of international banking. These factors, to be sure, still have an influence but expansion of foreign banking is proceeding somewhat independently of foreign trade. The banking industry is no longer a 'camp follower' of its domestic customers. "If you want to sum up international banking in one sentence," says Geoff Styles, Deputy General Manager, of The Royal Bank of Canada, "you could say that Canadian banks have changed from banks with international departments to international banks which happen to have their head offices in Canada."¹ In other words the banks have become multinational corporations.

It appears that U.S. regulatory bodies have become aware of the changing trend in the international operations of U.S. banks. An officer of the Federal Reserve Bank has observed: "In more recent years, however, U.S. banking organizations have diversified the scope of services available to their overseas customers and with these services have tried to attract new customers from the countries in which they are doing business."² It is the purpose of this chapter to develop a theory that will explain the above process.

The primary determinants of the expansion of foreign banking for at least the past five to ten years have been the market imperfections discussed in the preceding chapter. A model (Figure 8-1) encompassing

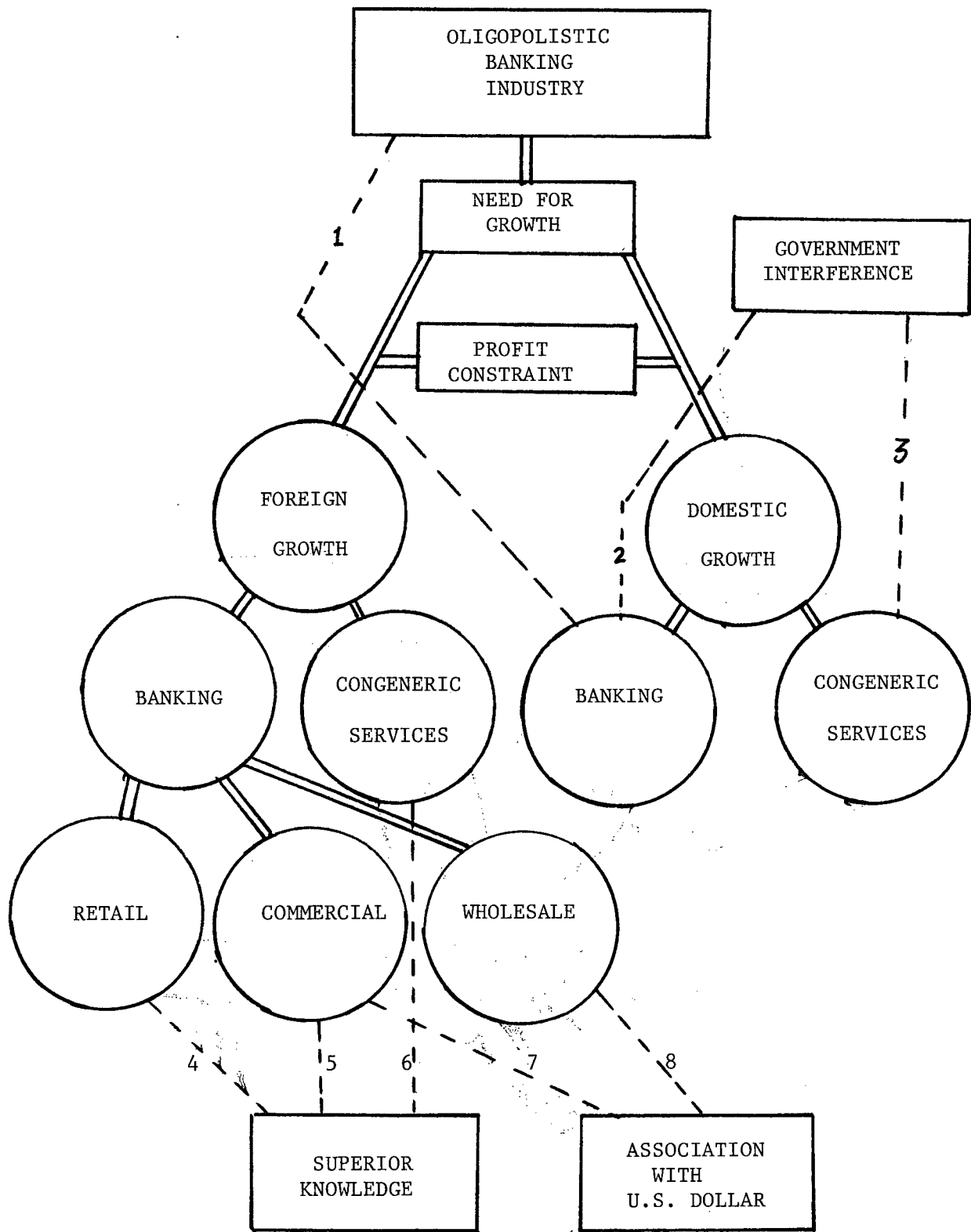


Figure 8-1

MODEL OF FOREIGN EXPANSION

the variables discussed in Chapter Seven has been developed to graphically illustrate the major forces leading to investment overseas. The diagram is meant to illustrate that the primary force behind overseas expansion is the oligopolistic industry structure and a need for growth.

Inclusion of growth as a key variable is the result of a wealth of impressionistic evidence available from various published sources. Some of this evidence was presented in the previous chapter. Prominent observers of the banking scene have also been impressed by the importance bankers place on growth. Paul Nadler, for example, has stated that:

Bankers are always kidded about their obsession with growth rather than profits. For it appears that many bankers would rather jump 20 or 30 places on the American Banker's list of the top 10,000 banks in order of size than increase earnings per share by a sizeable amount.³

Inclusion of the oligopolistic industry structure as a major variable has been influenced by Caves who:

hypothesized that firms in oligopolistic industries in each country encounter limits to increasing the sales of their traditional product in the domestic market; to continue their growth rate, they must choose between expanding across a product boundary in the domestic market or expanding across a national border with their traditional product.⁴

As will be demonstrated below, the choice for the banks has largely been influenced by another major variable: government interference.

Two other variables that receive less weight than the 'need for growth' but nevertheless are quite important, are government interference and a profit constraint. Note that the term 'interference' is used to indicate an observed governmental tendency to meddle in the affairs of

the banking industry. In general, this 'interference,' or 'meddling' if you will, represents a departure from perfectly competitive market conditions in the banking industry. The reader should note that no judgment is being passed on the desirability or otherwise of this government tendency. Clearly, some forms of government interference may, on net be desirable, while other forms may not.

It is important to note also that profit is included in the model as a constraint rather than as a goal. This is consistent with theories that stress growth as the main objective of a firm. From the evidence we have been able to locate on the banking industry, it appears reasonable to argue that the profit constraint on foreign operations is that the ratio of foreign profits to foreign assets employed be similar to the domestic ratio. That is, if foreign assets represent 50 per cent of total assets then foreign profits should also represent roughly 50 per cent of total profits.

Before discussing the model further we should perhaps clarify some of the concepts underlying the adoption of the oligopoly-growth model. The discussion that follows has been influenced in no small way by the writings of W. J. Baumol who hypothesized that oligopolists typically seek to maximize their sales subject to a minimum profit constraint.⁵ By simply substituting asset growth rather than sales growth as the objective in the banking industry we should be able to adapt Baumol's work for our purposes.

Figure 8-2 is a static model of the variables interacting in the growth-profit constraint part of our primary model (Figure 8-1).

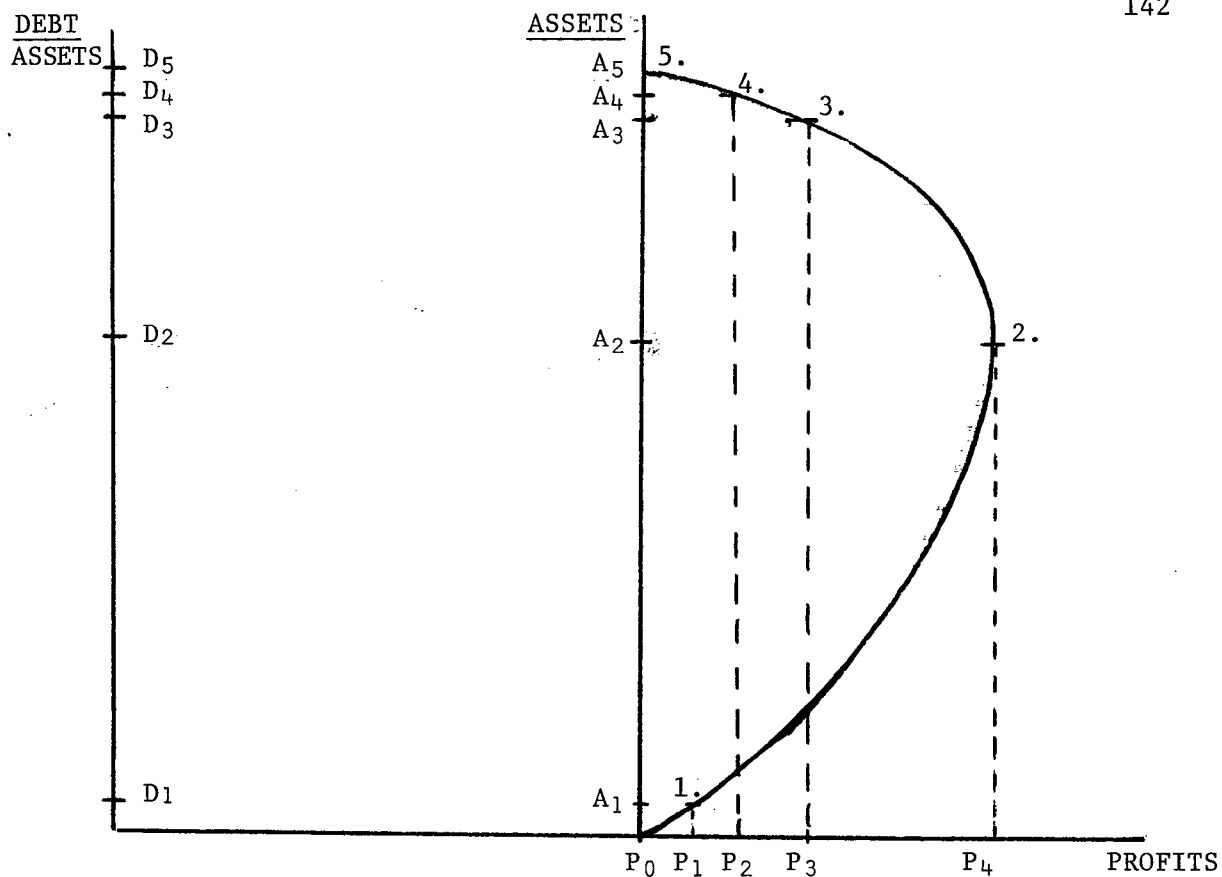


Figure 8-2

MODEL OF PROFIT CONSTRAINT

1. A₁ P₁ D₁ 100 per cent equity financing.
2. A₂ P₄ D₂ profit maximization point.
3. A₃ P₃ D₃ highly levered position: regulatory bodies restrict growth.
4. A₄ P₂ D₄ internally imposed profit constraints.
5. A₅ P₀ D₅ beyond this point the bank is technically insolvent.

According to the diagram, profits are maximized at a level of P4 with assets of A2 and a debt/asset ratio of D2. Asset maximization is undefined in an absolute sense but clearly cannot exceed A5 where the debt/asset ratio of 1.00, otherwise the firm would be insolvent. For operational purposes, asset maximization occurs at either A3 or A4. The reason for indecision on this statement is that there are two forms of constraints that impinge on the determination of asset maximization:

- a) P2 which is an internally imposed profit constraint (to be discussed below), and
- b) D3 which is a maximum debt/asset constraint imposed by regulatory bodies and/or the investment community.

There is no compelling reason to believe that one or the other constraint should always be dominant. We have shown the profit constraint to be dominant in Figure 8-2 because it represents what is going on today. However the governments--particularly the United States--are starting to worry about high debt/asset ratios and it may well be that this constraint will soon dominate the determination of maximum asset size. This feature will be discussed more fully in Chapter Nine.

Figure 8-3 represents a numerical example of the static determination of bank size. It is our contention that Bank D would be selected by bank management as the optimal size although the rational economic man would pick Bank C. Perhaps some justification of the assumptions made in Figure 8-3 is in order. We have assumed that the banks in our example are price takers in the debt market. That is, there is no price competition for

	Bank A		B		C		D		E		F	
Assets	1,000		2,000		4,000		5,000		6,000		8,000	
Debt	970		1,940		3,880		4,850		5,820		7,760	
SE	30		60		120		150		180		240	
Ir	.10A	100.00	.0975A	195.00	.095A	380.00	.0940A	470.00	.0935A	561.00	.0925A	740.00
Ip	.08D	77.60	.08D	155.20	.08D	310.40	.08D	388.00	.08A	465.60	.08D	620.80
E	.025A	25.00	.0175A	35.00	.015A	60.00	.015A	75.00	.015A	90.00	.015A	120.00
P	(2.60)		4.80		9.60		7.00		5.40		(.80)	
Pmin	(.04SE)	1.20	2.40		4.80		6.00		7.20		9.60	

Profit maximization = 9.60 Assets = 4,000

Asset maximization = 5,000 Profits = 7.00

Assumptions & Definitions

Assets = A

Debt = D

Equity = SE

Profits = P

Interest received = Ir

Interest paid = Ip

Other expenses = E

Minimum level of profits (profit constraint) = Pmin

$P = (Ir - Ip) - E$

Ip = constant 8%

Ir = declining function of A

E = declining function of A to 5,000, then constant @ 1.5% A

D/SE ratio = $97/3 = 32.33$

Pmin = .04SE

Figure 8-3

NUMERICAL EXAMPLE OF THE STATIC DETERMINATION OF BANK SIZE

savings and the banks have a good supply available at 8 per cent. Expenses are set as a declining function of assets to allow for scale economies. At some point these economies are assumed to cease and expenses become a constant proportion of assets. A constant debt/equity ratio is also assumed for this simple model. The consequences of relaxing this assumption will be discussed below. Up to this point the writer would argue that the assumptions are quite reasonable.

The assumption of a reducing yield on assets may prompt some criticism but it does appear reasonable to argue that some price cutting is necessary to promote asset growth. This is especially true when we consider that growth is occurring in a foreign market. It was pointed out above that even though the Canadian and United States banks are oligopolists (and behave as such) in their domestic markets, this behavior often does not carry over into the foreign market. Indeed it has been observed that entry by a Canadian or U.S. bank into a foreign market often introduces rivalrous behavior and improved market efficiency. Part of the rivalrous behavior manifests itself in the form of price competition for loans and investments so it seems appropriate to include the assumption that as assets increase so do revenues, but at a declining rate.

Inclusion of a profit constraint in Figure 8-2 seems very logical for obviously the firm cannot continue to grow or even survive if profits decline to zero. Profits are absolutely essential to allow the firm to grow. Baumol has described the determination of a minimum profit level as follows:

rational behavior would require that the firm determine its minimum profit level, its dividend payments and the magnitude of its retained earnings in a way which achieves a balance between its current financing needs and the effects of its dividend history on the availability of cash in the future in the form of demand for future issues of securities.⁶

The above description provides no operational way for determining a minimum profit level. However Baumol goes on to say that:

In practice, the determination of a minimum acceptable profit level probably comes down to no more than a rough attempt, again partly by rule of thumb, to provide competitively acceptable earnings to stockholders while leaving enough over for investment in future output expansion at the maximum rate which management considers to be reasonably safe.⁷

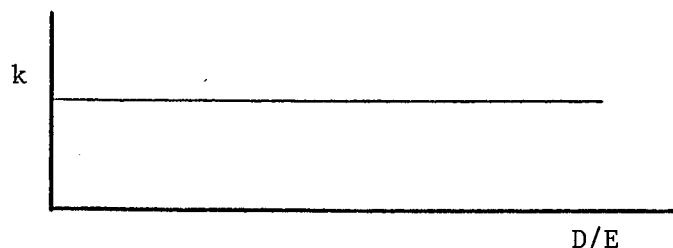
As will be pointed out in Chapter Nine, at present, there appears to be some disagreement between bankers and their regulatory bodies over the definition of a 'safe' rate of asset growth. It is this disagreement that has caused us to hedge in our definition of asset maximization in Figure 8-2.

As mentioned, we assumed in Figure 8-3 a constant debt/equity ratio. This was primarily to avoid a controversy over whether or not there exists some optimal ratio that will minimize the bank's cost of capital and thus maximize the value of the bank to its shareholders.

It is generally accepted within the field of finance that it is not possible to provide conclusive support for either the traditional approach which assumes the following relationship:



and therefore an optimal debt/equity ratio; or the 'Modigliani-Miller' approach which assumes the following relationship:



and therefore independence of the cost of capital and a firm's capital structure.

After some reflection it becomes clear that neither position does any harm to our approach. If we relax the assumption of a constant debt/equity ratio, the MM position would say that the cost of obtaining new equity financing increases as the debt/equity ratio increases by just enough to offset the savings achieved through the use of lower cost debt. What this means in terms of Figure 8-3 is that the minimum profit constraint would vary over different debt/equity ratios. It would not affect the choice of asset optimization over profit maximization.

The traditional approach (which appears to this writer to be a realistic depiction of the actual situation) offers good support for our model. The traditional approach hypothesizes that the cost of debt remains constant over a certain range. This results in a declining average weighted cost of capital. Beyond some point leverage becomes too high and debt costs increase, driving up the overall cost of capital.

The above phenomenon appears relevant to the banking industry and in fact has recently been experienced by the Japanese banks. In common with other Japanese businesses that country's banks are notoriously

over levered. After the oil crisis and resultant balance of payments problems changed the position of the Japanese banks from being net suppliers to net borrowers of Euro-dollars, these banks found, that, because of their over-levered position, they had to pay a full 2 per cent above the London inter bank rate.⁸ (This is the base rate banks charge each other for Euro currencies.) This event was a clear cut case of price discrimination brought about by recognition of increased risk due in large part to the extremely high debt/equity ratios of the Japanese banks. In this writer's opinion it would be difficult for Modigliani and Miller to argue that the average weighted cost of capital of the Japanese banks had remained constant throughout the above process.

If we hold to the traditional approach that the cost of capital increases beyond some optimal debt/equity ratio then this serves to tighten one of the profit constraints in Figure 8-2. More specifically, if the cost of capital begins to increase this will have the effect of giving management a more clear definition of the level of operations that the market considers appropriate given a certain level of equity capital. More about this feature will be presented in Chapter Nine.

A static model of the form set out in Figure 8-2 has only limited usefulness in a constantly changing banking environment. As Baumol has pointed out:

Although the static theory of the firm is a helpful snapshot description of a system in motion, it is useful also to have an alternative construction . . . another equilibrium analysis in which the rate of growth of output, rather than its level, is the variable whose value is determined by optimality considerations.⁹

Again, we consider it useful to adopt Baumol's formulation to set out the variables and constraints influencing the level of growth of the banks. The formulation is as follows:

$$\text{maximize } g = f(I, \Pi)$$

$$\text{subject to } I = f(\Pi, D) + E$$

$$\Pi = D + E$$

where g = growth rate of assets

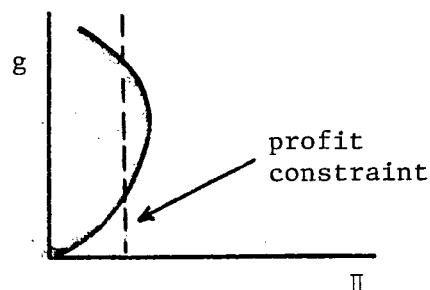
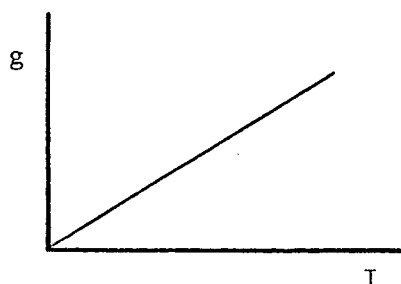
I = growth rate of equity capital

Π = profit rate as a % of present equity

D = dividend as a % of profits

E = retained earnings as a % of profits.

Under this formulation, the rate of growth is related to investment and profit rates as follows:



That is, growth varies directly with investment but has first a positive, then a negative relationship to profits. The behavioral reason for the eventual inverse relationship with profits is that, beyond some rate, growth strains the firm's entrepreneurial resources and adds to the company's risks.

The equation $I = f(\Pi, D) + E$ illustrates "that the profit rate

indirectly assists growth by providing capital through retained earnings, and by attracting funds from outside sources at a rate, $f(\Pi, D)$, which depends both on the dividend rate and the company's profit rate."¹⁰

Bank management would likely find the above formulation more relevant than the previous static model. As will be discussed in Chapter Nine, it appears that because of generally depressed market conditions, the banks now must rely on retained earnings to finance further growth. If we assume that the banks are at their maximum permissible debt/equity positions and that new share issues are not feasible, then the potential growth of assets just equals the rate of growth of retained earnings.

Assume the following situation for Bank X:

$$I = 0 ; \Pi = 10\% ; D = .4\Pi ; E = .6\Pi$$

Then the maximum rate of growth of assets of Bank X is simply 6 per cent as follows:

<u>Period 1</u>		<u>Period 2</u>	
A 1,000	D 970	A 1,060.00	D 1,028.20
	E 30		E 31.80
<hr/>	<hr/>	<hr/>	<hr/>
1,000	1,000	1,060.00	1,060.00

Note that the above example says nothing about profit maximization.

It is hoped that the foregoing discussion has clarified the concept of the profit constraint operating in our model (Figure 8-1). We now turn to a discussion of the other variables included in the model.

The other key variable in the model, government interference in

the banking industry, manifests itself in many ways. Bankers are used to 'floating on a sea of controls.' Citibank Chairman, Walter Wriston is reported to have shrugged off a question about the effect of controls with the short remark: "Our natural habitat is the controlled environment."¹¹ Government interference of various types was discussed in Chapter Seven.

The dashed lines in Figure 8-1 represent specific types of influence as follows:

1. Line one represents interference encountered when a firm in an oligopolistic industry attempts to grow by expanding its share of the domestic market. Inclusion of this variable has been influenced by Balassa who argued: "when a mature oligopolistic structure has been established in the domestic market, the firm may be induced to invest abroad because efforts at increasing its share in the domestic market would meet retaliation from other oligopolists."¹²
2. Line two represents government interference in the domestic market which is manifested by control of the money supply and thus the ultimate control of the size of the domestic market. In the United States, this line could also represent government control of the geographical markets which prohibits expansion across street, county, or state lines.
3. Line three represents various government imposed barriers to diversification into other domestic financial markets.

The primary message that the model attempts to convey is that the banks have a strong need for growth. This growth need could be met in the domestic and/or foreign markets, but government interference which limits growth in the domestic sector has deflected the focus of attention to the foreign market. This is the heart of the theory. It is only at this point that the other theoretical variables have a role to play. Superior knowledge and association with the 'preferred currency brand' only have an influence on bank behavior in specific areas. Superior knowledge enables the banks to enter certain foreign market segments--for example the medium term financing field mentioned above. This is represented by dotted line number five. Line number four represents superior knowledge in retail banking. For example the Canadian banks were able to establish an entire retail banking industry in the Caribbean. Superior 'knowledge' in retail banking does not apply generally however. For example, while at least two hundred foreign banks have established in the United Kingdom, none has seriously attempted to storm the retail market. The same would probably be true if foreign banks were allowed to branch into Canada. Witness the following comments by David Rockefeller:

I see no threat to the viability of any banking system--and certainly not one as healthy as Canada's--because of the presence of foreign banks. Canada's retail banking system is established so firmly across the nation that it should not suffer any adversity in the form of foreign banking presences.¹³

Line six indicates that the U.S. and Canadian banks may have superior knowledge in congeneric services--but only in specific areas.

For example, U.S. banks have developed expertise in the leasing field and have been able to profitably exploit this in foreign markets--particularly in Canada.

Association with the 'preferred currency brand' may give the U.S. and Canadian banks an advantage in the commercial and wholesale markets (lines seven and eight). This argument has been put forward by Aliber as follows:

The third advantage of U.S. banks in the new international market is that their domestic currency, the dollar, is likely to remain the preferred currency brand name. Indeed, the share of banking business denominated in dollars relative to other currencies is likely to increase. This gives a clear advantage to U.S. banks, for if depositors prefer dollar denominated deposits, they will also prefer that these deposits be issued by U.S. banks.¹⁴

For the reasons outlined in Chapter Seven, part of this advantage is thought to have 'rubbed off' on the Canadian banks. In summary, however, the superior knowledge and preferred currency variables have influence only in certain specific market areas.

The above comments represent the primary reason for the diversion away from the main line of the theory of direct investment--the focus on superior knowledge that allows a foreign firm to obtain higher rates of return than local competitors. Bankers look at overseas opportunities somewhat differently than do industrial corporations. The Canadian and U.S. banks do not generally attempt to compete head on with indigenous banks. This is in direct contrast to industrial corporations. Fortune magazine has put the process of foreign expansion by the banks in perspective as follows:

They (banks) cannot hope to storm the entrenched markets of native banks. Nor do they expect a particularly high rate of profit. Banking in Europe is not inherently more profitable than in the U.S.; the spread between what a bank pays and what it can charge a borrower is about the same. The banks going abroad do not even insist on substantial earnings from every branch. The aim rather is to build up a system whose intertwined operations will improve the bank's overall earnings.¹⁵

RESULTS OF INTERVIEWS

In general it is fair to say that the reaction of senior bankers to our model was mixed. Some bankers supported our hypothesis that government interference and limited domestic growth opportunities had influenced the decision to look outward to foreign markets. One or two pointed out that the model made no reference to profits. This was true at the time of our interviews. In the final version of the model however we have included profits as a constraining variable.

There was general agreement on the inclusion of 'superior knowledge' and 'association with the U.S. dollar' as important variables that allow entry into foreign markets. In this area however some bankers thought we should include a variable that recognizes the importance of trade flows. We resisted this suggestion for the reasons outlined in Chapter Five.

The area of our model that ran into heaviest opposition was the 'need for growth' variable. No banker was willing to admit that this variable played anything more than a minor role in the development of international banking. Some bankers insisted that the pursuit of profit was the more important variable. And yet at various times throughout our discussion we uncovered cases where direct investments were made

without giving profit projections anymore than a cursory glance. In fact one banker stated that his bank did not prepare profit projections when considering a foreign direct investment. In some cases ego involvement of a top executive was identified as the key to a decision to enter a foreign market.

Based on the wealth of impressionistic evidence available in the literature, some of which was presented in Chapter Seven, we are not willing to concede that 'need for growth' is anything less than the KEY variable that has influenced foreign growth over the past decade. In the final analysis however, we recognize that the reader must weigh the available evidence and then decide for himself.

SUMMARY

A logical extension of this chapter would be to subject our model to empirical testing. However the absence of sufficiently detailed 'hard' data rules out this possibility. The main support that can be offered is in the form of anecdotal evidence, much of which was presented in Chapter Seven. This evidence must be weighed against the rather negative reaction obtained in our field study.

We also have available some sketchy information on the decision making process followed when a bank invests in a foreign market. This process is discussed in Appendix II in the hope that it will lend some support for our model.

Notes for Chapter Eight

- ¹ Quoted in The Canadian Banker and ICB Review, I-74, p. 9.
- ² Federal Reserve Bank of Chicago: Economic Review (October 1974), p. 3.
- ³ Paul Nadler, "Why A Bank Has to Grow--A U.S. View," The Banker (June 1974), p. 615.
- ⁴ Quoted by R. Z. Aliber, "The Multinational Enterprise in a Multiple Currency World," in The Multinational Enterprise, J. H. Dunning (ed.), p. 50.
- ⁵ W. J. Baumol, Business Behavior Value and Growth (New York: MacMillan Company, 1959).
- ⁶ Ibid., p. 52.
- ⁷ Ibid., p. 53.
- ⁸ Financial Post (September 21, 1974), p. J12.
- ⁹ W. J. Baumol, "On the Theory of Expansion of the Firm," in The Theory of the Firm, G. C. Archibald (ed.), p. 319.
- ¹⁰ Ibid., p. 326.
- ¹¹ Quoted in The Banker, vol. 123 (1973), p. 613.
- ¹² Quoted in G. Ragazzi, "Theories of the Determinants of Direct Foreign Investment," IMF Staff Papers (July 1973), p. 489.
- ¹³ Excerpt from a speech to the Canadian Conference on Banking, Toronto, September 16, 1974.
- ¹⁴ R. Z. Aliber, The International Money Game (New York: Basic Books Inc., 1973), p. 161.
- ¹⁵ Fortune (December 1967), p. 143.

Chapter Nine

CURRENT EVENTS AND THE THEORETICAL MODEL

There are two elements of our model that are being influenced by the current international banking environment. The first is that growth is currently being retarded by various environmental factors. The second is that government 'interference' is being relaxed in some areas and tightened in others. In view of the fact that government interference and a need for growth form the foundation of our approach, it is appropriate to discuss the above events in order to test the 'durability' of the model developed in Chapter Eight.

The recent rapid growth rates of U.S. banks, in particular, has left them somewhat over levered. The amount of capital that a bank should have in order to ensure the safety of depositors is open to question but some rules of thumb have evolved. The capital/asset ratio has been suggested as a measure of the amount by which a bank's assets can shrink before the depositors will face a loss. Binhammer has pointed out however that a better measure of shock absorbing capacity may be the ratio, capital to risk assets since it emphasizes where exposure resides.¹ The principle that the quality of bank assets should be considered in judging capital adequacy has received growing acceptance among American bank supervisory and regulatory bodies.² While it is true that other factors such as age, size, managerial experience, and asset diversification, are also important, the capital/asset ratio is a convenient 'early warning' index. Once the ratio begins to fall the

signal is given to commence a more detailed evaluation encompassing the other factors named above.

The capital/asset ratio for the BankAmerica for example is as follows for selected years:³

1950	1955	1960	1965	1970	1971	1972	1973	1974
5.8%	5%	5.5%	5.2%	4.1%	3.9%	3.5%	3.1%	2.8%
								(projected)

It appears that the steadily declining ratio is placing a growth constraint on BankAmerica. The bank was recently turned down by the Federal Reserve Board in its bid to acquire a foreign insurance company. The following is an explanation of the Board's decision offered by Messrs. Wallich and Sheehan, members of the Board of Governors of the Federal Reserve:

We agree that the applicant's (BankAmerica's) capital position is somewhat lower than what the Board would consider appropriate. We also agree with our colleague's concern over the tendency of many U.S. banking organizations to pursue a policy of rapid expansion and agree that funds earmarked for expansion by U.S. banking organizations with capital positions not considered appropriate should be used instead to strengthen the capital positions of such organizations.⁴

While the 'appropriate' capital position is not defined, presumably it is something greater than 2 per cent to 3 per cent. The following graph (Figure 9-1) illustrates that a declining capital/asset ratio has occurred generally in the U.S. banking industry.⁵

While the adequacy of the capital of Canadian banks has not received widespread public attention, some securities analysts have

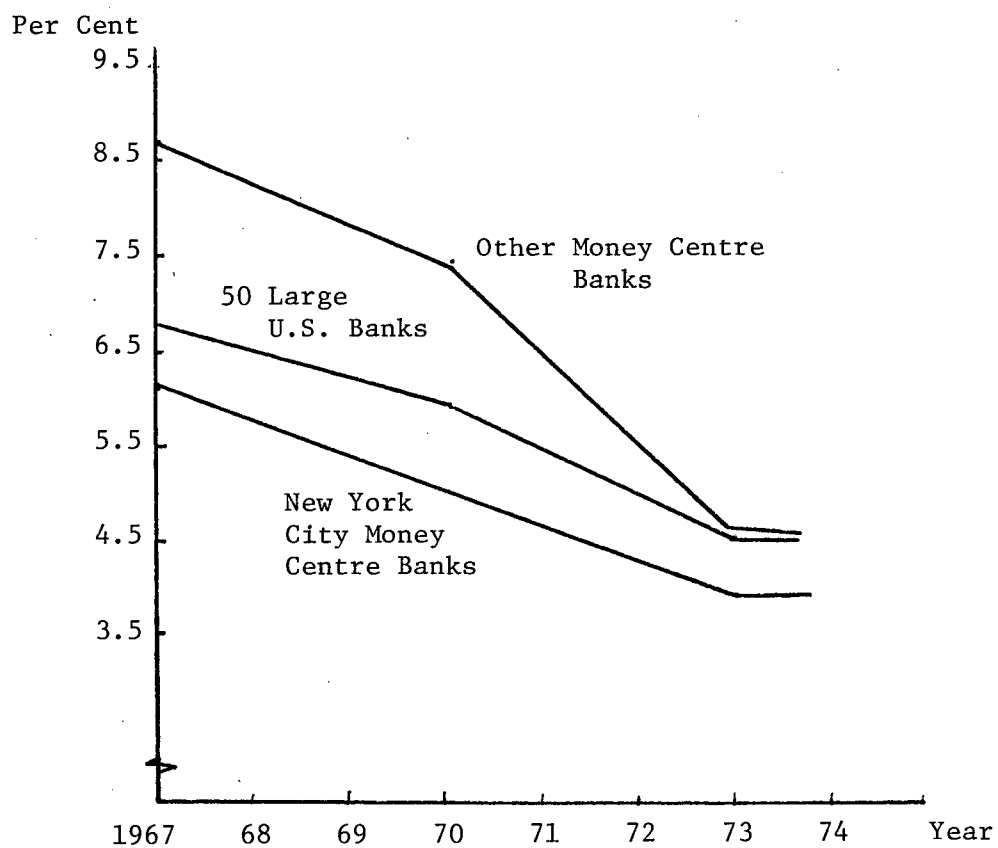


Figure 9-1

CAPITAL/ASSET RATIOS OF U.S. BANKING INDUSTRY

criticized the banks for operating on ratios that are too thin.

A comparison of capital/asset ratio of the Royal Bank and the Commerce reveals that they are indeed in a relatively weaker position than the BankAmerica:

	1965	1970	1971	1972	1973	1974
Royal	4.9%	3.4%	3.1%	2.9%	2.6%	2.3%
Commerce	4.9%	3.6%	3.7%	3.4%	3.0%	2.7%

The obvious solution to the above constraint on the ability of the banks to grow is to issue more share capital. However current depressed stock market conditions represent an environmental constraint on this alternative. No major U.S. banks have yet shown a willingness to attempt to float an equity issue although three Canadian banks have come out with rights issues in the past year. All issues were at relatively depressed prices. It certainly appears unlikely that any large bank will attempt to float a major share issue until the stock market turns around.

There is reasonable evidence that the banks themselves were not willing to forsake their goal of more growth--at least initially. The BankAmerica was vexed at the thought of the Fed giving the world's largest bank a public spanking. In response to criticism that it was undercapitalizing it argued that its "capital position is strong and fully capable of building dividend growth."⁶

The fact that the Federal Reserve has had to step in and rule against several other expansionary moves by the banks is also good evidence that the banks were not giving up growth without a fight:

Not only BankAmerica, but Citicorp, second biggest in the world, and Bankers Trust and First Chicago, each among the nations ten biggest banking operations, have all had planned acquisitions turned down by the Fed in recent months. Two weeks ago the Fed announced that it would not allow bank holding companies to underwrite mortgage guarantee insurance because it feared the holding companies were growing too fast.⁷

It appears that the 'go slow' message has recently been acknowledged by the banks. The Bank of America has recently received much publicity over its decision to slow down the growth of its assets.⁸ For our purposes it is vital that the reader understand that this decision was only taken after 'prodding by the Federal Reserve Board.'⁹ After being backed into a corner by the Fed it appears that the Bank is now merely attempting to make their decision publically 'acceptable.' One may rest assured that if its major competitors do not fall into line and adopt a consolidation philosophy, that BankAmerica will again adopt a growth objective. It is unlikely that the Bank of America will allow the First National City Bank of New York to replace it as the world's largest bank --at least not without a strong fight.

Bank management will not give up the growth objective for very long because, as pointed out by Galbraith, it is not in their best interests to do so. It is probably necessary to temporarily abandon what John Balles, President of the Federal Reserve Bank of San Francisco, calls the 'performance cult' of the 1960's and early 70's; but only until certain weaknesses that crept into the rapidly growing system can be shaken out. Of course the inadequate capital base will also have to be rectified.

While there has been no publicity over the state of the

capitalization ratios of the chartered banks, this writer submits that it is extremely likely that the Bank of Canada has used 'moral suasion' to slow down the banks. The reason is that some of the banks, in their 1974 annual reports, defended the adequacy of their capital levels. They are being prodded by someone--likely the Bank of Canada.

In defending the adequacy of their capital, the chartered banks put forth the argument that the following items constitute their capital:

shareholder's equity;
appropriations for losses; and
debentures.

The argument might have some validity--if the focus of attention is on the safety of depositors. This writer submits however that the focus of concern should also be on the shareholders. In this case it is only rational to argue that a bank's capital consists only of total shareholder's equity.

While the innate need for growth remains, the major banks do seem to be currently focusing their attention on liquidity problems brought about by the move of OPEC funds through the system. We have recently witnessed the unusual situation of major banks declining to take up all deposit funds offered. The reasons are twofold: (a) the funds are very volatile, and (b) the funds are provided by a limited number of sources. The latter point involves the concept of banker's risk (it is less risky to have 100 customers with deposits of \$10 each than ten

customers with deposits of \$100 each). The former point relates to the bank's liquidity problems--especially in the Euro dollar market.

Since the early 1960's the Euro dollar market has consisted mainly of banks collecting short term deposits and utilizing these funds to extend medium and long term loans to industrial clients. The market functioned reasonably smoothly--until the oil crisis. The oil producing nations have typically placed their funds on deposit for a very short term and often pull large sums out of the market for little apparent reason. This action of course severely limits the ability of the banks to re-cycle those 'petrodollars' toward productive use. In the circumstances some prudence has been self-imposed by the banks which indicates some awareness that growth cannot proceed without regard to other variables. In these uncertain times growth must take a back seat to the more important overriding goal of any organization: its own survival.

Governmental interference of both the positive and negative type is also currently having an influence on international banking. On January 29, 1974, the Federal Reserve Board announced termination of the Voluntary Foreign Credit Restraint (VFCR) program.¹⁰ This action was coordinated with the simultaneous lifting of the capital outflow restraint program administered by the Treasury and Commerce Departments of the U.S. This included termination of the Interest Equalization Tax. On January 30, 1974, the Ministers of Finance and of Industry, Trade and Commerce announced the withdrawal of Canadian guidelines that had originally been erected in order to obtain exemption from the U.S. program.¹¹

The result of the above action is that both Canadian and U.S.

banks have been granted an increased amount of freedom to operate in international markets. For the Canadian banks it means that they may be able to renew their role as a conduit of U.S. funds between North America and Europe. That is, a Canadian bank may bid for U.S. dollar deposits in Canada or the U.S. and, if interest rate differentials exist, the funds may be invested in a foreign market.

The effect of the removal of the various guidelines on the Canadian and U.S. banking systems is uncertain at this time. There are simply too many environmental variables. Clearly, the U.S. government would like the U.S. banks to participate in the Euro dollar market from a domestic base. In fact, former President Nixon's international economic report of February 1974 specifically urged that Euro dollar market operations of U.S. banks be brought home.¹²

However, there are significant barriers to this occurring. Reserve requirements and ceilings on deposit yields would likely make it impossible for the domestic U.S. banks to compete for Euro dollars. (Note that a Euro dollar placed on deposit at a domestic branch of a U.S. bank becomes subject to all the U.S. banking regulations.) It does not appear feasible for the Federal Reserve to grant exemptions for repatriated Euro dollars since 'a dollar is a dollar' within the border of the nation.

Some bankers have predicted however that the removal of controls will have an impact:

With the disappearance of controls, direct lending from the U.S. is bound to surge, thus lessening the need to use foreign branches to fund loans to multinational customers.¹³

Other bankers simply see the lifting of restrictions as giving them (and their client) the flexibility to choose the location of financing.¹⁴ Presumably the price mechanism, operating through interest rates will at last have a role to play in the allocation of funds on a worldwide basis from surplus to deficit spending units.

While the above government action might be termed 'positive,' there is a high probability that some additional negative interference will soon impinge upon the foreign operations of U.S. banks. The Board of Governors of the Federal Reserve System has created a steering committee:

charged with the responsibility of reassessing the structural aspects of U.S. international banking regulations that involve home country responsibilities for U.S. banks overseas.¹⁵

The Board of Governors of the Federal Reserve System has for some time been charged with the responsibility of regulating the international operations of U.S. banking organizations. The statutory authority stems from the following:¹⁶

- a) Section 25 of the Federal Reserve Act (amended 1966);
- b) Section 25(a) of the Federal Reserve Act (known as the Edge Act);
- and
- c) The Bank Holding Company Act 1956 (amended 1970).

Critics however have claimed that the policy of the Fed toward foreign banking has been much too lax.¹⁷

A different philosophy now seems to be emerging however and it

appears likely that a new 'interference' line will soon have to be added to our model (from government to the foreign market).

These same regulators (the Fed) that permitted banks to grow and diversify at breakneck speed are now trying to bring things back under control.¹⁸

Clearly, the Federal Reserve Board has the power to retard the growth of foreign banking activities of U.S. banks. However, if rationality prevails, one might hope that the Fed will concern itself only with minimizing the risk introduced to the domestic activities of U.S. banks by their foreign operations.

It was pointed out above that Canadian legislation has only had an indirect influence on the foreign operations of the chartered banks. Various Bank Act restrictions against diversifying into domestic financial markets are thought to have diverted attention to foreign operations. The Bank Act is scheduled for revision in 1977 however and some observers feel that the doors to some other Canadian financial markets may be opened to the chartered banks.

It was pointed out in Chapter Four that U.S. banks have entered Canadian financial markets by creating subsidiaries that provide many financial services that the chartered banks are barred from. An example is Citicorp Financial Services Canada Ltd., a wholly owned subsidiary of First National City Bank. The company provides a wide range of financial services including leasing, commercial credits, mortgage financing, consumer lending, and investment management. In a recruitment poster for MBA's the company advises prospective employees that: "In the past year

we have doubled in size and plans call for expansion at a similar rate during the next year."¹⁹ This rapid growth has caused Canadian bankers to lobby for entry into a wider range of domestic financial markets.

Here is an excerpt from the text of the 1974 Annual Report to Shareholders of the Bank of Nova Scotia presented by C. E. Ritchie, Chairman: "It is the utmost of absurdity to permit unregulated foreign institutions to do business such as leasing which domestic banks are forbidden to do."²⁰

It is not possible at this time to predict whether the government will allow the banks to expand into other domestic markets. However, if permission to enter other markets is granted, this would qualify as the removal of line '3' in terms of our model. The prediction that follows is that the pressure for growth that has in the past been diverted to foreign markets may be re-directed toward growth in the domestic area. Some slackening in the pace of foreign growth should then be expected.

In summary, environmental factors can be expected to continually play a role in the development of international banking. It is submitted that the model developed can adequately deal with various events as they occur although it may be that some additional variables (e.g., a government interference line running to foreign market) will have to be added. As long as the banks continue to embrace growth as a goal however, our model should remain valid.

The final chapter will be devoted to a 'crystal ball' look at the future. One feature that will be dealt with is the probability that growth will continue as the overriding goal of the banking industry.

Notes for Chapter Nine

- ¹ H. H. Binhammer, Money, Banking and the Canadian Financial System (Toronto: Methuen, 1968), p. 13.
- ² Ibid..
- ³ BankAmerica, 1973 Annual Report.
- ⁴ Business Week (Sept. 21, 1974), p. 52.
- ⁵ Ibid.
- ⁶ Ibid. (Feb. 24, 1975), p. 55.
- ⁷ Ibid. (Sept. 21, 1974), p. 52.
- ⁸ Ibid. (Feb. 24, 1975).
- ⁹ Ibid.
- ¹⁰ Board of Governors of the Federal Reserve System, 1973 Annual Report.
- ¹¹ Bank of Canada, 1973 Annual Report.
- ¹² E. P. Imhof, "Rapid Expansion of Overseas Banking," Inter-economics, No. 8, 1974.
- ¹³ S. C. Eyre, "Exploring Some Trends in International Banking," Burrough's Clearing House (February 1974), p. 54.
- ¹⁴ J. P. Morgan and Co. Inc., 1973 Annual Report.
- ¹⁵ "Business Conditions," Federal Reserve Bank of Chicago (Oct. 1974), p. 3.
- ¹⁶ Ibid.
- ¹⁷ Business Week (Sept. 21, 1974).
- ¹⁸ Ibid., p. 52.
- ¹⁹ Excerpt from recruitment poster, Citicorp Financial Services Canada Ltd.
- ²⁰ "International Challenges and Canadian Responses," Bank of Nova Scotia Monthly Review (Dec. 1974), p. 5.

Chapter Ten

THE FUTURE

The reader should keep in mind throughout this chapter that predictions of the future are notoriously unreliable. Nowhere is this more true than in the banking industry. Banking is an area constantly being interfered with by various governmental bodies; progression through time is characterized by banking action--government reaction--banking reaction. In these circumstances, it is easy to see the problems involved in 'star gazing.' Nevertheless, there are some events unfolding that seem to point the banks in certain directions.

There is no doubt that the various strains in the international environment (oil crisis, balance of payment problems, inflation, and creeping socialism) have had and will continue to have more than a nominal impact on international banking. The liquidity crisis (discussed earlier), foreign exchange losses and several bank failures are partly the result of these environmental events. Incompetent management has also contributed; especially in the failure of some smaller banks. The major Canadian and U.S. banks appear capable of weathering the storm, however public attention has now been focused on the banking industry. From the point of view of bankers, this is unfortunate. Bankers generally prefer to maintain a low public profile, which permits them more freedom to pursue their growth goals.

The focus of public attention on banking has resulted in a groundswell of protectionism in several international banking markets. As at

June 1973, one of the world's top ten banks rated the degree of difficulty with which a foreign bank can operate in a particular country. In order to rate the degree of difficulty or ease of operation the countries have been ranked on a one to five scale. The criterion by which the countries are ranked is as follows:*

- 1) Complete freedom on the same terms as indigenous banks, i.e., no discrimination at all.
- 2) Areas where some discrimination, e.g., there must be some legal participation or formal rules applied to foreign banks; informal constraints are ignored.
- 3) Areas of heavy discrimination, e.g., no branches allowed or direct subsidiaries.
- 4) Areas where only a very faint foreign banking presence is allowed, e.g., only through representative offices.
- 5) Areas where all foreign banks of whatever description are banned.

Grouped by regions, the countries have been rated according to (a) before opening offices, and (b) after offices have been established. Where only one rating is given, the rating is the same for both (a) and (b). Where there are two numbers, the first is (a) and the second (b).¹

* Taken from The Banker, vol. 123, 1973.

EUROPE		Nassau	1	Algeria	5	Muscat	1
U.K.	1	Jamaica	1	Tanzania	5	United Arab Emirates	1
Germany	1	Haiti	1	Kenya	1	Lebanon	1
Greece	1	Cayman Islands	1	Ghana	3	Jordan	1
Netherlands	1	Costa Rica	2	Uganda	2	Syria	5
Italy	1	Honduras	2	Angola	2	Turkey	3
France	1	Venezuela	2	Mozambique	2	Iran	3
Belgium	1	Trinidad	2	Cameroon	1	Kuwait	4
Luxembourg	1	Dominican Republic	2-1	Upper Volta	1	Iraq	5
Switzerland	2	Canada	3	Mali	5	India	1
Republic of Ireland	2	Mexico	3	Rhodesia	1	Pakistan	1
Austria	2	Bermuda	3-2	Tunisia	1	Afghanistan	3
Denmark	2	Guatemala	4	Malawi	1	Nepal	1
Portugal	3	Cuba	4	Ivory Coast	1	Bangla Desh	1
Spain	3	United States*	3	Zambia	2	Sri Lanka	1
Sweden	3	SOUTH AMERICA		Guinea	3	Cyprus	1
Norway	3	Ecuador	2-3	Senegal	1		
Finland	3	Paraguay	2	Niger	1	ASIA-PACIFIC	
U.S.S.R.	4	Bolivia	2	Chad	1	Hong Kong	1
Hungary	4	Colombia	3	Somalia	5	Brunei	2-1
Poland	4	Brazil	3	Dahomey	1	Fiji	2
Yugoslavia	4	Argentina	3	Sierra Leone	1	Malaysia	2-3
Rumania	4	Uruguay	3	Libya	5	Singapore	2-3
Bulgaria	5	Peru	4	Togo	1	Philippines	2
Albania	5	Chile	5	Central African Republic	1	Vietnam	2
Germany Democratic		AFRICA		Liberia	1	Guam	2
Republic	5	MIDDLE EAST		Mauritania	1	Japan	2-4
		SOUTH ASIA		Lesotho	1	Taiwan	2-4
CANADA-CARIBBEAN		Nigeria	2	Congo (Brazzaville)	3	Australia	3-4
Nicaragua	1	Egypt	5	Mauritius	1	Indonesia	3-4
El Salvador	1	Ethiopia	2	Botswana	1	Thailand	3-4
Barbados	1	South Africa	1	Gabon	1	Korea	3-4
Netherlands Antilles	1	Zaire	1	Swaziland	1	People's Rep/China	4
Puerto Rico	1	Sudan	3	Gambia	1	Burma	5
Virgin Islands	1	Morocco	2	Saudi Arabia	1	Mongolia	5

* writer's estimate

There is no doubt that the intensity of discrimination against foreign bankers will grow. The European Commission (the initiator of policy for the European Economic Community) has currently under study a proposal that would severely restrict the operations of foreign banks within the Community. The proposal is being strongly resisted by the United Kingdom (a country that welcomes foreign banks) but other member countries may be in favor.

Surprisingly enough, protectionism is very prevalent in the United States. American politicians long ago adopted the Marxian view that banking is one of the commanding heights of the economy. As such it is a height that should be barred to the foreigner. The American attitude also has its roots in the populist fear of large banking organizations who are thought to move savings from rural areas to the national (or international) money centres. Representative Wright Patman (a populist), formerly Chairman of the Banking and Currency Committee in the U.S. House of Representatives has long been an opponent of the entry of foreign banks into the U.S. His highly restrictive Foreign Bank Control Act submitted in 1973, while not passed into law, served to focus attention on the problem.² There are now several studies underway that might lead to discrimination against foreign banking in the U.S.

It seems to this writer that the most reasonable and logical approach to take in this area is to adopt the philosophy of reciprocity and equality. That is, foreign banks be allowed into the country provided that domestic banks are allowed to enter the relevant foreign market. This is basically the approach adopted by the American Banker's

Association.³ Support for this philosophy also comes from the Bible: "One law shall be to him that is homeborne, and unto the stranger that sojourneth among you."⁴

The writer is not optimistic however that the above philosophy will prevail. Surprisingly enough the Canadian Banker's Association has not come out with a policy statement on the reciprocity and equality issue. During the course of our interviews we found out why: the Canadian banks cannot agree on the issue. Three of the major banks are solidly in favor of reciprocity and equality and the other two are either opposed or very non-committal about the subject.

In an apparent attempt to eliminate the stultifying seniority system that resulted in barriers to the effective flow of legislation, the U.S. House of Representatives recently removed several key committee chairman, including Wright Patman, Chairman of the Banking and Currency Committee.⁵ Patman's replacement is a younger man who has the power to strongly influence the American policy toward international banking. From the point of view of the banking community, the new chairman, Henry Reuss is a disappointment. The following quotation provides evidence that Reuss is likely to continue where Patman left off:

The Government should do for people that, and only that, which they cannot do for themselves, like standing up to conglomerates and multi-nationals, and other examples of giantism . . . If that be Populism, I'm a Populist.⁶

As Kindleberger has pointed out, populism and nationalism are closely related and are attitudes of the 'True Believer.'

Those who hold extreme opinions are thoroughly persuaded that the other extreme actually shapes the course of events. Nationalism can easily be carried to the point of believing that foreigners plot against the nation. Joined with populism, it fears foreign banking as the Christian Scientist fears fluoride.⁷

Canada, of course, has her share of nationalists, the most famous of whom is probably Walter Gordon. He has recently received renewed attention in the media with his "30-firm plan for buying back Canada."⁸ Gordon claims that a Gallup Poll published in March 1974 indicated that 52 per cent of Canadians favour legislation that would significantly restrict and control further foreign investment; and a further 17 per cent partly favoured such a move.⁹ This is bad news for international banking. If Canadian politicians reflect the above sentiments, then it appears unlikely that the doors will be opened to foreign banking. Other nations who permit foreign banks to enter often stipulate for reciprocity so the expansion by the chartered banks into these markets could be prevented. Japan is a good example. Since the Japanese banks are only permitted to open representative offices in Canada, the chartered banks are only permitted to enter the Japanese market on the same basis --although it is known that both parties would prefer to establish full service branches.

In summary, the first prediction that evolves from the above comments is that international banking is heading into a period of increased governmental interference; spawned in part by world economic troubles and in part by economic nationalism that focuses quite naturally on banking as a 'commanding height' of the economy.

Of course the banks have become used to operating in controlled

environments and can be expected to react in ways that allow continued growth. One possibility that has received a good deal of attention in recent years is the development of consortia. It is thought that the banding together of four or five banks from different countries tends to reduce nationalistic sentiment somewhat. J. H. Coleman, formerly with the Royal Bank once stated that economic nationalism was one of the reasons behind the Royal's decision to take an equity position in the Orion banking group (discussed above). In an address to the 1974 Canadian conference on Banking, A. F. Tuke, Chairman of Barclay's Bank Limited, stated that: "The most important aspect of the next five to ten years is the question of consortia banking."¹⁰

It should be remembered that consortia banking brings potential problems with it. When economies are booming, all partners are likely to be happy with the arrangement. However, if problems occur (large loan defaults, etc.) it will be interesting to see if conflicting management interests will arise.

Another possible reaction to growth constraints imposed by various governments is the development of improved banking technology. Aliber has predicted that a technological revolution is about to hit commercial banking.

The technology of money payments is about to change, the geographic scope of the market will increase, and the effectiveness of national controls in limiting competition among banks is being eroded.¹¹

What Aliber has in mind of course is more sophisticated utilization of computer technology in banking.

Electronic banking will further enlarge the market area for deposits beyond national boundaries. Chicago banks will advertise in Frankfurt for mark deposits and loans while Frankfurt banks will compete for Chicago deposits and loans. Banks will be able to attract foreign customers without the costs of establishing offices abroad.¹²

With all due respect to Professor Aliber, he does miss a very important point. As John Coleman, former Deputy Chairman of the Royal Bank once said: "The product of banking is the same, so its the personal contact that counts."¹³ Every banker has been aware of this for years. The story is often told of the man who came to J. P. Morgan, the famous banker, during the panic of 1907 to borrow a million dollars. Mr. Morgan's reply was reported to be: "No, I won't lend you the money, but for a slight fee, I'll walk down Wall Street with my arm around you."¹⁴ While computers will undoubtedly play an increasing role in banking, it is inconceivable to this writer that the importance of personal contact will decline--that is unless mechanized robots who speak computereze assume executive management of our major corporations. It follows therefore that the need to have physical representation in foreign markets will not be eliminated by an improved payments mechanism. This argument received unanimous support from the bankers interviewed. In fact one banker strongly suggested that computers had been 'oversold to the banking community.'

Up to this point, the study has been primarily descriptive in nature. This is particularly true about the theoretical model stressing need for growth as the major motivator behind foreign banking. The desirability of growth as a goal has not been called into question. Perhaps it is now time to step back somewhat and look at banking as just

one part of spaceship earth. Growth as a goal has been called into question by the famous club of Rome study entitled "The Limits to Growth."¹⁵

While some of the assumptions and methodology used by the researchers has been questioned, there appears to be reasonable evidence that if the growth trends of industrialization, population, and depletion of non-renewable resources is not brought into check, the world is heading for serious trouble. The author's specific conclusion is:

If the present growth trends in world population, industrialization, pollution, food production, and resource depletion continue unchanged, the limits to growth on this planet will be reached sometime within the next one hundred years. The most probable result will be a rather sudden and uncontrollable decline in both population and industrial capacity.¹⁶

One might ask what all this has to do with banking. The answer quite simply is that banking may well be viewed as the gasoline that fuels the engine of industrialization. Evidence that the banking industry view themselves in this role is provided by the following statement by executives of the Chase Manhattan Bank:

Our major challenge lies at the heart of our service to corporate customers--financing their continuing need to expand and modernize productive assets. In short fueling corporate growth.¹⁷

That this objective might be somewhat out of step with society's wishes is evidenced by the pressure from many interest groups to include more social goals in the determination of loan and investment policy. Bankers are reluctant to give in to this pressure for two reasons:

- a) it is the government's not the banker's duty to decide what should and should not be done to improve the quality of life; and
- b) funds placed at the bank's disposal are to be invested in financially safe assets that provide some positive yield. Rare is the social project that promises safety and a positive return.

Nevertheless, there is no denying the pressure brought to bear upon the banks. Since the banks hold an inordinately large proportion of society's financial resources, they may be expected in the future to play an increasing role in the allocation of resources for social purposes. There are some bankers who will fight this. Walter Wriston, Chairman of Citicorp responded to a question about the social responsibility of banks as follows:

Oh, the social audit was the girl at last year's dance. Nobody knew what it was, but it sounded as if it was something wonderful, and good. Then you analyze what they're talking about and I've never yet found anybody who knew.¹⁸

It is the prediction of this writer however that if banks are going to expect to continue operating in foreign markets, they are going to have to adopt the view that social responsibility is a normal cost of doing business.

The problem facing the chief executives of banks is the same as for leaders of other major corporations: they are judged by their contribution to the corporation over a very short time span. Most corporate executives are in power for only five to ten years and there is pressure

on them to produce within that period. The Club of Rome study highlights this as an important variable in mankind's pursuit of short run goals.

The two missing ingredients are a realistic, long-term goal that can guide mankind to the equilibrium society and the human will to achieve that goal. Without such a goal and a commitment to it, short term concerns will generate the exponential growth that drives the world system toward the limits of the earth and ultimate collapse. With that goal and that commitment, mankind would be ready now to begin a controlled, orderly transition from growth to global equilibrium.¹⁹

Senior executives in the banking industry will certainly not be leaders in the rejection of growth for growth's sake. It remains to be seen whether society is able to develop the will to force the transition from growth to equilibrium. I believe it is fair to say that the banks will adapt to society's wishes. Once the rules are laid down the banks will play the game.

Notes for Chapter Ten

- ¹ Reproduced in The Banker, vol. 123 (1973).
- ² C. S. Ganoe, "Banking Across Borders: Reciprocity and Equality," Burrough's Clearing House (February 1974).
- ³ Ibid.
- ⁴ Quoted in "Future of Multinational Enterprise," in The International Corporation, C. P. Kindleberger (ed.).
- ⁵ Time (February 3, 1975).
- ⁶ Ibid., p. 11A.
- ⁷ C. P. Kindleberger, American Business Abroad: Six Lectures on Direct Investment (New Haven: Yale University Press, 1969), p. 124.
- ⁸ Financial Post (Oct. 5, 1974).
- ⁹ Ibid.
- ¹⁰ A. F. Tuke, "Recent Developments and Future Trends in Multinational Banking," speech presented to the Canadian Conference on Banking, Toronto, September 16, 1974.
- ¹¹ R. Z. Aliber, The International Money Game (New York: Basic Books Inc., 1973), p. 149.
- ¹² Ibid., p. 156.
- ¹³ Quoted in Macleans (March 1972), p. 77.
- ¹⁴ H. V. Prochnow and H. V. Prochnow, Jr. The Changing World of Banking (New York: Harper and Row, 1974), p. 383.
- ¹⁵ D. H. Meadows et al., The Limits to Growth (New York: Signet Books, 1972).
- ¹⁶ Ibid., p. 29.
- ¹⁷ The Chase Manhattan Corporation, 1973 Annual Report, p. 8.
- ¹⁸ Interview in The Banker (July 1974), p. 744.
- ¹⁹ Meadows, p. 188.

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A P P E N D I X E S

APPENDIX I

INTERVIEW GUIDE FOR FIELD STUDY

DISCUSSION QUESTIONS

A. Scope of International Operations

1. Preliminary to our discussion we would like to obtain an overall view of your Bank's commitments to international business. Would you kindly indicate the approximate percentage distribution of resources employed in the following areas:

	<u>Foreign</u>	<u>Domestic</u>
a) employees - number		
- compensation		
b) loans		
c) deposits		
d) total assets		
e) gross revenue		
f) net profits		

B. The Decision to Invest Abroad

In this section the objective is to determine those variables which play an important role in the decision to commit management time and other resources to the conduct of international operations.

2. We would like to discuss an expansion project which is presently under consideration:
 - a) what resources would be required?
 - b) what criteria will you use to determine the value of the foreign operation?
 - c) are these criteria different from those used--say, five years ago?
3. What objectives do you have for international operations over the next five years?
 - a) are these objectives different from those set five years ago?
4. Have growth opportunities in the domestic sector been limited in recent years? If so, what is the nature of the domestic limitation? For example:

- a) few profit opportunities?
 - b) low profit margins?
 - c) restrictions against domestic diversification?
5. Have limited growth opportunities at home influenced your decision to expand abroad?
 6. Some analysts maintain that overseas investment occurs because the investing firm possesses some advantage (computer technology, managerial expertise, economies of scale) that allows them to operate in the foreign markets more profitably than indigenous firms.
 - a) does this explanation apply generally to the banking industry?
 - b) to your bank?
 - c) what is the nature of the advantage?
 - d) do you compete in any foreign market where you do not have an advantage over indigenous banks?
 7. Have you entered, or would you consider entering a foreign market by any form other than direct* investments (for example by: licensing or management services contract)?
 - a) what factors would you consider in choosing the form of entry?

C. The Role of Government

In this section the objective is to determine whether governments have played a role (positive or negative) in the growth of international banking.

8. Is the Canadian money supply growing or able to grow fast enough to enable your bank to meet its growth objectives?
9. Have Canadian government barriers to domestic diversification had any influence on overseas expansion?
10. In general, should governments adopt a 'reciprocity and equality' attitude toward foreign banks? Why?

* (including investments in representative offices, agencies, branches, subsidiaries and consortia)

D. Reflections and Expectations of the Future

14. In retrospect, what would you say have been the major disadvantages (if any) in going international?
 - a) lost of profit opportunities in home market?
 - b) political complications?
 - c) stiff competition--low profits margins?
 - d) economic nationalism?
15. What, do you see, is the future for private international banking?
 - a) do you foresee a continuation of growth?
 - b) do you anticipate the entry of more banks into the international arena?
 - c) what changes in operating forms would you predict?
 - d) what changes in operating methods, organization and management techniques do you foresee?
16. Some observers of the banking scene say that as the technology of the payments system develops (increasing use of computers), the major banks will be able to service foreign customers without incurring the costs and risks of establishing overseas offices. Do you agree?
 - a) will the importance of personal contact with clients diminish?

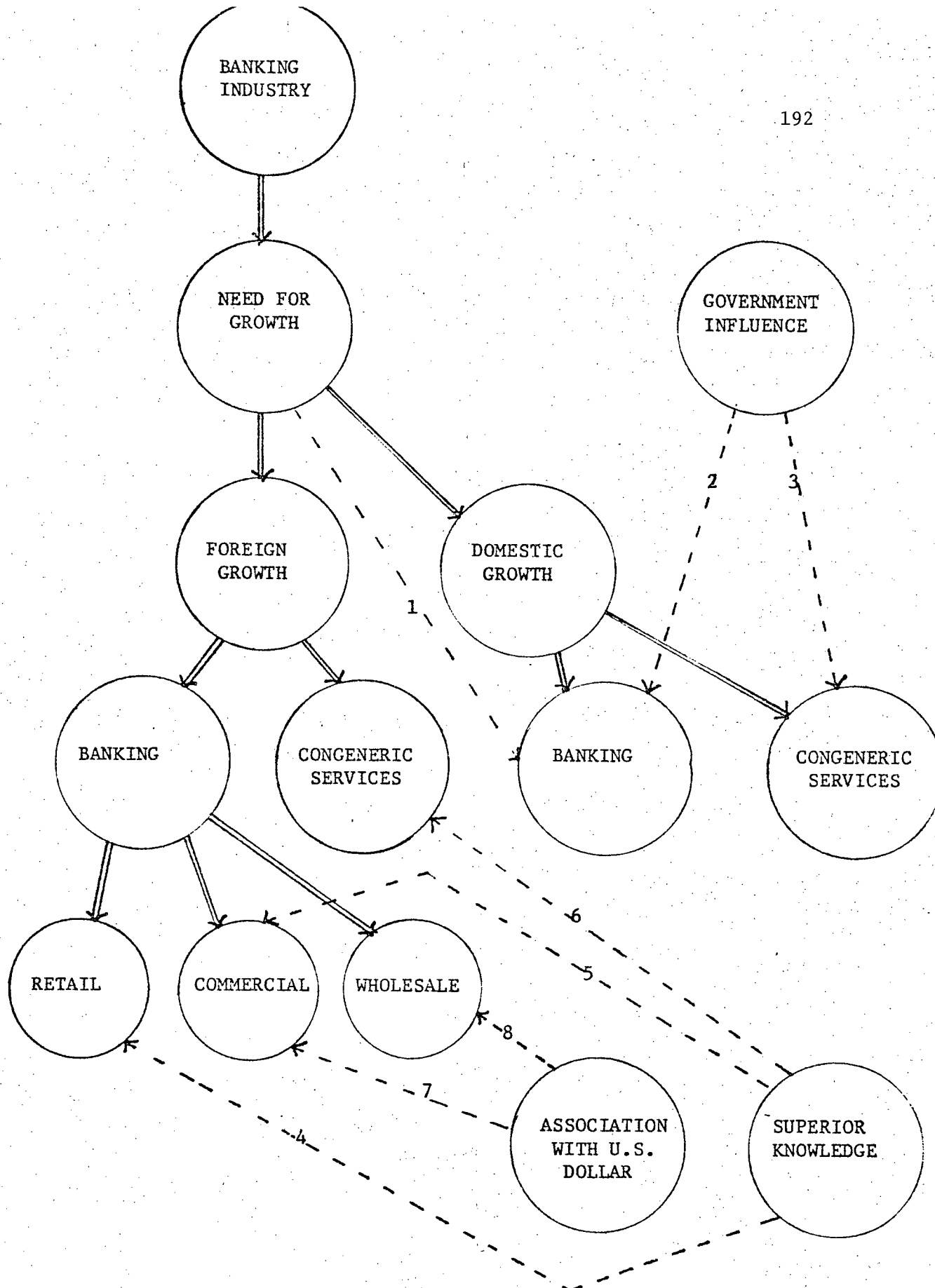


Figure AI-1

SCHEMATIC OF BANK EXPANSION ABROAD

APPENDIX II

THE FOREIGN INVESTMENT DECISION

It is hoped that the theoretical framework developed in Chapter Eight meets the test of logical consistency. The writer believes that the theory is consistent with observed facts.

Perhaps an exploration of the decision-making process followed when a bank makes a direct foreign investment will unearth some additional support for the theory. In launching this discussion it may be advisable to remind the reader that today's banker is not an individual entrepreneur, motivated solely by the prospects of profit. Rather he is an employee of a huge corporation composed of hundreds of other decision-makers, each with his own set of values and goals. Furthermore, today's banker operates in a world of uncertainty where decisions are often, in the end, really based on intuition rather than hard data. This is far removed from the economically perfect world often assumed in textbooks where investment decisions--foreign or domestic--are simply made on the basis of selecting those investments which maximize the net present value of the earning stream. The problems of decision-making in the real world have been explored by Y. Aharoni in his book, The Foreign Investment Decision Process.¹ Aharoni's framework will be kept in mind throughout our discussion of the decision-making process followed by the banks when making a foreign direct investment.

One central Aharoni hypothesis has relevance from the outset:

In fact, one important thesis of this book is that in organizations composed of individuals and groups within a certain culture, faced with uncertainty, operating on a basis of incomplete information, and constantly pressed by ongoing activities, one simply cannot behave in a rational way as this term is defined in economic theory.²

There is very little evidence that the banks generally have a master plan to use when considering a foreign investment. One exception is Citicorp, one of the more aggressive international banks. It is interesting to note that Walter Wriston, Chairman of Citicorp was formerly in charge of international operations. The fact that a strong internationalist is in charge of overall operations may have an influence on that bank's focus on offshore banking. Aharoni has found evidence that the drive of a high ranking executive can be a powerful motivating force for international growth.³

Citicorp's plan is based on a pattern of decentralization.⁴ Long term goals include the setting of target rates of return, however the focus in the short run seems to be more upon growth than on profits. The planning followed by Citicorp seems to pay off eventually in profits however. For the twelve months ended June 30th, 1974, Citicorp reported net operating income of \$268.2 million compared to \$235 million for the larger BankAmerica.⁵ Citicorp has had a ten year growth rate in earnings per share of 10.5 per cent, well in excess of its two major competitors. This might be evidence that a more sophisticated planning process should be adopted by the other banks.

During interviews with senior executives of the five major chartered banks it became clear that planning has not reached a very high level of sophistication. The question was asked: "What objectives do you have for international operations over the next five years?" In some cases a general answer such as "to become a major international financial institution" was given. This is fine as a statement of an

overall objective, but some operational strategies must be implemented to achieve this end. In all cases except one it was clear that the bank did not have an operational plan. The one bank that did, stressed the point that once objectives were established, progress toward achieving them is closely monitored. It is interesting to note that this bank was described by other bankers as being the industry leader in international operations.

In two cases we were told that the bank either did not set objectives or if objectives were set by the top executive, they were not revealed to international division. It appears that there is much room for improvement in the planning area.

Research carried out by B. Bruce generally supports the above, and furthermore, Bruce discovered a tendency for the banks to engage in "reactionary planning."⁶ Reactionary planning is the same as Knickerbocker's oligopolistic reaction discussed below. That is, the banks consider it essential to be where their competitors are. This phenomenon would be predicted from our theoretical model which stresses growth over profit. Some American bankers deny that they enter markets because their competitors are there; implying that a totally independent decision-making process is followed. This contention is not consistent with the evidence.

There is considerable evidence that growth is the real objective --rather than profits. When asked about the objectives of international investment most bankers include profits as a goal. However, when pressed with evidence that a significant amount of foreign banking may be

unprofitable, bankers respond with the point, apparently well known, that maximization of a system may require sub-optimal performance from one or more sub-systems. Banks appear to draw on this idea in explaining their activities in the international arena--and it may be valid. The thinking is that an unprofitable foreign subsidiary may produce valuable but intangible benefits to head office. The problem with this type of analysis however is that it is virtually impossible for the banks to obtain good evidence of the dollar value of the invisible or collateral benefits to head office. There is a danger that a real losing foreign operation may be hidden in the system.

As mentioned above, there is evidence that the banking industry engages in oligopolistic reaction (an interactive kind of corporate behavior by which rivals in industries composed of a few large firms counter one another's moves by making similar moves themselves).⁷

Julien-Pierre Koszul, Vice-President, Citicorp, says:

Competition is very intense among American banks. It is clear that if one American bank opens a branch in a part of the world where American firms are located it will stand a good chance of getting the local companies' banking business. This would be too much for the other American banking competitors to sit back and watch.⁸

Koszul goes on to point out that there is more at stake than just loss of the foreign banking business of a major domestic client: "It is also to prevent the head offices of these foreign subsidiaries from globally shifting their huge business to another more international American bank."⁹ An example of this is the acquisition by Citicorp of the accounts of Samsonite, a Denver based manufacturer of luggage.¹⁰

Commencing in 1964, Samsonite established subsidiaries in four European countries. As it turned out Citibank had a branch in each of the relevant areas. As a result Samsonite turned to Citicorp for its foreign banking needs and it was not long before the bank obtained a significant portion of the domestic business as well. Walter Page, Vice-President, Morgan Guaranty believes that his company was able to move from number two bank for a major U.S. chemical company to number one because of services performed for the chemical company in various foreign areas where Morgan had branches.¹¹

Evidence that the follow-the-leader syndrome is still going on is provided by the recent change of events in the Middle East. A recent Banker article entitled "Bankers Troop to the Middle East" describes the rush by various banks to obtain a foothold in a previously ignored area.¹² The Canadian Imperial Bank of Commerce and BankAmerica for example, have taken equity positions in Compagnie Arabe et Internationale d'Investissement in an apparent attempt to tap some of the new 'petrodollars' flowing into the Arab states. The company was formed in April 1973 and is engaged in channeling funds to the Eurodollar market and into direct and portfolio investments around the world. It is interesting to note that several other chartered banks had something to say about the Middle East market by the time their October 1973 annual reports were made available.

South East Asia is another case in point. The big five chartered banks have all recently established banking connections in the area. The Toronto-Dominion Bank and The Royal Bank were first to make a

concentrated drive into the market.¹³ The other major banks now have made direct investments in this area as well.

In summary, it is hoped that this brief look at the decision-making process has added some support for our model. Specifically it appears that the focus of decision-making on growth is consistent with the model. The process of oligopolistic reaction is also consistent with the model. From an economic point of view of course these processes may appear irrational. However, as Aharoni has pointed out, once pre-conceived economic notions are set aside, an orderly system of behavior emerges.¹⁴ It has not been the purpose of this study to develop normative theory based on restrictive assumptions. Rather, our purpose has been to develop theory that can be used to describe and predict the behavior of banks. While oligopolistic reaction, for example, might appear to purists to be illogical, from the point of view of bank management the process may be essential to the ability of the bank to survive in its competitive environment. The fact that some profits may be sacrificed in favour of growth becomes somewhat irrelevant given all the circumstances.

Notes for Appendix II

- ¹ Yair Aharoni, The Foreign Investment Decision Process (Boston: Harvard University Press, 1966).
- ² Ibid., p. 9.
- ³ Ibid.
- ⁴ G. A. Constanzo, "Planning For International Growth," The Banker (June 1974).
- ⁵ Business Week, "Annual Survey of Bank Performance," September 21, 1974.
- ⁶ Barry Bruce, "International Banking Activities of Canadian and American Banks," M.B.A. Thesis, University of British Columbia, 1969.
- ⁷ F. T. Knickerbocker, Oligopolistic Reaction and Multinational Enterprise (Boston: Harvard University Press, 1973).
- ⁸ J. P. Koszul, "American Banks in Europe," in The International Corporation, C. P. Kindleberger (ed.).
- ⁹ Ibid., p. 279.
- ¹⁰ Fortune (December 1967).
- ¹¹ Ibid.
- ¹² The Banker, "Bankers Troop to the Middle East," March 1974.
- ¹³ Financial Post, "Canadian Banks Push the Asian Connection," October 13, 1973.
- ¹⁴ Aharoni.