Foreign competition in U.S. banking markets

Foreign penetration of U.S. wholesale banking already exceeds that of most other industry groups; unless market capitalization ratios for U.S. banks go up—or down for foreign banks—this trend is likely to continue.

Herbert L. Baer

The global integration of the world's banking markets seems an inevitable, if not an already accomplished, fact. However, the accommodations that global integration will force upon U.S. banks may well be more disruptive and anxiety-inducing than those experienced in other sectors of the U.S. economy that have been integrated into the global marketplace. This article discusses the extent and nature of foreign competition in U.S. banking and argues that the increasing importance of foreign banking organizations is primarily a consequence of their superior capitalization.

Banking in perspective

Firms in most sectors of the U.S. economy have been free to sell their products in a nationally integrated market. And, despite tariff protection, these sectors have been subject to foreign competition for many years. In contrast, for most of its history, the American banking system has been simply a collection of local banking markets tied together by a correspondent banking network and the existence of large domestic corporate customers. For many bank customers, interstate competition, let alone international competition, has been rare. Indeed, as recently as twenty-five years ago, foreign and U.S. branches of foreign banks accounted for only 1.5 percent of total commercial lending by banks. At that same time, imports of manufactured and semi-manufactured goods were about 7 percent of the supply of U.S. manufactures.

The fragmented nature of U.S. banking is likely to place U.S. banks in a weak position as they compete for market share in an increasingly global market for banking services. Indeed, by 1988 foreign banking organizations accounted for 28 percent of wholesale banking in the United States (see Figure 1). Thus, foreign penetration of U.S. wholesale banking markets exceeds the levels achieved in primary metals, in electronic equipment, and in the transportation equipment sector. A higher level of foreign penetration been achieved in only one broad industry group—leather goods. In short, U.S. wholesale banking has gone from an extremely protected position in the 1960s to a quite exposed position in the 1990s.

Accessing the U.S. market

Foreign banks provide services to U.S. customers through branches located in the United States, through subsidiary banks chartered in the United States, and through offices outside the United States. Legally, foreign-owned banks chartered in the United States are subject to exactly the same regulations as a domestically owned bank chartered in the United States. If the owner of the bank is a bank or some other corporation, then the owner is generally treated as a bank holding company for regulatory purposes. However, in practice, some attempt is made to accommodate differences in banking practices across countries. For instance, foreign banks that

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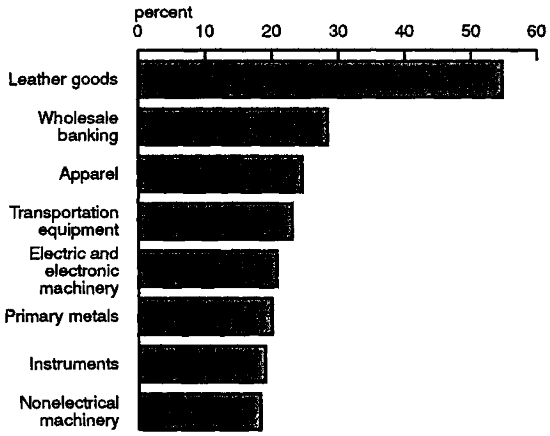
FIGURE 1

Foreign penetration of U.S. markets



*Imports plus value-added by foreign-owned U.S. firms as a percent of new supply.
SOURCE: Statistical Abstract of the United States, 1989, p.734; and "U.S. Affiliates of Foreign Companies: Benchmark Survey Results," Survey of Current Business, July 1989

have controlling interests in commercial firms are permitted to own bank subsidiaries in the United States. At the other extreme, foreign banks lending to U.S. customers from overseas offices are entirely free of U.S. regulation. Foreign-owned banks can also serve U.S. customers using a third approach—setting up a branch in the U.S. In this case, the U.S. branch's assets and liabilities are commingled with the rest of the bank's assets and liabilities. Capital requirements and lending limits are set by regulators in the bank's home country. However, the branch is subject to examination by the licensing state.

Market shares

Foreign banking organizations play virtually no role in the retail segment of the U.S. banking market. However, they are playing an increasingly important role in the wholesale banking market.

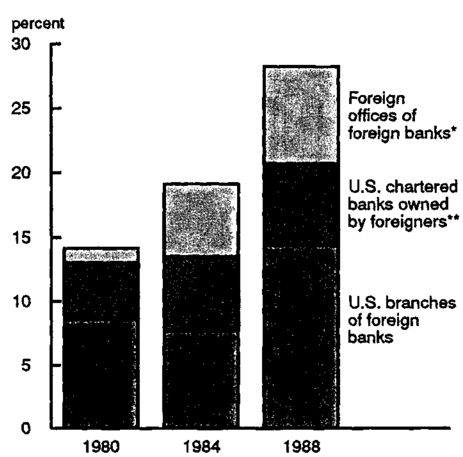
Commercial lending

The share of commercial and industrial (C&I) lending accounted for by U.S. branches of foreign banks has risen from 8.6 percent in 1980 to 14.4 percent in 1988 (see Figure 2). All of this increase is accounted for by branches of Japanese banks. In 1980, the U.S. branches of Japanese banks accounted for 2.7 percent of all C&I lending. By 1988, their share had risen to 8.5 percent. Over the same period, the market share of the U.S. branches of other foreign banks remained steady at 5.9 percent. The growth in C&I lending by foreign-owned banks chartered in the United States has been less dramatic, rising from 4.4 percent in 1980 to 6.3 percent in 1988. In contrast to the striking inroads made by branches of Japanese banks, the share of Japanese-owned U.S. banks has been relatively small, rising from 0.1 percent in 1980 to 2.4 percent in 1988.

The volume of C&I lending to U.S. firms through banking offices located outside the United States is more difficult to come by. The Bank for International Settlements (BIS) reports total foreign bank exposure to U.S. nonbank borrowers (including government and corporate bonds) while the Federal Reserve reports total loans by foreign firms (bank and nonbank) to nonfinancial firms. Neither source permits a breakdown by nation. However, using either definition, borrowing from offshore offices has grown dramatically. Using the Federal Reserve numbers, which include borrowings from banks and nonbanks, the share of C&I lending accounted for by offshore offices has risen sixfold from 1.2 per cent in 1980 to 7.6 percent in 1988.

FIGURE 2

Foreign share of commercial lending in the U.S.



*Estimates based on foreign borrowings of U.S. nonfinancial corporations as reported by Board of Governors, 1989. Includes lending by nonbank entities.
**Banks with greater than 50 percent foreign ownership.

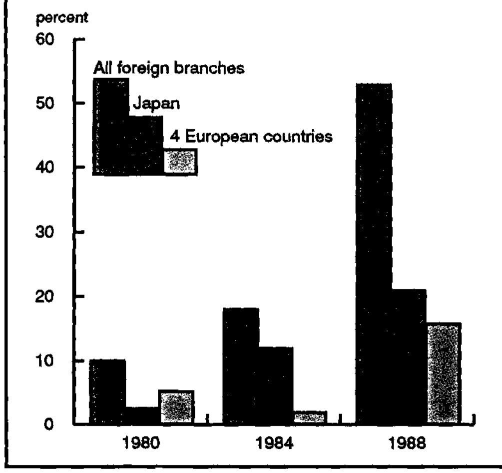
Guarantees

Guarantees in the form of standby letters of credit (SLOC) represent another important wholesale banking product. When a bank writes a SLOC, it guarantees that the customer will meet a financial commitment. SLOCs are used to guarantee a wide array of financial agreements. Examples include loans, commercial paper, bonds, asset-backed securities, and futures margin payments. The market for SLOCs, while smaller than the market for C&I lending, is clearly sizeable. As of December 1988 there were a total of $288 billion in SLOCs outstanding to U.S. customers versus $660 billion in commercial loans. There are a number of reasons why banks may choose to intermediate indirectly through the issuance of SLOCs rather than through direct lending (Baer and Pavel, 1987). These include avoidance of reserve requirements, deposit insurance premiums, or other regulatory factors that place the bank at a disadvantage relative to its customer in raising funds and declines in the credit quality of the issuing bank (Benveniste and Berger, 1987).

The growth in SLOCs issued by foreign banking organizations has been explosive (see Figure 3). In 1980 U.S. branches of foreign banks accounted for only 10 percent of all SLOCs issued to U.S. customers. By 1988, they accounted for 53 percent. Moreover, in contrast to the market for C&I loans, branches of Japanese banks have been responsible for only a third of this increase. Market shares of banks based in Switzerland, West Germany, France, and the United Kingdom have all grown dramatically.

FIGURE 3

Foreign branch shares of domestic standby letters of credit



Factors promoting increased foreign competition

What explains the rapid growth in competition from foreign banking organizations? One possible factor is the continued integration of the nonfinancial portion of the U.S. economy through greater trade and increased foreign direct investment in the U.S. However, this increase is capable of explaining only a portion of the observed increase in the market shares of foreign banking organizations. U.S. imports have been growing at roughly 7.6 percent a year and foreign direct investment has been growing at 14 percent a year. However, total C&I loans outstanding have been growing at 8 percent a year. This means that, at best, taking into account the increased integration of the U.S. economy into the global economy would only explain half the growth in the share of C&I for foreign banking organizations. At worst, global integration of nonfinancial activities accounts for none of the growth in market share experienced by foreign banking organizations. Other data support the contention that the growth in foreign banking organizations is not simply the result of increased foreign trade and foreign direct investment.

Sales of domestic C&I loans by U.S. commercial banks account for a significant portion of the competitive inroads being achieved by foreign banking organizations. Banks voluntarily sell loans to other institutions (including foreign banks) to avoid violating lending limits; to achieve a more diversified loan portfolio; to reduce capital requirements; or to take advantage of lower funding costs available at other institutions. Loans are purchased by other banks because they seek to diversify their portfolios; because their ability to raise deposits exceeds their ability to generate loans directly; because they are attempting to develop a banking relationship with a customer; or because they are able to raise funds at a lower rate than the seller (see Pavel and Phillis, 1987). By all accounts, loan sales were relatively unimportant prior to the early 1980s. In 1985, the first year for which formal figures are available, loans sold to U.S.

branches of foreign banks accounted for 1.9 percent of total C&I loans outstanding and 24 percent of total loans held by U.S. branches of foreign banks. By 1988, they accounted for 2.5 percent of total C&I loans. Thus, U.S. banks have been directly responsible for over two-fifths of the 5.8 percentage point increase in the market share of U.S. branches of foreign banks that occurred between 1980 and 1988 (Board of Governors of the Federal Reserve System, various years).

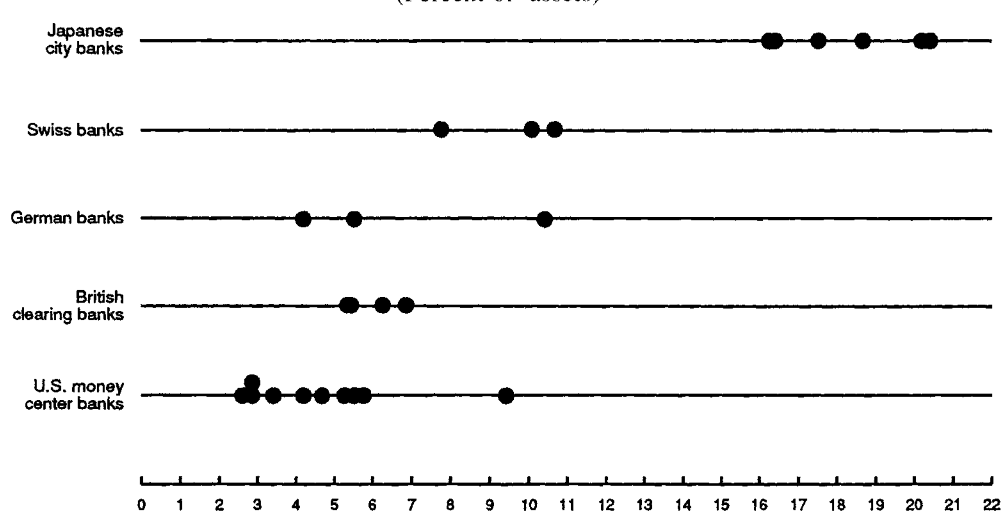
Some observers have been concerned that the rapid penetration of the U.S. wholesale banking market by foreign firms is the result of lax regulation by foreign governments (for instance, Walters, 1987). Excessive regulation of banks in their home markets has certainly played a role in the growth of the Eurodollar activities of U.S. banks (Baer and Pavel, 1987) and the Eurodollar and Euroyen activities of Japanese banks (Terrell, Dohner, and Lowrey, 1989). However, the links between lax regulation in a foreign bank's home markets and its competitive position in the domestic U.S. market is less well documented. Fears regarding the competitive advantages conveyed by lax regulation at home may be justified, particularly with respect to banks owned by foreign governments. And although no objective rankings exist, this concern would also appear to be valid where privately-owned foreign banks enjoy stronger guarantees from their governments than U.S. banks enjoy from the U.S. government. Whatever the particulars of the complaint, it ultimately boils down to the assertion that foreign banks are able to hold less capital per dollar of risk or pay less for the capital that they raise.

If this complaint is correct, then we would expect that those banks that have made the greatest inroads into the U.S. market—that is, the large Japanese banks (known as "city" banks)—would be the least capitalized of the major international banks. Yet, as Figure 4 shows, the large Japanese city banks, as a group, have the highest ratio of market capitalization (share price times number of shares outstanding) to assets of all the major international banks. As of January 1990, the lowest figure for a Japanese bank is about 16 percent while two have ratios over 20 percent.

The major U.S. money center banks, in contrast, have much lower market capitalization ratios. The highest market capitalization ratio for a U.S. money center bank is about 9.5 percent, while three money center banks have market capitalization ratios of under 3 percent. Banks based in Switzerland, West Germany, and the United Kingdom lie between the extremes of the U.S. and Japanese banks.

FIGURE 4

Market capitalization of U.S. and foreign banks
(Percent of assets)



SOURCE: Salomon Brothers, "Bank Stock Weekly," January 12, 1990; and "International Bank Biweekly," January 11, 1990

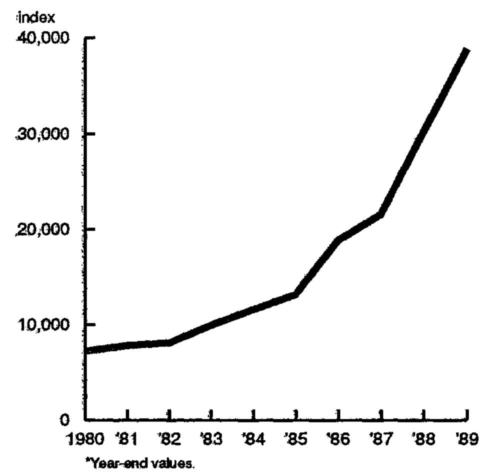
While the market capitalization of Japanese banks is extraordinarily high, their reported book values are relatively low, with the major Japanese banks reporting book capital ratios ranging from 2.5 to 3.0 percent in early 1990. Much of the discrepancy between the relatively low book values of Japanese banks and their relatively high market values is accounted for by unrecognized gains on their holdings of equity investments in Japanese nonbanking firms (Hanley et al., 1989). Japanese banks are permitted to hold up to a five percent interest in a nonbanking firm. The Japanese city banks are members of "keiretsus" or clubs that are the postwar successors to the powerful "zaibatsus." Banks frequently hold equity positions in other firms belonging to the keiretsu and it is not uncommon for a bank to be a firm's leading shareholder (Tokyo Keizai, 1989). A bank will also hold equity stakes in firms that are not members of its keiretsu.

The value of the equity portfolios of the large city banks has soared in the last decade along with the dramatic increase in Japanese (as well as worldwide) share prices (see Figure 5). By 1988, unrealized gains on securities accounted for 45 percent of the market capitalization of Japanese city banks. Unrealized gains on real estate, while not currently disclosed, are also likely to account for a nontrivial portion of the gap between the market and book values of Japanese banks because each has an extensive branch network and Japanese real estate values are high relative to those in other countries. The remainder of the discrepancy is accounted for by discounted future earnings on banking activities. And, while book earnings of Japanese banks are low by Western standards the discount rates applied to these earnings are also typically quite low (French and Poterba, 1990).

Even ignoring the unbooked value of Japanese real estate and the present discounted value of future earnings—i.e., counting only book equity and unrealized gains on securities net of unrealized gains on LDC debt—Japanese banks, as a group, are the most heavily capitalized banks in the world. In 1988, the least capitalized Japanese city bank had an adjusted book value of 6.4 percent while the best capitalized city bank had an adjusted book value of 12.6 percent. Clearly,

FIGURE 5

Japanese share prices: 1980–1989
(Nikkei-Dow Jones Index)



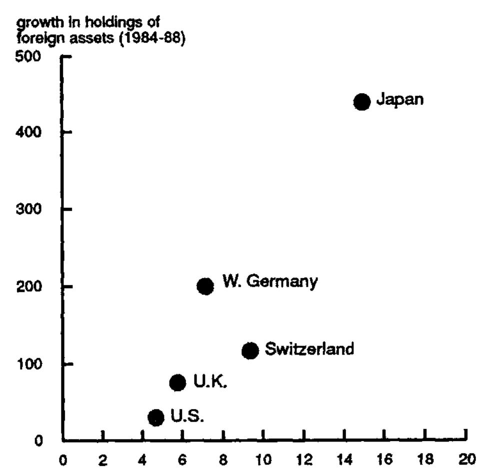
the impressive growth of Japanese banks cannot be explained by too little capital.

Too much of a good thing?

If too little capital does not explain the rapid growth of Japanese banks in the United States perhaps it is worth considering whether the high level of capital can explain their relatively high growth. Figure 6 plots the growth in international assets and market capitalization ratios for banks in Japan, Switzerland, the

FIGURE 6

Impact of market capitalization on growth in foreign bank activity



SOURCE: Bank for International Settlements and Salomon Brothers

United Kingdom, the United States, and West Germany. Banks from France and Italy are excluded because their ownership by a national government makes it difficult to measure their true capital. Figure 6 suggests that the success of Japanese banks is only the most dramatic example of a more general principle—banks that have high market capitalization ratios have made greater inroads in foreign markets than have banks with relatively low market capitalization ratios. Swiss and German banks, which also have relatively high market capitalization ratios due to unrecognized gains on equity portfolios, have also been expanding into foreign markets at a relatively rapid rate.

At the November 1989 conference on globalization, a well-known economist remarked that he had never met a bank that had too much capital. Many in the audience chuckled at this remark with knowing agreement. In the context of American money center banking, where large windfall profits have been fairly rare while losses due to regional downturns and poor performance by third-world borrowers have been large relative to capital, the remark is correct.

How should a bank holding an equity portfolio that experiences a significant appreciation respond? One possible response would be to realize some of the unrecognized gains and pay the proceeds to the bank's shareholders through a special dividend. In the case of Japanese banks, however, both the shareholders and the bank want to avoid paying a special dividend. The bank owns much of its equity holdings as a direct result of its membership in its keiretsu. If the bank sells off its shareholdings in these firms, it risks weakening its ties to and influence over the keiretsu. The taxation of dividend income for individual investors is also an issue since dividend income is taxable while income from capital gains is not (Spicer and Oppenheimer, 1988). Furthermore, any capital gains realized when the bank sells securities are taxable at a rate of 52 percent (Hanley et al., 1989).

Clearly, there are strong incentives to avoid realizing capital gains in the absence of offsetting losses. As long as the discrepancy between the bank's current and "potential" share price is less than the tax that would be paid on the special dividend, bank shareholders prefer to realize the capital gain by selling the bank's shares rather than by having the bank pay a special dividend. Thus, for Japanese banks, strategy and shareholder tax avoidance both point toward retaining any capital gains within the bank.

The bank's decision to retain its capital gains places it in the position of having too much capital. If the bank's portfolio was previously in equilibrium, the bank now is able to issue uninsured liabilities at a lower rate than before. It is also able to take larger exposures to borrowers while maintaining the same level of diversification in its portfolio. The shift toward highly leveraged transactions by large U.S. and British firms in the latter half of the 1980s has accentuated this effect and surely explains a significant portion of the rapid growth of Japanese banks in the United States.[1]

Even if the bank is forced to raise book capital, it will still have strong incentives to grow. It can either increase book equity by realizing capital gains or by simply issuing additional securities. In contrast to banks with relatively low market capitalization, it will find securities issuance inexpensive, in large part because the issuance of additional securities does not generate an offsetting loss of government guarantees.[2] As Edward Kane points out elsewhere in this issue, this factor explains why Japanese banks have had little trouble raising additional equity.

However, the decision to retain capital gains within the bank may also give managers the leeway to pursue goals that do not maximize shareholder value. One common tactic in such situations is to pursue rapid growth both internally and through acquisition. This has proved common in nonbanking firms and there is no reason to believe that banks would behave any differently given the opportunity (Jensen, 1986). However, the conglomerate merger wave of the 1960s was reversed in the 1970s and 1980s as shareholders came to realize that these mergers were not in their interests. It is equally likely that inroads by foreign banks that have been driven by runaway management will be reversed in the next decade.

Conclusions

Many explanations have been advanced to explain the rapid growth of foreign banking organizations in the United States over the past decade. Some have argued that this growth simply reflects the increasing globalization of financial markets while others have argued that it is the result of the relatively lax regulation of foreign banks that permits them to operate with too little capital. The facts support neither explanation. Increased trade and foreign direct investment are capable of explaining only a portion of recent inroads made by foreign banking organizations while data on market capitalization suggest that the fastest growing foreign banking organizations, the Japanese city banks, are four to five times better capitalized than the typical U.S. money center bank.

The rapid growth of foreign banking organizations in the U.S. is best understood as a result of three events. First, Japanese banking organizations experienced a rapid increase in market capitalization due to rapid increases in the value of their equity portfolios. Second, the increasing importance of large-value highly leveraged transactions conveyed an advantage to well-capitalized banks able to lend large amounts of money quickly. Third, the market capitalization of the largest U.S. banks suffered repeated reverses due to a series of regional downturns and the failure of many LDC borrowers to repay loans as scheduled. According to this view, foreign inroads will ease only if asset growth or declines in the value of the equity portfolio bring the market capitalization ratios of Japanese banks back to the levels of the early 1980s, or if the market capitalization ratios of major U.S. banks rise significantly.

FOOTNOTES

[1]Kane (1990) and (1988) makes a similar point.

[2]When a bank is poorly capitalized and deposit insurance is mispriced, the deposit insurance can account for a substantial portion of the bank's market value. Issuance of new equity reduces the value of the deposit insurance and hence the overall value of the bank's equity. Existing shareholders must compensate new shareholders for this decline in value. This makes new equity expensive to issue.

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