

# International Banking in Philadelphia

*By Janice M. Westerfield\**

Over the last few years, Philadelphia bankers have made substantial strides in international banking. The volume and breadth of international services have grown, and foreign earnings have grown, too, until now they make up an appreciable part of total earnings for some Philadelphia banks.

What caused this advance? Primarily, the expansion of world trade, which brought with it a new demand for financial services. Philadelphia is a major port city with a natural entree to international commercial circles. And Philadelphia bankers provide a large share of the financial services used in foreign trade locally. But there are other sources of growth as well—sources that can't be measured in tonnage passing through the

port or in pallets lifted over local piers. As American manufacturing and service firms have gone abroad, they have continued to rely on American banks for financing. And where those bankers have followed, they have found new opportunities for profit. Philadelphia bankers have been in the forefront of this movement.

What does the future hold? That depends not only on commercial conditions but also on the legal environment in which financial services are provided. Trade may get a boost from Philadelphia's International City project, which already is bearing fruit. And foreign bankers are moving into the Delaware Valley. Developments like these, however, pose new issues for the regulatory and supervisory authorities here and abroad, who are working to preserve both the soundness and the competitiveness of the international banking community. As the trading world becomes more tightly knit, their cooperative efforts in

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this area will help to shape the course of international banking in Philadelphia.

#### PHILADELPHIA BANKS ON THE MOVE

New opportunities for international finance during the 1960s spurred many Philadelphia bankers to initiate foreign operations. Once the benefits from exploring new markets became apparent, they moved rapidly to expand.<sup>1</sup>

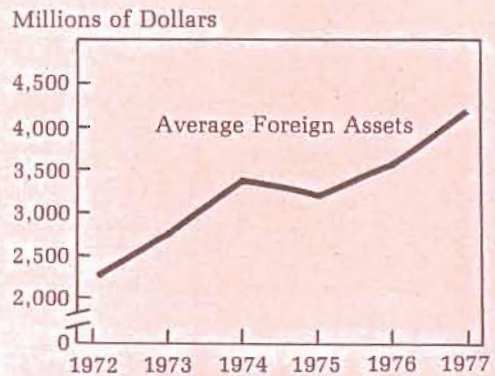
**Expansion . . .** At first it seemed that foreign operations could be handled adequately by setting up correspondent banking relationships—arrangements to provide services through banks in other localities. But by 1972, Philadelphia banks had decided to establish their own branches in London, the Virgin Islands, and the Bahamas, and foreign assets had reached \$2.2 billion.<sup>2</sup>

During the following five years, Philadelphia banks broadened and deepened their commitment to international banking. Foreign assets increased substantially, to \$4.2 billion, and the banks cultivated customers in a variety of markets (Figure 1). Loans were up from slightly less than \$1 billion in 1972 to \$2.7 billion in 1977—a compound growth rate of 22.8 percent per year. And even though bankers have proceeded more cautiously since 1975, growth rates have held up at just under 20 percent annually. Further, the ratio of average foreign loans to average total loans increased steadily from 14 percent in 1972 to 24 percent in 1977 for Philadelphia banks as a group.

<sup>1</sup>Fidelity, First Pennsylvania, Girard, Philadelphia National, and, to a lesser extent, Provident National are the Third District banks that have substantial foreign operations. Several other area banks have branches in the Cayman Islands.

<sup>2</sup>A correspondent banking relationship with a foreign bank provides a U.S. bank with services in return for fees and compensating balances. These services enable banks that don't have their own international departments to transact foreign business for their customers. Where foreign volume is low, using a correspondent bank may be less costly than establishing a foreign branch or an international department in house.

**FIGURE 1  
PHILADELPHIA BANKS  
SEE THEIR FOREIGN ASSETS RISE**



SOURCE: Delaware River Port Authority.

Also, Philadelphia banks have set up corporations, expressly for conducting international banking operations, under the Edge Act.<sup>3</sup> Some of these corporations have remained in the Third District, while others have opened offices in New York—the traditional home of international finance in the United States.

Thus additional foreign branches and subsidiaries, as well as representative offices, have expanded the network of Philadelphia banks. And foreign earnings, which now account for over 40 percent of total earnings at the banks most heavily involved, have kept pace with this expansion.

**. . . With a Pattern.** Philadelphia bankers as a group prefer relatively short maturities for their foreign loans, placements with banks, and other claims. Nearly 70 percent of these

<sup>3</sup>Edge Act Corporations are U.S. corporations that banks may establish, under Section 25(A) of the Federal Reserve Act, to engage in foreign banking and finance. They accept deposits, make loans and investments, and offer other services, but only in international transactions.

claims have a year or less remaining to maturity. But the distribution among individual banks is uneven, with some banks having as much as 85 percent in short-term claims while others have as little as 50 percent.

Different kinds of borrowers tend to be associated with claims of different maturities. U.S. bank claims on foreign banks typically are short-term placements or loans; and these account for over 60 percent of total foreign claims. Claims on nonbank public borrowers—foreign governments and their agencies—are mostly medium to long term and make up about 20 percent of the total. The final 20 percent have various maturities and are distributed mainly among private, nonbank borrowers.

Philadelphia bankers are active in developed and developing countries in many parts of the world. In the late 1960s, the largest portion of credits went to Latin America, and that area still accounts for nearly one-third of total claims. Growth in claims over the last ten years has been strongest in Europe, which now accounts for 42 percent. Asian claims, once strong, have been reduced from over a third to about 18 percent. And Africa accounts for about 4 percent.<sup>4</sup>

In short, foreign banking is big business in Philadelphia. Recent years have seen dollar involvement rise dramatically, with area bankers seeking out profit opportunities around the world.

#### **SOURCE OF GROWTH: WORLD TRADE**

The main contributor to the growth of international banking has been the upward

<sup>4</sup>This geographical distribution is changed only slightly when external guarantees are taken into account. An external guarantee is a commitment by an entity located in a third country, such as a government or international institution, to protect the lender against default; although the borrower may be physically located in Country A, someone in Country B has agreed to repay should the borrower default. So it can be argued that the risk of a loan should be treated as if the characteristics of Country B are important to assess also.

movement in the volume of trade. Exports and imports of goods both have risen, and so has the volume of financial transactions such as movements of bonds and currencies. Domestic banks finance the foreign operations of many U.S. corporations. In the course of providing financial services to these multinational clients, U.S. bankers have learned that they can make profits in foreign countries and that sometimes they can acquire funds there at a lower cost than at home. Philadelphia banks, because of their nearness to a riverfront port, have been especially well situated to benefit from trade growth.

**Financing Trade and Capital Flows.** There are obvious opportunities for bankers to service merchandise flows through nearby U.S. ports of entry. But besides financing stateside trade, U.S. banks service financial and commercial activity in many distant markets (see MEASURES OF RISK AND RETURN overleaf). U.S. private investment abroad, for example, grew at a compound annual rate of 34.2 percent from 1972 to 1977. And it's no longer just the big corporations that invest abroad. Smaller businesses also are finding attractive investment opportunities on foreign shores.

Many American businesses have established close client relationships with U.S. banks on domestic matters. These firms often find it convenient to continue this relationship when expanding abroad. Foreign operations may involve less familiar currencies, with different economic and political institutions and modes of conduct. Further, tax laws or currency controls multiply the complexity of financial decisions in foreign countries. Familiar banking contacts may be helpful in providing information or overcoming obstacles in foreign markets. So American business in foreign countries continues to depend on American banks, boosting the volume of their international transactions.

**Finding Funds.** U.S. bank foreign involvement has been encouraged also by require-



ments for new sources of funds. These requirements are influenced not only by the volume of trade but also by changes in the regulatory environment.

In the mid-1960s, the Federal government introduced policies designed to curtail outflows of U.S. capital and reduce the balance of payments deficit. The capital controls established at that time included guidelines for bank lending to foreigners, ceilings on foreign direct investment, and taxes on foreign securities. In response to those restrictions on capital flows, U.S. multinational corporations began to seek external sources of funds to finance their foreign operations. And U.S. banks set up networks to tap foreign sources of funds and to place loans.

Later, during the 1969-70 credit crunch, banks were unable to compete effectively for domestic funds because of interest-rate ceilings, and so many turned to their foreign branches to supplement their traditional sources of funds. Although later regulatory changes diminished the incentives for member banks to borrow from their overseas branches, their initial move abroad opened up new horizons.

**Activity at the Port.** While the growth of trade financing has affected most U.S. international banking centers in roughly similar ways, Philadelphia has felt the impact more strongly than others because its customs region accounts for an increasing share of U.S.

### MEASURES OF RISK AND RETURN

One useful way to try to get a grip on the foreign operations of Philadelphia banks is to focus on foreign exposure and financial return. Foreign exposure usually is viewed as the volume of claims subject to a foreign risk, and it can be measured by calculating these claims or assets as a percent of consolidated capital. This measure may indicate potential trouble if the ratio is so high as to suggest that capital would be endangered if defaults were to rise significantly. But it is difficult to establish a critical level that says "any ratio above this percentage is too high."

Another approach along this line is for the bank to measure a group of its most risky claims against total capital. The assumption underlying the use of a subset of claims is that some borrowers are more likely to default than others and the bank certainly does not expect to cover more than a negligible portion of defaults with its capital.

A more direct way of assessing the performance of foreign lending operations is to look at net chargeoffs—loan losses minus recoveries. Whereas exposure ratios attempt to measure the likelihood of default, chargeoffs record loan losses that already have occurred. Foreign net chargeoffs for the representative Philadelphia bank are slightly below the national average of 0.176 percent and compare favorably to their domestic net chargeoffs.\*

Foreign-income-to-asset ratios provide another view of the financial side of foreign operations. Essentially, these ratios give a picture of the rate of return on foreign assets—a return which surpasses that on total assets for Philadelphia banks. This result may be caused partly by sluggish domestic loans and unusual domestic loan losses. But the foreign asset picture generally is a bright one. Although foreign income and revenue figures for Philadelphia banks actually peaked around 1974, yearly income figures are on the rise again and soon will reach their former high level.

The importance of foreign earnings to Philadelphia banks probably is captured most accurately by the ratio of foreign income to total income—currently 40 percent. Judged by this or the other ratios, international financial services clearly provide substantial returns to Philadelphia bankers.

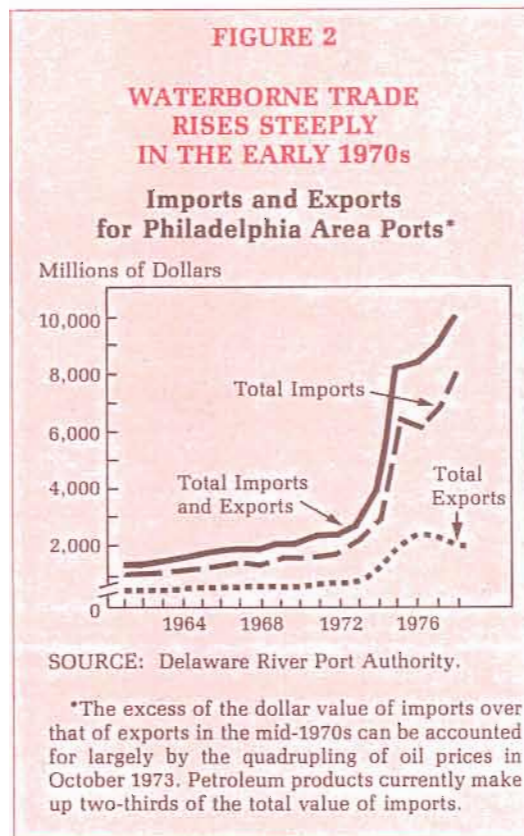
\*The 0.176 percent comes from a survey of 127 banks by Robert Morris Associates, a Philadelphia-based organization. Their domestic loan loss figure of 0.51 percent measures chargeoffs as a percentage of the average loan portfolio for 751 banks surveyed.

merchandise trade.<sup>5</sup> The nine ports of the Philadelphia area—ranging from Trenton to Wilmington—more than tripled the dollar value of their exports and imports from the 1972 figure of \$2.9 billion to over \$10 billion in 1977. And they moved into first place nationally in terms of dollar value of general cargo and bulk (Figure 2).

Exports from the area in dollar terms are dominated by machinery, especially transportation equipment. But when both exports and imports are counted, petroleum clearly is the big ticket commodity. In 1977, petroleum products, at \$5.2 billion, accounted for two-thirds of the value of imports and were greater in value than all exported cargo. Since the Philadelphia-Delaware River area is known as a major refinery and petrochemical center, this figure is not surprising. And as might be expected from the strength of oil products, several oil exporting nations—Saudi Arabia, Nigeria, and Venezuela—are among the major exporters to this area. But millions of dollars of cargo also go to and from many other countries in the world, especially Japan. As international business of area companies has expanded, it has produced a new wave of demand for financial services.

Thus it appears that the demand for international financial services has come from a broad spectrum of both commercial and non-commercial activity in the region. And new initiatives on both fronts can be expected to expand the role of international banking in Philadelphia. But it has become clear in the

<sup>5</sup>Philadelphia banks finance a substantial portion of trade through the Delaware River ports. Much of the financing is handled by banker's acceptances and letters of credit, both short-term claims. For example, take the case of a local exporter who is selling some machinery to a company located in Germany. The German importer arranges for his banker in Germany to issue a letter of credit in favor of the exporter. This letter gives the terms of the merchandise transaction and states that the U.S. exporter may draw a time draft on the German bank. The exporter then draws the draft on the German bank, negotiates it at his U.S. bank (at a discount), and



course of this present growth phase that certain adjustments of a legislative and regulatory kind may be required to preserve the efficiency and competitiveness of the international banking environment.

receives payment. The U.S. bank forwards the draft to the German bank which accepts the obligation to pay the draft, hence the name 'banker's acceptance.'

Thus the accepting bank transfers funds to the exporter and is reimbursed subsequently by the importer. The exporter shifts the burden of assessing the creditworthiness of the importer, and thus the default risk, to the bank that accepts the draft; and the exporter can get his money at a discount without waiting for the importer to pay for the goods. The importer is enabled to defer payment; in effect, he gets a loan, for which he pays a fee. And the U.S. bank gets possession of a marketable, interest-earning asset which provides liquidity, and also receives a fee for guaranteeing the transaction.



### AN INTERNATIONAL FUTURE FOR PHILADELPHIA BANKS

Just as the growth of commerce in Philadelphia has spurred the demand for bank services, the banks themselves now are actively involved in attempts to develop inducements for trade, including a major new trade effort—the International City project. Bankers, civic leaders, private organizations, and others are working on a design to make Philadelphia a recognized international city by 1982—the city's Tricentennial year.

**International City.** Philadelphia needs a strong investment plan and an overall economic strategy to revitalize the city's economy and especially to create jobs. And any city that wants to remain economically viable will find that it must develop sound international business institutions. It's not that Philadelphia is isolated now; this city is far more cosmopolitan than many people realize. The port and its shipping lines, the large pharmaceutical companies, banks, insurance companies, and others all have offices or other connections in other countries. Moreover, the population of the city and surrounding suburbs is highly diverse in ethnic and racial background. These things are a good start, and the International City project emphasizes building upon them to develop the two-way nature of international trade. The game-plan is to seek foreign investment while at the same time strengthening the capability of Philadelphia-based business to compete in foreign markets.<sup>6</sup>

There are several segments to the program, most of which still are in the planning stage. One of these is the Philadelphia Financial Network—a commitment to make Philadelphia a leading regional financial center by offering financial services that might induce foreign companies to locate here. Such ser-

vices might include loans to foreign companies or precommitments for financing that recognize the special borrowing requirements of firms that are unfamiliar to lenders in this area. Or they might include the development of innovative banking services to identify leads and attract foreign investment, providing information to reduce the uncertainties of locating in Philadelphia or the nearby area.

Other major elements in the project are geared to demonstrate that Philadelphia is equipped to service foreign firms as well as a thriving international business community. One proposal is to centralize business and communications for many international firms in a world trade center at the port. Another proposal that's actually made it off the drawing board is the establishment of a free trade zone for goods on the waterfront. Approved by the Department of Commerce in March 1978, the new zone permits firms to avoid duties on their products until processing or manufacturing is completed. The reduction of tariffs and customs regulations in this zone is expected to create incentives for new firms to locate here, creating jobs and increasing cargo flows.<sup>7</sup>

<sup>7</sup>S.I. Le Saffre, a French yeast firm which plans to occupy a large portion of the free trade zone on the Philadelphia waterfront, provides an example. The firm benefits because the materials it imports won't be taxed in the zone. Nor will the yeast that it exports to other countries. Only yeast that enters the U.S. will be taxed. The local area benefits from the employment and income that the firm generates as it builds its plant and produces its product.

Bankers in Pennsylvania and other states also are watching to see what happens in New York, where a state law allowing a free trade zone for banking was signed in June 1978. This law permits banks to establish international banking facilities to transact foreign business free of state and New York City taxes. Currently, these taxes on loan activities add an appreciable burden over and above the Federal tax of 48 percent. The new facilities are intended to attract loans which now are booked in the Caribbean and elsewhere. Supporters of the free banking zone are hoping to persuade the Federal Reserve to exempt such facilities from Regulation Q ceilings on interest rates and Regulation D reserve requirements.

<sup>6</sup>For further information on the International City project see *News You Should Use*, a newsletter issued periodically by the Greater Philadelphia Partnership.

Thus the international banking community in Philadelphia could have a central role in the movement to make Philadelphia more of an international city. But the future role of Philadelphia's banks in this and other international trade efforts will depend in part upon banking legislation and regulation that even now is under study.

**The Banking Outlook.** Area banks have a solid foothold in international operations upon which to develop their expertise. But international banking is growing and innovating rapidly, and many changes lie ahead.

At the Federal level, changes are occurring both formally, on the legislative front, and informally, through increased cooperation among the central banks. In September 1978, Congress passed the International Banking Act regulating the activities of foreign banks in the U.S. This act is based on the principle of national treatment. In the past, foreign banks operated under the regulations of the home office, giving them what many considered an unfair competitive advantage over U.S. domestic banking institutions in being able to cross state lines. But under the new law, U.S. regulatory controls are broadened to treat foreign banks more like their domestic counterparts. Foreign banks now, for example, must designate a home state and limit deposits at branches outside the home state to those permissible for an Edge Act Corporation.<sup>8</sup> Thus outside branches are limited to less than full-service banking. Further, the law authorizes the Federal Reserve Board to impose mandatory reserve requirements on foreign banks in consultation with state banking authorities.

As the International Banking Act demonstrates, the extent and means of supervision of bank subsidiaries located outside the home

country are complex issues. Two basic principles—reciprocity and nondiscrimination—come into play. Reciprocity requires that U.S. banks in foreign countries be afforded regulatory treatment similar to that given foreign banks operating in the U.S. Nondiscrimination ensures that foreign banks are treated like U.S. domestic banks, regardless of how the foreign country treats U.S. banking operations. These principles aren't easy to accommodate, since each country accepts responsibility for home office banks and subsidiaries worldwide and therefore expects some degree of control via adherence to its own laws and regulations.<sup>9</sup> Thus supervision of subsidiaries in foreign countries must be shared with the country in which the subsidiary is located.

Cooperation among central bankers is critical to the resolution of supervisory issues as well as to the overall safety and soundness of the banking institutions. This cooperation can take the form of informational exchange on supervisory responsibilities and analyses of the commercial banks that operate in more than one country. Banking regulations in each country can be reviewed and disseminated, and standards of conduct for foreign banking units can be coordinated. Much of this can be accomplished via informal consultation.<sup>10</sup>

At the state level, banking legislation (Act No. 1977-37) which permits foreign banks to

<sup>9</sup>See Philip E. Coldwell, Member, Board of Governors of the Federal Reserve System, "International Cooperation for Improved Banking," an address delivered before the Caribbean Basin Conference, Atlanta, August 3, 1978.

<sup>10</sup>Already, new and more comprehensive methods of data collection are being developed to provide regulatory authorities with more information. These authorities—the Federal Reserve, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation—are coordinating a joint approach to the evaluation, measurement, and analysis of foreign operations. Part of this approach is to evaluate the internal procedures or guidelines of the banks to help ensure a sound U. S. banking system.

<sup>8</sup>Foreign banks having operations in more than one state when the bill was passed have a grandfather clause enabling them to continue those branch operations.

establish offices in Pennsylvania was signed in July 1977. Since then, several foreign banks have applied to open offices and five applications have been approved by the state banking authority. These banks plan to locate offices in Pittsburgh and Philadelphia. The Pittsburgh offices will offer wholesale banking services to corporate customers; those in Philadelphia plan to offer retail services. Thus U.S. bankers face growing competition from foreign bankers right here on U.S. turf.

The law states that treatment of U.S. banks in the foreign bank's home country shall be considered in reviewing foreign bank applications. Other provisions require that foreign banks maintain large enough deposits of assets in U.S. banks to protect customer deposits, that they be examined by and report to the state Department of Banking, and that they maintain a level of approved assets equal to 108 percent of liabilities. Thus both Federal and state actions are sure

to affect the way Philadelphia banks and their foreign counterparts respond to future demand for international financial services.

#### IN PROSPECT

International banking can be expected to keep pace with the development of world trade. This outlook signals further commercial and financial growth for Philadelphia, which already is on a sound footing in foreign markets.

For more than a decade, U.S. bankers have viewed international banking as a matter of seeking profits in foreign countries. Now it looks as if foreign banks are ready to reciprocate, entering local markets to compete for the opportunity to provide financial services. While some of the ground rules remain to be worked out, Philadelphia bankers are almost sure to find that, in this new phase, international operations will be bidding for even more of their attention.