International Banking Facilities

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INTERNATIONAL Banking Facilities (IBFs) started operation in the United States in early December 1981. Since then, they have grown to the point where they now represent a significant part of the international banking business worldwide. The purpose of this article is to examine IBFs and to discuss their significance for international banking.

OFFSHORE BANKING

A substantial "offshore" international banking sector, often called the "eurocurrency" market, grew up in the 1960s and 1970s. Its key characteristic is that banking business is transacted in a location outside the country in whose currency the business is denominated. Thus, eurodollar transactions are conducted outside the United States, eurosterling transactions are conducted outside Britain, and so on. Much of this offshore business occurs in major financial centers like London, though some business is literally in islands offshore from the United States, such as the Bahamas or Cayman Islands.

Offshore banking business is somewhat different from that conducted onshore. Though, in both cases, banks take deposits and make loans, offshore banks have virtually no checking deposit liabilities. Instead, their deposits are typically made for specific periods of time, yield interest, and are generally in large denominations.

Offshore banking arose as a means to avoid a variety of banking regulations. For example, offshore banks that deal in eurodollars avoid reserve requirements on deposits, FDIC assessments and U.S.-imposed interest rate ceilings. The first two of these regulations increase the margin between deposit and loan rates. Avoiding these costs enables offshore banks to operate on much smaller margins. Interest ceilings, where binding, reduce the ability of banks subject to such ceilings to compete internationally for deposits.

Many "shell" bank branches in offshore centers, such as the Caymans and Bahamas, exist almost solely to avoid U.S. banking regulations. Shell branches are offices that have little more than a name plate and a telephone. They are used simply as addresses for booking transactions set up by U.S. banks, which thereby avoid domestic monetary regulations.

IBFs: ONSHORE OFFSHORE BANKS

IBFs do not represent new *physical* banking facilities; instead, they are separate sets of books within existing banking institutions — a U.S.-chartered depository institution, a U.S. branch or agency of a foreign bank, or a U.S. office of an Edge Act corporation.[1] They can only take deposits from and make loans to nonresidents of the United States, other IBFs and their establishing entities. Moreover, IBFs are not subject to the regulations that apply to domestic banking activity; they avoid reserve requirements, interest rate ceilings and deposit insurance assessment. In effect, they are accorded the advantages of many offshore banking centers without the need to be physically offshore.

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[1] As a result of a 1919 amendment to the Federal Reserve Act initiated by Sen. Walter Edge, U.S. banks are able to establish branches outside their home state. These branches must be involved only in business abroad or the finance of foreign trade. The 1978 International Banking Act allowed foreign banks to open Edge Act corporations which accept deposits and make loans directly related to international transactions.

The Establishment of IBFs

Three regulatory or legislative changes have permitted or encouraged the establishment and growth of IBFs. First, the Federal Reserve Board changed its regulations in 1981 to permit the establishment of IBFs. Second, federal legislation enacted in late 1981 exempted IBFs from the insurance coverage and assessments imposed by the FDIC. Third, several states have granted special tax status to the operating profits from IBFs or altered other restrictions to encourage their establishment. In at least one case, Florida, IBFs are entirely exempt from local taxes.

Restrictions on IBF Activities

While IBFs may transact banking business with U.S. nonresidents on more or less the same terms as banks located offshore, they may not deal with U.S. residents at all, apart from their parent institution or other IBFs. Funds borrowed by a parent from its own IBF are subject to eurocurrency reserve requirements just as funds borrowed from an offshore branch would be.

Four other restrictions on IBFs are designed to ensure their separation from domestic money markets. First, the initial maturity of deposits taken from nonbank foreign customers must be at least two working days. Overnight deposits, however, may be offered to overseas banks, other IBFs and the parent bank. This restriction ensures that IBFs do not create a close substitute for checking accounts.

Second, the minimum transaction with an IBF by a nonbank customer is $100,000, except to withdraw interest or close an account. This effectively limits the activity of IBFs to the "wholesale" money market, in which the customers are likely to be governments, major corporations or other international banks.[2] There is no restriction on the size of interbank transactions.

Third, IBFs are not permitted to issue negotiable instruments, such as certificates of deposit (CDs), because such instruments would be easily marketable in U.S. money markets, thereby breaking down the intended separation between IBFs and the domestic money market.

Finally, deposits and loans of IBFs must not be related to a nonresident customer's activities in the United States.[3] This regulation prevents IBFs from competing directly with domestic credit sources for finance related to domestic economic activity.

Where Are IBFs Located?

IBFs are chiefly located in the major financial centers (see table 1). Almost half of the nearly 500 IBFs are in New York; California, Florida and Illinois have the bulk of the rest. In terms of value of liabilities, however, the distribution is even more skewed. Of IBFs reporting monthly to the Federal Reserve (those with assets or liabilities in excess of $300 million), 77 percent of total liabilities were in New York, with California (12 percent) and Illinois (7.5 percent) a long way behind. It is notable that Florida, which has 16.5 percent of the IBFs, has only 2 percent of the liabilities of reporting banks.

While the distribution of IBFs primarily reflects the preexisting locations of international banking business, differences in tax treatment between states may have influenced the location of IBFs marginally. For example, the fact that Florida exempts IBFs from state taxes may well explain why it has the largest number of Edge Act corporation IBFs and ranks second to New York in terms of numbers of IBFs set up by U.S.-chartered banks.

Although Florida has the most advantageous tax laws possible for IBFs, it is not alone in granting them favorable tax status. Nine other states (New York, California, Illinois, Connecticut, Delaware, Maryland, Georgia, North Carolina and Washington) and the District of Columbia have enacted special tax laws that encourage the establishment of IBFs.[4]

The reason for the favorable tax treatment for IBFs in states like Florida is not clear. There is no doubt that Florida has tried to encourage its development as an international financial center.[5] The benefits from encouragement of IBFs per se, however, are hard to see. For example, the employment gains are probably trivial. Since IBFs are merely new accounts in existing institutions, each IBF will involve *at most* the employment of a handful of people. In many cases, there may be no extra employment.

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[2]Foreign governments are treated like overseas banks for purposes of maturity and transaction size regulations.

[3]"The Board expects that, with respect to nonbank customers located outside the United States, IBFs will accept only deposits that support the customer's operations outside the United States and will extend credit only to finance the customer's non-U.S. operations." See "Announcements" (1981), p. 562.

[4]These provisions vary from case to case. For a summary of the position in New York and California, see Key (1982).

[5]See "Florida's Baffling Unitary Tax" (1983).

Table 1
Location of International Banking Facilities

	Total IBFs	U.S.-chartered banks[1]	Agencies and branches of foreign banks	Edge Act corporations	Liabilities of Monthly Reporting IBFs, Other than to Parent Entity: Amount (billions of dollars)	Percent of total reported	Number of banks reporting
TOTAL	477	144	264	69	$173.43		
New York	208	38	154	16	133.8	77%	90
California	84	16	57	11	20.1	12	27
Florida	79	27	29	27	3.3	2	8
Illinois	30	6	17	7	13.1	7.5	11
Texas	20	14	0	6			
District of Columbia	11	8	3	0			
Pennsylvania	9	7	2	0			
Washington	7	3	4	0			
Georgia	6	4	1	1			
Massachusetts	5	3	1	1	3.1	1.8	10
New Jersey	4	4	0	0	(There are too few reporting banks in other states for a data breakdown to be made available.)		
Ohio	4	4	0	0			
Connecticut	2	2	0	0			
Kentucky	2	2	0	0			
Michigan	2	2	0	0			
N. Carolina	2	2	0	0			
Rhode Island	1	1	0	0			
Virginia	1	1	0	0			

NOTE: Figures for numbers of IBFs are as of September 28, 1983. Figures for liabilities are as of October 26, 1983. Monthly reporting banks are those with assets or liabilities of at least $300 million. SOURCE: Federal Reserve Board Release G.14(518)A and Federal Reserve Board unpublished data.

[1]One savings and loan association has an IBF that is in the Florida figure.

What Do IBFs Do?

The assets and liabilities of IBFs on December 30, 1981, December 29, 1982, and October 20, 1983, are recorded in table 2; as of October 20, 1983, over 98 percent of their liabilities were dollar-denominated.

The December 30, 1981, figures largely reflect business switched from other accounts either in the parent bank or an offshore branch. Operations of the IBFs themselves are reflected more clearly in the later figures. Consider the latest available figures in the third column of table 2. The most important aspects of these figures is the proportion of business with other banks vs. the proportion with nonbank customers. On the asset side, about one-sixth of total assets are "commercial and industrial loans" (Item 5a) and one-ninth are loans to "foreign governments and official institutions" (Item 5c). The remainder, over 70 percent, are claims on either other IBFs, overseas banks or an overseas branch of the parent bank. Claims on overseas banks (Items 3a and 5b) are largest, while claims on other IBFs (Item 2) and overseas offices of the parent bank (Item 1) are of broadly similar magnitude.

The liability structure is even more heavily weighted toward banks. Only about 16 percent of the liabilities of IBFs (as of October 26, 1983) were due to nonbanks. Of these, one-third was due to "foreign government and official institutions" (Item 10c) and two-thirds were due to "other non-U.S. addressees" (Item 10d). The latter are mainly industrial and commercial firms.

The high proportion of both assets and liabilities of IBFs due to other banking institutions reinforces the conclusion that they are an integral part of the eurodollar market. A high proportion of interbank business is characteristic of eurocurrency business in which

Table 2

Assets and Liabilities of International Banking Facilities (millions of dollars)

	December 30, 1981	December 29, 1982	October 26, 1983
ASSETS			
1. Gross Claims on Non-U.S. Offices of Establishing Entity	$7,188	$20,125	$30,322
(1) Denominated in U.S. Dollars	6,785	19,150	29,204
(2) Denominated in Other Currencies	403	975	1,118
2. Loans and Balances Due From Other IBFs	903	16,577	26,256
3. Gross Due From:			
A. Banks in Foreign Countries	8,470	26,666	29,093
B. Foreign Governments and Official Institutions	12	276	482
4. Securities of Non-U.S. Addressees	438	1,130	1,875
5. Loans To Non-U.S. Addressees			
A. Commercial and Industrial Loans	17,081	32,808	36,753
B. Banks in Foreign Countries	11,705	30,300	32,237
C. Foreign Governments and Official Institutions	7,791	16,960	22,348
D. Other Loans	1,164	1,070	958
6. All Other Assets in IBF Accounts	880	3,839	3,262
7. Total Assets Other Than Claims on U.S. and Non-U.S. Office of Establishing Entity	49,409	132,569	156,484
(1) Denominated in U.S. Dollars (Sum of Items 2 through 6)	48,445	129,626	153,264
(2) Denominated in Other Currencies	965	2,943	3,219
8. Total Assets Other Than Claims on U.S. Offices of Establishing Entity (Sum of Items 1 and 7)	56,597	152,694	186,806
(1) Denominated in U.S. Dollars	55,229	168,776	182,469
(2) Denominated in Other Currencies	1,368	3,917	4,337
LIABILITIES			
9. Gross Liabilities Due To Non-U.S. Offices of Establishing Entity	$29,091	$56,372	$69,756
(1) Denominated in U.S. Dollars	28,779	55,114	68,535
(2) Denominated in Other Currencies	313	1,258	1,221
10. Liabilities Due To:			
A. Other IBFs	1,009	17,382	28,803
B. Banks In Foreign Countries	10,127	37,045	42,446
C. Foreign Government and Official Institutions	2,834	7,439	9,115
D. Other Non-U.S. Addressees	952	13,816	19,073
E. All Other Liabilities in IBF Accounts	336	2,756	2,170
F. Total Liabilities Other Than Due To U.S. and Non-U.S. Offices of Establishing Entity	15,686	80,080	103,674
(1) Denominated in U.S. Dollars (Sum of Items 10.A Through 10.E)	15,258	78,439	101,608
(2) Denominated in Other Currencies	428	1,641	2,066
11. Total Liabilities Other Than Due to U.S. Offices of Establishing Entity (Sum of Items 9 and 10.F)	44,777	136,452	173,430
(1) Denominated in U.S. Dollars	44,037	133,552	170,143
(2) Denominated in Other Currencies	741	2,899	3,257
RESIDUAL			
12. Net Due From (+) / Net Due To (−) U.S. Offices of Establishing Entity (Item 11 Minus Item 8)	$ − 11,820	$ − 16,242	$ − 13,376
(1) Denominated in U.S. Dollars	− 11,193	− 15,224	− 12,325
(2) Denominated in Other Currencies	− 627	− 1,018	− 1,051
Number of Reporters	56	122	146

NOTE: Unless otherwise noted, figures include only amounts denominated in U.S. dollars. This report contains data only for those entities whose IBF assets or liabilities are at least $300 million, that is, for those entities that file a monthly report of IBF accounts on form FR 2072. SOURCE: Federal Reserve Board Release G.14 (518).

there may be several interbank transactions between ultimate borrowers and ultimate lenders.[6]

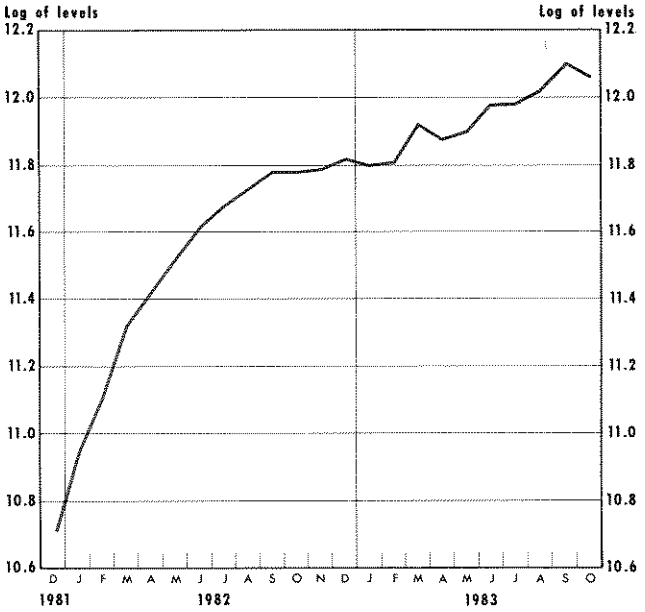
An important role for interbank transactions is to provide "swaps" that reduce either exchange risk or interest rate risk for the parties involved. Suppose, for example, an IBF has a deposit (liability) of $1 million that will be withdrawn in one month, and it has made a loan (asset) to a customer of $1 million that will be repaid in two months. There is a risk that when the IBF comes to borrow $1 million to cover the second month of the loan, interest rates will have risen, and it will incur a loss on the entire transaction. If, however, this IBF can find a bank that has the opposite timing problem (a deposit of $1 million for 2 months and a loan of $1 million outstanding for one month), the two banks could arrange a swap. The second bank would loan the IBF $1 million in one month and get it back in two months (with suitable interest). The interest rate involved will be agreed on *at the beginning*, so that neither bank would suffer if interest rates should change in the second month.

These swap arrangements enable banks to match the maturity structure of their assets and liabilities. The existence of such swaps explains the high levels of both borrowing and lending between IBFs and overseas branches of their parent bank.[7]

THE GROWTH OF IBFs

Chart 1 shows the growth of total IBF liabilities since the end of 1981. Although the most rapid growth occurred in the first six months of their operation, IBFs have grown considerably over a period in which international banking business in general has been stagnant.[8] Within two years, they have come to be a significant part of the international money market. The liabilities of IBFs as of October 1983 (other than to parent banks) represent about 8½ percent of gross eurocurrency liabilities (as measured by Morgan Guaranty) or about 7½ percent of total international banking liabilities (as measured by the Bank for International Settlements. This includes onshore bank lending).

Chart 1
Total Liabilities of IBFs



NOTE: Liability levels were $44,777 million on December 30, 1981, and $173,430 million on October 26, 1983. Figures exclude liabilities to parent entity.

Where did this growth come from? Has the creation of IBFs generated a large volume of new business or has business been shifted from elsewhere? The evidence is that IBF business has almost entirely been shifted from elsewhere. Terrell and Mills use regression analysis to test the hypothesis that the creation of IBFs has led to greater growth of external bank assets.[9] This hypothesis is decisively rejected.

Some evidence concerning the origins of business shifted to IBFs is available in Key.[10] It is convenient to consider separately shifts from existing institutions in the U.S. and shifts from overseas banking centers.

Shifts from Banks in the United States

Up until January 27, 1982, about $34 billion of claims on overseas residents were shifted to IBF books from other U.S. banking institutions. The bulk of this (85 percent) came from U.S. branches of foreign banks — especially Japanese and Italian. Foreign banks typically would have had a higher proportion of assets eligible for shifting to IBFs, while Japanese and Italian banks generally had not established shell branches in Caribbean offshore centers.

[6]See Niehans and Hewson (1976) for an explanation of the intermediary function of euromarkets. The interbank market is also discussed in Dufey and Giddy (1978), chapter 5.

[7]For a discussion of the role of swaps in foreign exchange markets, see Chrystal (1984).

[8]According to B.I.S. figures, international bank assets grew 8.8 percent in 1982 in nominal terms. This compares with figures typically in excess of 20 percent throughout the 1970s. The combined assets of overseas branches of U.S. banks declined by 0.6 percent in 1982 [see Press Release (1983)], though this partly reflects the growth of IBFs.

[9]See Terrell and Mills (1983).

[10]See Key (1982).

In the same period, shifts of liabilities (due to parties other than overseas branches of the parent bank) from books of parent entities were much smaller. These amounted to about $6 billion, of which 90 percent came from branches of foreign banks. The small shift of liabilities relative to assets was affected by several factors: the negotiable nature of some deposits (CDs); the existence of penalties for renegotiations before maturity; the delay in passing New York tax relief for IBFs until March 1981; the small proportions of short-term deposits unrelated to trade with the United States; and the availability of accounts with similar returns yet fewer restrictions as to maturity and denomination (such as repurchase agreements).

If only the domestic books of U.S.-chartered banks are considered, the shift to IBFs is extremely small. Key reports a shift of $4.3 billion (through January 27, 1982) of claims on unrelated foreigners and only $0.1 billion of liabilities to unrelated foreigners. An alternative figure for claims shifted to IBFs is obtainable by looking at the change in commercial and industrial loans to non-U.S. addressees plus loans to foreign banks (*Federal Reserve Bulletin*, table A18, for large weekly reporting banks with assets of $750 million or more). This indicates a decline of $3.3 billion in the same period.

Shifts from Other Offshore Centers

Whereas foreign banks were mainly responsible for shifts to IBFs from banks located in the United States, banks chartered in the United States were mainly responsible for shifts of business from offshore centers and other overseas banking locations. Key estimates that U.S.-chartered banks shifted about $25 billion in claims on unrelated foreigners and about $6 billion in liabilities due to unrelated foreigners (through January 27, 1982) to IBFs from overseas branches. The comparable figures for foreign banks were $5½ billion and $9 billion, respectively.

This difference in the propensity to shift assets to IBFs is probably explained by the differential tax incentives of U.S. and foreign banks. U.S. banks pay taxes on worldwide income and may benefit from tax advantages of IBFs. Foreign banks may increase their tax liability to the United States by establishing an IBF instead of operating in an offshore center.

The bulk of business shifted by U.S. banks from their overseas branches has come from the Bahamas and Cayman Islands (collectively called Caribbean). In the first two months of operation of IBFs (11/30/81–1/29/82), liabilities to unrelated foreigners of branches of U.S. banks located there fell by $6.8 billion, while claims on unrelated foreigners fell by $23.3 billion. Much of this shift reflected the redundancy of shell branches, at least for business with non-U.S. residents, once IBFs were permitted.

While much of the *raison d'être* of Caribbean branches for business with foreigners has been removed by the establishment of IBFs, these branches continue to be important for business with U.S. residents. Terrell and Mills report that the proportion of the liabilities of Caribbean branches due to U.S. residents rose from less than half in mid-1981 to about 70 percent by the end of 1982. However, the attraction of offshore deposits to U.S. residents is likely to decrease as interest regulations on domestic U.S. banks are relaxed, thereby narrowing the gap between domestic and offshore deposit rates.

Based on the figures of the Bank for International Settlements, Terrell and Mills estimate that the proportion of total international banking assets and liabilities due to U.S. banks' offshore branches declined by 4 percent in the first year of IBF operation. Another 3½ percent was lost by other overseas banking centers to IBFs.

THE SIGNIFICANCE OF IBFs FOR INTERNATIONAL BANKING

The primary significance of the experience with IBFs is that it enables us to better understand the forces that led to the growth of eurocurrency markets. In particular, the significant decline in business in Caribbean branches following the creation of IBFs suggests that the growth of business in this area was almost entirely intended to bypass U.S. monetary regulations. Deregulation of domestic banking in the United States will presumably have further effects, since much of the remaining business in Caribbean branches of U.S. banks is with U.S. residents.

The regulatory changes that permitted the establishment of IBFs were intended to ease the burden of domestic monetary restrictions on U.S. banks in the conduct of international banking business.[11] The extent to which this aim has been achieved is probably very limited. This is because IBFs play no role in financing either activities of U.S. residents or the U.S. activities of nonresidents.

Major U.S. banks that were involved in international finance to a significant degree had already found ways around U.S. banking regulations and were not restricted in their ability to compete internationally. The

[11] Ibid., p. 566.

fact that major U.S. banks have shifted business to IBFs from offshore centers means, of course, that there must be some benefit from having an IBF. This may result from lower transaction costs, some tax advantages or the greater attraction, from a risk perspective, of deposits located in the United States. However, the biggest gainers among U.S. banks may be medium-sized banks that were big enough to have some international business but not big enough to have an offshore branch.[12]

Other major beneficiaries from IBFs have been the U.S. branches and agencies of foreign banks. It is no accident that well over half of all IBFs have been established by these banks. The benefit to them arises from the high proportion of their existing business that is IBF-eligible, that is, the portion with nonresidents. Not the least of this would be transactions with their parent banks overseas.

CONCLUSIONS

The establishment of IBFs in the United States represents a change in the geographical pattern of international banking. It facilitates the conduct in the United States of some business that was previously conducted offshore. It also increases the ease with which foreign banks can operate branches in the United States. The creation of IBFs, however, does not seem to have increased the total volume of international banking business. Indeed, IBFs have grown at a time when international banking growth has been at its slowest for over two decades. This growth has been largely at the expense of banking offices in other locations.

For the U.S. and world economies, however, IBFs are not of great significance. There may be efficiency gains resulting from the relaxation of U.S. regulations that led to the establishment of IBFs. But such gains are small. Interest rates in world capital markets are unlikely to have been affected. Benefits that accrue to banks located in the United States from their IBF facilities are largely offset by losses in offshore banks, though in many cases the gainers and losers are both branches of the same parent bank.

[12]It is true that the largest banks have the largest IBFs. However, the cost saving at the margin from IBFs for a bank that had, say, a Caribbean shell operation is much smaller than for a bank that had no offshore booking location.

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