International Banking Facilities and the Future of Offshore Banking

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Last December, the Federal Reserve Board for the first time authorized the establishment of domestic International Banking Facilities. The stated purpose of the new policy was to attract back to the US banking transactions which had been conducted "offshore" — that is, beyond the reach of American legal jurisdiction — in order to escape American regulation. In the following article, David W. Wise explains the conditions which led to the creation of offshore banking centers, describes recent Federal Reserve Board measures to facilitate unregulated banking operations conducted in the United States, and suggests some possible consequences of this policy.

> National borders are no longer defensible against the invasion of knowledge, ideas or financial data. The Eurocurrency markets are a perfect example. No one designed them, no one authorized them, and no one controlled them. They were fathered by controls, raised by technology and today they are refugees, if you will, from national attempts to allocate credit and capital for reasons which have either little or nothing to do with finance and economics.
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> Walter Wriston[1]

Throughout history, banking centers have often been found on islands, where they have had ready access to world trade, but are insulated from the interference of the mainland.[2] The first great center of banking and commerce in modern history was Renaissance Venice. The great financial and trading center of the next several centuries was London, the capital of an island kingdom whose possessions were found on all parts of the globe. The islands of Manhattan, Singapore and Hong Kong are contemporary banking centers which are products of the commercial flows of the British Empire. Bahrain, the Bahamas and the Cayman Islands must be added to the list to bring it up to date.

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1. Walter Wriston, "Information, Electronics and Gold," a speech delivered to the International Monetary Conference, London, 11 June 1979 (New York: Citicorp, 1979), p. 3.
2. Anthony Sampson, *The Money Lenders* (New York: The Viking Press, 1982), p. 182, p. 221.

It would, of course, be inaccurate to suggest that banking centers *must* be located on islands or even near the sea. Even if that had been true in the past, world trade is less dependent today on the vagaries of trade winds and sea travel. In the age of instant telecommunications, insularity is not determined by geography. Today, offshore banking centers are not necessarily physical islands set off by the oceans; rather, they are islands surrounded by a sea of regulation. They are "offshore" in the sense that they are beyond the grasp of regulations and regulators. The term itself reflects the influence of the maritime past.

The banking industry in the US, due in part to its populist political heritage and in part to its federal nature, has been one of the most regulated in the developed world. As a result, a large portion of banking transactions take place offshore, beyond the scope of US regulatory control. In order to attract some of these transactions back into the American banking system, the Federal Reserve Board authorized the establishment, effective 3 December 1981, of domestic International Banking Facilities (IBFs). To borrow imagery from Citibank's Walter Wriston, it was as if the United States threw a lasso around the Bahamas and the Cayman Islands, in order to pull the operations transacted there back to the American shore.

Framework for Analysis

The structure of any financial market is determined by the interaction between profit–seeking financial enterprises and the regulatory environment in which those enterprises operate. Financial enterprises are particularly vulnerable to regulation because the commodity in which they trade — money — is the product of the government, and the flows of capital and credit directly affect the national economy. They are also particularly sensitive because an activity such as banking deals in narrow margins between the cost of funds borrowed and lent. As Gunter Dufey has written: "The impact of government policy on the organization of financial markets is pervasive."[3]

The regulatory pattern in the US is the result of a deep public distrust of the centralization of financial power. The unit banking system and prohibitions against interstate branching led to the creation of over 14,000 separate banks in the US. In addition, since 1933 there has been a legal division between commercial and investment banking activities.[4] This

3. Gunter Dufey, "International Capital Markets: Structure and Response in an Age of Instability," *Sloan Management Review*, Spring 1981, p. 35.
4. This division is the result of the Monetary Control Act of 1933, more commonly known as the Glass-Steagall Act. This Act was passed due to certain questionable practices which existed prior to and during the financial crisis which began in 1929.

situation differs almost completely from the so-called universal banking system prevalent in West Germany, where there are only a few major banks each possessing numerous branches which perform both lending and underwriting functions.

It is obvious that national legislation can have a profound effect upon the structure of the banking system within a given country. Yet, in a "closed system"[5] such as the international financial market, national rules have transnational effects. The transportation cost of money is extremely low. Funds can be transferred from one country to another or from one currency to another for the price of a telex message, which, of course, would be nominally the same for a transfer of one dollar as for a million dollars. In such an environment, high interest rates or relatively severe regulations in one nation could profoundly affect the flow of money and thus affect the interest rates and regulatory regimes of other members of the global system.

The world banking system exhibits a three-tiered structure: 1) domestic markets; 2) a set of foreign markets, attached to each of the domestic markets; and 3) the external market, located in a different political jurisdiction, with only the currency used to denominate financial claims linking it to the national market.[6]

These tiers correspond to the three types of banking transactions: domestic, international, and eurocurrency. Domestic transactions are, of course, those which take place between residents of a single country in the currency of that country. An international transaction is one which takes place between entities which are resident in different countries, but in which the transaction currency is the legal tender in the country of deposit. A eurocurrency transaction, or more properly an external transaction, is one taking place in a currency which is not the legal tender in the country of deposit.

Accordingly, a loan denominated in US dollars from a British bank to a British citizen in London would be a eurocurrency transaction. If a British bank were to deposit French francs with a French bank in Paris, it would be an international, but not a eurocurrency deposit. If an American were to deposit dollars with either a British bank or the branch of a US bank in London, the deposit would be a eurocurrency deposit. To reiterate, the determinant of whether or not a deposit is a eurocurrency deposit is solely based on whether it is made in the unit of account of the country where the deposit is made.

The external market consists of two parts: a market which accepts

5. Dufey, "International Capital Markets," p. 40.
6. *Ibid.*, p. 37.

deposits from the non-bank public and lends to the non-bank public, and an interbank market where banks lend and borrow excess funds. The interbank market is by far the more important aspect of the external currency market. It has been estimated that as much as 85 percent of the gross market represents interbank liabilities.[7] This market corresponds on a transnational basis to the domestic Federal Funds market and comprises, in the words of Paul Einzig, "a truly international money market."[8]

What distinguishes transactions in this global money market from those taking place in a domestic money market is not just the external nature of the deposit, but that these funds are borrowed and lent at a rate structure which is different from those of domestic markets. This is not to suggest that the external rate is independent of the domestic rate. The external rate is affected not only by the interest rates which exist in domestic markets, but also by the degree to which funds can be moved from one market to another.

External transactions are those which result from what two commentators have called "the escape motivation."[9] This is a somewhat unexpected occurrence whereby banks seek to escape from a market in which there was an effort to set a regulated floor profit into an unregulated or extremely competitive market. The banks forego the minimum regulated rate of profit in order to escape also the regulated ceiling on maximum profits. A second factor contributing to this "escape" is that in a closed and interconnected system, it is difficult to regulate a minimum profit. The system which attempts to provide banks with cheap sources of funds through non-interest demand deposits and low-interest time deposits cannot function if people refuse to hold such deposits. Bankers did not seek competitive markets by choice, but by necessity.

Thus, the external market is an "adjunct of the New York money market . . . an offshore market in US bank deposits." This is demonstrated by the fact that during the 1960s, when the US had capital controls in effect, the lending rate in the US placed a ceiling on external lending rates, while the US deposit rate set a floor on the external deposit rate.[10] "Strictly speaking," commented Paul Einzig, "all transfers of dollars into

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7. Henry Wallich, "Why the Euromarket Needs Restraint," *The Columbia Journal of World Business*, Volume 14, number 3 (Fall 1979), p. 17.
8. Paul Einzig and Brian Scott Quinn, *The Euro-dollar System*, 6th edition (New York: St. Martin's Press, 1977), pp. 1-3.
9. Jean M. Gray and H. Peter Gray, "The Multinational Bank: A Financial MNC?" *Journal of Banking and Finance*, March 1981, p. 48.
10. David T. Llewellyn, *International Financial Integration* (New York: John Wiley & Sons, 1980), pp. 117-123.

Euro-dollars constitute interest arbitrage between conventional short-term investments in New York and the Euro-dollar market."[11]

It is important at this point to distinguish between international financial centers and banking centers which are nothing more than "booking" centers for external transactions. Although external deposits are made in London, that city is an important financial center in its own right. In other words, the volume of financial transactions which takes place in that city is not strictly determined by the regulatory climate. Offshore centers, on the other hand, "are either based in countries whose national markets are otherwise insignificant, or they are carefully insulated from the underlying market."[12] These strictly offshore centers were created in response to the regulatory environment and are dependent upon that environment for their continued existence. More specifically, these external markets must have a competitive advantage over internal markets and must be free from controls on the flow of capital thus allowing external deposit and lending activity.[13]

External banking activity will tend towards those markets which are relatively less regulated. This rule is subject to three provisos. First, the regulation in such a market, although minimal, must be "appropriate";[14] that is, it must establish sufficient confidence in the operation of that market. Second, such a center must have the necessary communications, transportation, and administrative support to permit the efficient functioning of the banking center. In this regard, the volume of banking is determined not only by the regulations on the books (or absence of them), but also by the infrastructure of that location which allows for taking advantage of the favorable regulatory climate. Third, transactions which have an underlying commercial or precautionary rationale will not be induced away merely by regulatory considerations. In other words, the fact that New York is a more regulated market than the Cayman Islands does not mean that Manhattan will close down in favor of George Town.

It is, therefore, possible to see the massive external currency market which has developed as an alternative market which exists in competition with the domestic banking market. As Ian Giddy and D.L. Allen have written, "if bank regulation is an industry in which the regulator's services are in demand only to the extent that they serve the banking public's interest, then regulators might do well to take a business-like approach

11. Einzig and Quinn, *The Eurodollar System*, p. 48.
12. Jean M. Gray and H. Peter Gray, "The Multinational Bank: A Financial MNC?" *Journal of Banking and Finance*, March 1981, p. 48.
13. *Ibid.*, p. 42.
14. Ibid., p. 37.

to their market."[15] It would appear that this is the rationale for the Federal Reserve's decision to authorize International Banking facilities.

THE RISE OF THE EXTERNAL MARKET

The origin of the market in external currency deposits traces back to the year 1949 when the new revolutionary government in China attempted to shield its dollar holdings from American authorities by placing them on deposit with the Soviet-owned *Banque Commerciale pour l'Europe du Nord* in Paris. The telex code for that bank (Eurobank) lent its name for these deposits: eurobank deposits. This decision by the Chinese was quite fortuitous, for in 1950, as a result of the Korean War, the US attempted to block dollar flows to the People's Republic of China. The Soviet Union took notice of this action and subsequently placed a portion of its dollar holdings at the Narodny Bank in London. Although the Cold War gave rise to external dollar deposits, the real growth and strength of this market was the result of balance of payments considerations and US regulation.

In 1958, the US went into deficit on its current account. This set the stage for the rise of the external market — a market which has always been dominated by dollar deposits. Central banks which held increasing deposits of US dollars "drifted into the market as a matter of expediency," in order to achieve a higher yield on these otherwise idle deposits. This recycling of official dollar holdings has always been relatively high — despite the opposition to such activity by the International Monetary Fund (IMF).[16] In addition, central banks induced commercial banks to hold dollar deposits through profitable forward swaps.[17]

In order to combat the persistent balance of payments deficits, the US resorted to certain measures aimed at reducing capital outflows. The Kennedy administration instituted the Interest Equalization Tax (IET) to make the US capital market unattractive to foreign borrowers. Ironically, this only increased the demand for eurodollar borrowing. In 1965, the Johnson administration announced the Voluntary Credit Restraint Program (VCRP). This program was made mandatory in 1968. These credit restraint programs had the unintended effect of inducing banks to move operations abroad where restrictions did not apply. Official attempts to curb the growth of the external market continued to have the opposite effect.[18]

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15. Ian Giddy and D. L. Allen, "International Competition in Bank Regulation," Banca Nazionale del Lavoro *Quarterly Review*, September 1979, p. 326.
16. Einzig and Quinn, *The Eurodollar System*, p. 82.
17. Sarkhis J. Khoury, *Dynamics of International Banking* (New York: Praeger, 1980), p. 26.
18. Paul Einzig, in *The Eurodollar System*, gives an interesting example of this tendency:

The highly–regulated nature of the US banking industry also contributed to the growth of offshore deposits. The motivation for a bank to operate on an international basis can be the result of either active or reactive factors. Active motives would include the desire to service the foreign branches of US multinationals or to participate in an attractive domestic market of a foreign country. Reactive motives would encompass those which correspond to the "escape motivation" discussed above. In this sense, banks would not seek international operations for positive reasons, but because of the perceived negative environment in the domestic market.

The regulations which the banking industry found onerous were ironically those which were intended to make the banking industry profitable (interest rate ceilings) and safe (reserve requirements). Federal Reserve Board regulation Q prohibited the payment of interest on deposits of maturities of less than thirty days and set a structure for maturities beyond that length. Regulation D required that a small percentage of bank deposits be held in the form of non-interest-bearing reserves, in order to promote bank liquidity and to facilitate monetary policy. Yet interest rate ceilings reduced the access of US banks to funds which were placed in higher yielding deposits in the external market, while the reserve requirement acted as a tax on banks, making them uncompetitive vis-à-vis banks which stood beyond the reach of domestic regulations.

The predicament faced by regulated banks in a situation where they must compete with non-regulated banks can be easily demonstrated by a simplified example. If a bank has deposits of $100, but is required to maintain reserves equal to 3 percent of deposits, it will then have $97 to lend. If the bank must pay 10 percent for its funds, it would incur interest rate expenses of $10 for the year. Since the bank must earn at least $10 on its loan portfolio to break even, it would have to charge a minimum of interest of approximately 10.31 percent ($10 divided by 97 percent) just to break even. The bank must acquire a higher rate from its loans than it pays to attract deposits, because its earning assets (loans — $97) are less than its liabilities (deposits — $100). The amount of that difference is explained by the reserve requirement.

The competitive restraints are obvious. Given a deposit rate of 10 percent in the regulated country, the domestic bank must earn at least 10.31 percent on its loans just to break even, while the non-regulated

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In 1969 the United States authorities, in a half-hearted attempt to discourage American banks from borrowing Eurodollars through their London branches, applied reserve requirements to those amounts in excess of those outstanding in May 1969. This measure defeated its objective; because the banks borrowed in London the amounts that they needed to comply with the reserve requirement. p. 90.

TABLE ONE
Cost Advantage of Offshore Banks Relative to Domestic Banks

Differential Reserve Requirement (Percent)	Average Interest Rate on Domestic Assets (percent)						
	6	7	8	9	10	11	12
2	.12	.14	.16	.18	.20	.22	.24
3	.18	.21	.24	.27	.30	.33	.36
4	.24	.28	.32	.36	.40	.44	.48
5	.30	.35	.40	.45	.50	.55	.60
6	.36	.42	.48	.54	.60	.66	.72
7	.42	.49	.56	.63	.70	.77	.84

Source: Robert Aliber.[19]

bank could charge as little as 10 percent. Given that the regulated bank must charge at least 10.31 percent for loans, it could pay no more than 10 percent for funds in order to balance earnings with expenses, while the non-regulated bank could pay as much as 10.31 percent for funds. In practice, the non-regulated banks would pay neither 10.31 percent for funds, nor charge 10 percent for loans (an unprofitable position). Rather, they would simultaneously undercut the regulated loan rate, while paying a premium over the domestic deposit rate. In such a situation they would be simultaneously competing for loans and deposits, charging less than the maximum on loans and paying more than the minimum for deposits, while still managing to break even. This means that an external bank is able to operate with a narrower margin and still maintain a competitive advantage. That it can do so is once again explained by the presence of the reserve requirement in the domestic market. It is for this reason that the external or eurocurrency interest rates are sometimes referred to as a "reserve adjusted" rate.

The effects of an interest rate ceiling are even easier to illustrate. If depositors demand 10 percent for their money, but the legal maximum that can be paid is 8 percent, those depositors will do one of three things: 1) find alternative uses for their funds, such as consumption; 2) lend funds directly to users of capital via debt or equity instruments; or 3) they will reluctantly accept 8 percent. If, however, there is a competing market that is not subject to this regulation, money will flow from the domestic to the external market to the extent that it is able to do so. Larger depositors are traditionally better able to circumvent such regulations, with the result that the external market is exclusively a wholesale market, leaving the smaller, retail depositors at home.

19. Robert Z. Aliber, "Monetary Aspects of Offshore Markets," *The Columbia Journal of World Business*, Volume 14, number 3 (Fall 1979), p. 10.

In 1958 the interest rate ceiling on deposits with 90– to 108–day maturities was held at 12½ percent.[20] Intermittent periods of tight credit and competition from various money market instruments, such as government debt, led to efforts to escape from this restraint. In 1961, First National City Bank (now Citibank) created the certificate of deposit, which although still subject to Regulation Q ceilings, allowed for a negotiable instrument which effectively permitted interest on deposits of less than thirty days. In 1963, Regulation Q ceilings were raised so that an instrument maturing in 90 to 365 days could earn 4 percent. Rates were increased again in both 1964 and 1965. In 1966, a bifurcated ceiling was created for deposits above and below $100,000.

Nevertheless, allowable rates were still below the domestic supply curve, and the exodus of funds continued. Regulation was eased in 1970 and then suspended on 16 July 1973 for all deposits above $100,000. In 1979, money market certificates were allowed for deposits of $10,000. In each of the above-cited changes, the domestic rules gave way to pressures from external competition, with the result that after 1973, Regulation Q ceased to be a major stimulus for the external market.

Regulation D, however, continues to have significant effects. As of 31 December 1981, the reserve requirement for demand deposits in reserve city banks was 16¼ percent. This rate has never varied greatly since 1958, although it went as high as 18 percent in 1973 and 1974. Yet, demand deposits represent the extreme, as they are non-interest accounts kept for transaction purposes. On a wholesale basis, such accounts ceased to be significant with the creation of certificates of deposit in 1961.

The reserve requirement for time deposits was 5 percent in 1958, reduced to 4 percent in 1962. In 1966, deposits of over five million dollars were subject to a 6 percent reserve requirement, while deposits for less than this amount were subject to a 4 percent rate. Subsequently, these rates were reduced to 5 and 3 percent, respectively. As of 1975, the reserve requirements for time deposits were varied by length of maturity as well as by deposit size. The rates effective as of the end of 1981 were:

TABLE TWO

	1-179 Days	180 Days to 4 Years	More than 4 Years
Less than $5 Million	3%	2.5%	1%
More than $5 Million	6%	2.5%	1%

Source: Federal Reserve Bulletin

20. The following is based on *Federal Reserve Bulletins* from 1958 to 1981.

It is quite apparent that the competitive restraint imposed on domestic banks is still quite significant.

In addition to Regulation D reserve requirements, there were also reserve requirements imposed on borrowings by parent banks from their foreign branches. This requirement was imposed by Regulation M, and was commonly referred to as the eurocurrency reserve requirement. This requirement was set at 20 percent when it was first imposed, but was reduced shortly thereafter to 8 percent in 1973. Further reductions to 4 and then 1 percent were instituted in 1975 and 1977, before the requirement was reduced to zero in 1978. Under the Depository Institutions Deregulation and Monetary Control Act of 1980, a 3 percent requirement will be phased in on such borrowings.

It is one thing to author regulations and quite another to have them be effective. Economic reality cannot be legislated, although such reality can be distorted through regulation. Markets will find a way to accomplish that for which there is an underlying economic justification. This is especially true when the market deals in something as fungible, liquid and instantaneously transported as money. As Janet Kelly stated in her book, *Bankers and Borders*, "Monetary policy stops at the water's edge, but money does not."[21]

Money Without A Country

External currency deposits are commonly thought of as being composed of "stateless money." In fact, this is an inaccurate description. When a bank makes a deposit in eurodollars, or in euro-French francs or any other currency, it is quite clear that the deposit is made in a specific national unit of account. Generally, such external deposits remain a part of the national banking system from which they originate, as each transaction has two bookkeeping entries. In this way, external deposits do not constitute money without a country in the sense of being stateless, but rather "without" in the sense of being outside the country to which they belong.

Morgan Guaranty's *World Financial Markets* estimates the gross external currency market, as stated in dollars, to be $1,575 billion as of June 1981. Because this market is largely composed of interbank transactions, the gross figure overstates the actual size of the market, as one dollar is deposited and redeposited a number of times. When redepositing is factored out of the total, the net market is estimated at $790 billion. Even so, the growth of the market has been staggering. Just ten years ago the gross market size was $210 billion, with a net size of $110 billion. The

21. Janet Kelly, *Bankers and Borders* (Cambridge, Massachusetts: Ballinger Publishing Company, 1977), p. 102.

increases in this market have been well above those experienced in the major Western economies, with gross annual increases between 22.7 and 28.4 percent since 1973 and a fifty percent increase between 1972 and 1973.[22] While much of this growth can be explained by the fact that it started from a low base, the presence of more than 1.5 trillion dollars on deposit externally is nothing short of phenomenal.

TABLE THREE

	Annualized Rates of Change in Percent	
	1965-1970	1971-1977
Dollars		
External	32.8%	19.3%
Domestic	7.3%	7.8%
Marks		
External	43.9%	21.3%
Domestic	15.0%	15.8%
Swiss Francs		
External	36.9%	14.1%
Domestic	12.9	15.3

Source: Robert K. Aliber.[23]

The above market size estimates were stated in terms of dollars. While the US dollar constitutes the most significant sector of the market, other currencies, such as the Deutsch mark and the Swiss franc, comprise about a quarter of the total. In June 1981 the "eurodollar" represented 77 percent of the gross liabilities of the external currency market. This figure has been rather stable over the past decade, ranging from a low of 72 percent in 1972 to a high of 80 percent in 1976.[24] The fact that the gross market figures are generally stated in dollars also causes some fluctuations in the estimated figures. For instance, the dollar's appreciation in 1980 reduced gross figures by $32 billion, while in 1979 exchange rates had increased these estimates by $12 billion.[25]

The growth of the US banking industry's presence in multinational banking over the last two decades has been equally remarkable. There were 117 branches in 1957. By 1980, the number increased to 799.[26] The number of banks having foreign branches increased from seven in 1957 to 139 by 1980. Between 1960 and 1972 the total assets of all US

22. *World Financial Markets,* Morgan Guarantee Trust Company, December 1981, p. 13.
23. Robert Z. Aliber, "The Integration of the Offshore and Domestic Banking System," *Journal of Monetary Economics* 6 (1980), p. 510.
24. *World Financial Markets,* December 1981, p. 13.
25. *Annual Report,* Bank for International Settlements, July 1981, p. 112.
26. *Federal Reserve Bulletins,* 1958-1981.

banks increased at an annual rate of 8.2 percent while total foreign credit held by US banks increased 22.2 percent. Between 1973 and 1979, total banking assets increased by 17 percent, while foreign credits grew at a 36.5 percent rate.[27] It is not at all surprising that banks sought international expansion, as domestic earnings between 1970 and 1976 increased by 2 percent while earnings from international operations for the largest US banks increased by 400 percent.[28]

Yet, the mid-1970s proved to be the zenith of the American expansion in international banking. The return on assets for international operations of the ten largest multinational banks in 1975 had outpaced returns from domestic banking by a margin of .67 to .39 of 1 percent. By 1979, the relative positions had reversed so that domestic operations produced .57 on each dollar of assets to .44 from the international side. After peaking at 52 percent in 1975, the percentage of bank earnings derived from international operations declined to 43 percent by 1979.[29] After 1974, the applications to the Federal Reserve Board to open new foreign branches "subsided."[30] Such applications represent marginal activity, and are thus sensitive to competitive conditions.

This decline is reflected in the decrease in the rate of growth of overseas branch bank operations of the largest US banks. Between 1976 and 1977 the growth rate in branch deposits was 20.3 percent while loans increased by 22.5 percent. By 1980, the annual growth rate for both deposits and loans stood at 13.1 percent. The US banking share of outstanding international claims within the Bank for International Settlements (BIS) reporting area declined from 43 percent in 1976 to 27 percent in 1981.[31]

An interesting contrast to the decline of offshore operations of American banks is the increase in foreign banking operations in the US. Foreign operations in this country are the result of "active" motivations, namely, the desire to participate in the US financial market, which is the largest and deepest market in the world; to finance the American operations of multinational firms based in their home countries; and to exploit the opportunity to invest excess dollar-denominated funds on deposit with their parent banks.

According to a study done by Francis A. Lees, *Foreign Banking and Investment in the United States*, foreign banks are in an excellent position

27. F. John Mathis, ed., *Offshore Lending by U.S. Commercial Banks*, 2nd edition (Washington and Philadelphia: Bankers Association for Foreign Trade and Robert Morris Associates, 1981), p. 4.
28. Christopher M. Korth, "The Evolving Role of U.S. Banks in International Finance," *The Bankers Magazine*, July-August 1980, p. 71.
29. Arturo C. Porzecanski, "The International Financial Role of U.S. Commercial Banks: Past and Future," *Journal of Banking and Finance*, March 1981, pp. 9-10.
30. Kelly, *Bankers and Borders*, p. 107.
31. *U.S. Multinational Banking Statistics*, Bank Securities Department, Salomon Brothers, Inc., 10 November 1981.

to arbitrage funds between the US and offshore markets. This participation is producing a closer alignment between "euro" lending rates and the US prime rate. Lees identifies several advantages that a foreign bank with operations in the US would gain. Of these advantages, the access to a lower cost lending base, access to a large, multisource money market, and the option of operating from a home, "euro," or US lending base are the most important. That same study indicates that, as early as 1973, about half of the deposits in the US banking system were subject to foreign competition, with New York (89.5 percent) and California (84.0 percent) being the most competitive. "Only large American banks," concluded Lees, "are able to effectively compete with foreign banks in the US banking markets."[32] If anything, this competition is even more intense today, as the number of majority-owned foreign banking facilities more than doubled in the five years since his study was written.[33]

State regulations have had a particularly important influence on the structure of foreign banking operations in the US. For example, Illinois is one of the states which specifically allows for foreign operations within its borders, and is the site of one of the major money centers in the country (Chicago). Yet, Illinois is a unit banking state which does not permit branching. As a result the portion of the banking deposits in Illinois subject to foreign competition (45.1 percent) was only about half of that in either California or New York.[34]

Until the 1978 passage of the International Banking Act (IBA), foreign banks operating in the US were solely under the jurisdiction of state laws and state banking supervision, although the Federal Reserve attempted to exert "moral suasion." At the time of the passage of the IBA, more than half of the 136 foreign banks operating in the US had branches in more than one state,[35] something forbidden domestic banks under the McFadden Act and domestic bank-holding companies under the so-called Douglas Amendment. In this sense, foreign branches operating in the US were still operating offshore, out of reach of federal regulation even though they might have offices in the same building as domestic US banks.

The Changing Regulatory Climate

Inequalities in the regulation of markets have led to the creation of alternative markets which are external to regulation. This fact poses a dilemma for regulators inasmuch as the external mechanism undermines

32. Francis A. Lees, *Foreign Banking and Investment in the United States* (New York: John Wiley & Sons, 1976), pp. 47-66.
33. Khoury, *Dynamics of International Banking*, p. 91.
34. Lees, *Foreign Banking and Investment in the United States*, pp. 52-55.
35. Sydney J. Keys and James M. Brundy, "Implementation of the International Banking Act," *Federal Reserve Bulletin*, Volume 65, number 10 (October 1979), pp. 785-796.

the objectives of regulation. In the final analysis, policymakers are presented with just two options. Either they must seek to mitigate regulations in the direction of conditions existing in the external market or, conversely, they must seek to gain control over the external market.

This latter alternative was incorporated in the initial response to the rise of offshore banking. Critics of the emergence of the external currency market decried the fact that domestic banking regulation was so easily and openly avoided and feared the effects of such evasion. Domestic monetary control is established to provide both regulation as a means of furthering monetary policy, and supervision to make the banking system safe.[36] External activities defeat attempts at both regulation and supervision, and could endanger the domestic banking system if credit creation produced inflation or imprudent banking practices. In either case, ill effects would be transmitted back into the domestic market.

Central to this debate was an effort to apply the idea of the commercial bank multiplier to the external market. If the absence of reserve requirements domestically could lead to a theoretically infinite expansion of the money supply, analysts argued that it would have such an effect when funds were placed on deposit outside the domestic banking system. This view was prevalent during most of the first two decades of the external market's existence.

This line of reasoning overlooked several factors which made the external and domestic situations quite different. In fact, the basic problem with this argument was that it relied on the fallacy of seeing the two as being totally separate, rather than the one being an extension of the other. In addition, as has already been indicated, the gross market size is misleading due to interbank transactions. There are also substantial "leakages" whereby external deposits are not redeposited externally, but rather are placed back in the domestic market. Finally, in the absence of a reserve requirement, even in the domestic banking market, the money supply would not be infinite, as money supply would still be restricted by the workings of supply and demand.[37]

A substantial amount of research was done in the 1970s which undermined the multiplier argument. This research concluded that the multiplier in the external market was quite small and probably created less credit than did the US commercial banking system.[38] Because the two

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36. Gerard Bekerman, *Should the Eurocurrency Market Be Controlled?* (Hogeschoollaan, The Netherlands: S.U.E.R.F., 1981), pamphlet 33, p. 14.
37. Bluford H. Putnam, "Controlling the Euromarkets: A Policy Perspective," *The Columbia Journal of World Business*, Volume 14, number 3 (Fall 1979), p. 26.
38. *See:* John Hewson, *Liquidity Creation and Distribution in the Eurocurrency Markets* (Lexington, Massachusetts: Lexington Books, 1975).

markets are not separate, but in fact are two parts of the international financial market, whether a currency unit is on deposit domestically or externally almost becomes merely a portfolio choice. Preference for one type of deposit over the other is determined by relative factors. As Jane Sneddon Little has written:

> If . . . a shift in asset preferences from US dollars to Eurodollars occurs, the shift probably causes a relative decline in Eurodollar interest rates that induces some funds to flow in the reverse direction. . . . In other words, the multiplier is likely to be close to one and may even be a divisor.[39]

This has led to the widespread belief that the external currency market is an intermediary for, rather than a creator of, credit. The external market is an extremely efficient market, and has thus increased the velocity of money rather than its supply. Paul Einzig has described this effect as permitting "us to eat our cake and keep it," in that a dollar lent abroad can be simultaneously used by US banks for either domestic or external lending.[40] This view supports the position that the external market is merely a channel for credit flows which would take place by some other means.

Contrary to the fears of many, the external market is not out of control, nor, as commonly asserted, is it totally unregulated. Commentators such as Ian Giddy, who opposes extraterritorial regulations, and Henry Wallich, who supports reserve requirements for external deposits, agree that the previously expressed fear of an uncontrolled offshore market is unfounded. The fact that the external and domestic interest rates track one another is cited as proof.[41] Due to the double-entry nature of such transactions, an external dollar deposit remains on the books of a US bank, unless, in a *reductio ad absurdum*, the dollars are withdrawn in currency and hoarded overseas. A bank holding external deposits is under the control of the central bank where it is located and also under the authority of the parent bank's government. This control is even more apparent in light of the Basle Concordat of 1974.[42]

The old approach of seeking extraterritorial application of reserve requirements has, in the words of Ian Giddy, given way to a "new approach."

39. Jane Sneddon Little, "Liquidity Creation by Eurobanks, A Range of Possibilities," *The Columbia Journal of World Business*, Volume 14, number 3 (Fall 1979), p. 39.
40. Einzig and Quinn, *The Eurodollar System*, p. 39.
41. Wallich, "Why the Euromarket Needs Restraint," p. 19 and Ian Giddy, "Why Eurodollars Grow," *The Columbia Journal of World Business*, Volume 14, number 3 (Fall 1979), p. 60.
42. This was an agreement among the principal central banks that a parent bank was responsible for any of its foreign subsidiaries that were in financial trouble and that the central banks would stand behind the commercial bank if necessary.

That new approach is a recognition that "monetary authorities can influence Eurodollar credit conditions simply by influencing those at home."[43] Although the presence of this new approach has stifled the debate concerning whether extraterritorial controls are needed,[44] it does reflect a way of thinking which has spurred a changing regulatory climate in the 1970s.

An important measure directed towards the assertion of greater control over international activities conducted within the purview of US monetary authorities was the passage of the International Banking Act (IBA) of 1978. That act was directed at the elimination of differences between the regulation of US and foreign banks operating within the United States. The act can be seen as a first step in a process of placing the international operations of US banks on a better footing with foreign banks.

The International Banking Act abolished the following competitive advantages which foreign banks were alleged to have had over domestic banks. First, foreign agencies and branches were not legally subject to reserve requirements; although the Fed attempted to assert moral authority. Second, foreign banks other than subsidiary banks were free to establish offices across state lines, whereas domestic banks were prohibited from interstate banking. Third, branches and agencies of foreign banks were permitted to hold equity interests in securities firms, something which US banks were barred from doing by the Glass-Steagall Act. Finally, foreign banks operating through either a branch or agency were not subject to the prohibitions against non-banking activities contained in the Bank Holding Company Act.[45] The IBA is in part an effort to terminate the distinctions between foreign and domestic banks, save ownership. The act gave foreign banks the option to receive a federal charter, and placed these banks under the supervision of the Comptroller of the Currency. In addition, foreign branches were required to designate a home state, out of which branching would not be allowed and were also made legally subject to reserve requirements. Foreign banks were also brought under the provisions of the Bank Holding Company Act, except for those operations which were "grandfathered" pending a final ruling to be made by the Federal Reserve Board on 31 July 1985. Foreign banks which prior

43. Ian Giddy, "The Public Policy Implications of the Eurocurrency Market," *The Columbia Journal of World Business*, Vol. 14, number 3 (Fall 1979), p. 5.

44. Henry Wallich believes that this argument misses the point because a disproportionate burden is placed on the domestic market in the adjustment process. Bluford Putnam makes a contrary argument stating that a reserve requirement would make monetary policy harder to administer. Instead he believes that monetary authorities should concentrate on just one effective tool: open market operations.

45. For a complete discussion of this Act refer to Gerald H. Anderson's "Current Developments in the Regulation of International Banking," Federal Reserve Bank of Cleveland, *Economic Review*, January 1980, pp. 1-15.

to the IBA were not allowed to have Edge Act Corporations (EAC) or Federal Deposit Insurance Corporation (FDIC) insurance, were not allowed these privileges.[46]

In passing the IBA, Congress attempted more than simply to excise the distinctions between domestic and foreign banks. A second Congressional objective was to enhance the attractiveness of the Edge Act as an instrument for international banking. Consequently, the reserve requirement on Edge corporation time deposits, which had been 10 percent, was reduced to the level for other domestic banks (see Table Two). Edge Act subsidiaries were now allowed to finance the production of goods for export, to be merged into one subsidiary, and to engage in banking for clients who conducted two-thirds of their principal business internationally. Prior to this, Edge Act corporations were strictly held to the actual finance-of-export costs and the various Edge Act subsidiaries of a single parent bank were required to be separate entities, each with a minimum capitalization of two million dollars. These changes succeeded in making the Edge Act a more attractive option. In the fifteen months after passage of the IBA, thirty-nine new EACs were established, eleven of which were located in six cities where Edges had not previously been established. By way of contrast, only two new EACs were set up in both 1977 and 1978.[47]

A second major step towards the twin objectives of enhanced national control and a greater parity in the regulatory requirements among financial institutions was made with the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980. That act simultaneously aimed at a reduction of many of the regulations which had fostered the drive for external markets, while increasing the authority of the Federal Reserve Board. Senator William Proxmire, then chairman of the Senate Committee on Banking, Housing and Urban Affairs, described this legislation as the most significant in the banking field since the passage of the Federal Reserve Act in 1913.[48]

Title I of this legislation, the Monetary Control Act, established a universal reserve requirement for all depository institutions. Prior to that time, banks which were not members of the Federal Reserve System, such as state-chartered banks, were beyond the control of monetary authorities in this regard. Concurrent with the mandate to extend such requirements to all domestic banks was the directive to reduce the actual level of those

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46. The permission to own Edge Act subsidiaries was extended only to foreign banks and not to foreign individuals or corporations. *See: The International Banking Act of 1978*, a report of the Board of Governors of the Federal Reserve System, 17 September 1980, p. 9.
47. *Ibid.*, pp. 4-5.
48. Charles R. McNeill and Denise Rechter, "The Depository Institutions Deregulation and Monetary Control Act of 1980, *Federal Reserve Bulletin*, Volume 66, number 6, p. 444.

required reserves. In consideration of the universal nature of this act, any depository institution holding such reserves would be given access to the same discount and borrowing privileges as member banks. Title I also obligated the Federal Reserve Board to set an explicit schedule of fees for the services that it provided to member banks. Title I, then, not only established a greater parity between banks, but also placed the Federal Reserve in the same market as an alternative provider of services.

Title II of the Act, the Depository Institutions Deregulation Act of 1980, was instituted in recognition of the fact that the prior policy of placing interest rate ceilings on accounts had failed to meet its intended objectives. This act created a Depository Institutions Deregulation Committee (DIDC) made up of the Secretary of the Treasury, the chairman of the Federal Reserve Board, the Federal Home Loan Board, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Comptroller of the currency. It legislates an orderly phasing out of all remaining interest rate ceilings, and empowers the board to oversee this process until 31 March 1986. After that date, both the board and regulated interest rates shall cease to exist. Deposits will then command the market rate.

Competition from foreign banks led to the passage of the International Banking Act, which established greater parity between foreign and domestic banks. Competition from non-bank financial institutions led to the Depository Institutions Deregulation Act, which shall lead to a greater parity in deposit rates. The ability of certain domestic banks to leave or to remain outside of the Federal Reserve System led to the Monetary Control Act. The ability of certain banks to operate offshore also exerted a competitive pressure which remained to be addressed.

International Banking Facilities

At first glance, the Federal Reserve Board's decision to authorize International Banking Facilities (IBFs) seems to have been an act of capitulation. "If you can't beat 'em, join 'em" was the phrase used in a number of press accounts regarding this decision. To be sure, the presence of the vast external currency market created certain pressures which contributed significantly to the exemption of certain domestically conducted transactions from most central bank regulations through the device of the domestic International Banking Facility. At least part of the motivation, however, was consistent with the "new approach" enunciated by Ian Giddy; namely, the exertion of greater control over the external market via greater control over the domestic banking market. The New York Clearing House Association presented the IBF concept to the Federal Reserve Board as a means of attracting a portion of the euro-market back

under domestic jurisdiction. The Federal Reserve Board seemed to accept this reasoning, and hoped that it would put US monetary authorities in a better position to negotiate a common approach to such markets with other principal nations.[49]

The idea of such regulation-exempt international banking is as old as the external market itself. The forerunners of the IBF included such proposals as a "foreign window," a "free-trade banking zone," and Domestic International Banking Units or DIBUs. Proposals of this type were recommended at various times by certain Federal Reserve officials, private bankers and by the House of Representatives Banking Committee's Study on Financial Institutions and the Nation's Economy in 1976, the so-called FINE study. Yet, on each occasion the Federal Reserve Board concluded that the advantages of such proposals would be outweighed by the potential negative effects on domestic monetary control.[50]

In order to understand what an IBF actually is, it is necessary to dispel some inaccurate impressions found in certain press accounts. International Banking Facilities do not entail "free-trade-zone" banking. The exemptions of a certain class of foreign transactions from Regulations D and Q were national in scope and any bank in the US can establish an IBF by notifying the Federal Reserve Board. An IBF is essentially a separate recordkeeping process, and does not therefore constitute a separate entity or branch. Generally, IBF-eligible deposits must be from foreigners, and the loans they make must be made in order to support foreign operations. Such transactions can be denominated in dollars or in a foreign currency. A unique feature of the IBF concept is that such deposits, even when denominated in dollars, will not be included in aggregate figures of the US money supply.[51]

The campaign to win approval for what ultimately became the IBF concept was carried out by twelve major New York banks under the aegis of the New York Clearing House Association. These banks were apparently disturbed by the fact that New York City was a distant second to London as an international banking center in spite of the dollar's role as the world's principal vehicle and reserve currency.[52] Not only did New York have

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49. Letter of Gordon T. Wallis of the New York Clearing House Association to Paul A. Volcker, 28 May 1980:

> To the extent that IBF's succeed in attracting Eurodollar business back to the United States . . . U.S. monetary authorities would have some portion of the Eurodollar market under their direct jurisdiction with the attendant ability to monitor the "domestic" Euromarket close at hand.

50. *World Financial Market*, November 1981, p. 7.
51. *Ibid.*, pp. 7-10.
52. *See:* Einzig and Quinn, *The Eurodollar System*, p. 54. Also, Howard Curtis Reed, *The Preeminence of International Financial Centers* (New York: Praeger, 1981).

fewer banks directly represented there than in the City of London (255 to 355),[53] but even worse, London had more American banks operating in its city limits than did New York City.[54]

The first important break came when the New York Clearing House Association was able, through the powerful advocacy of industry spokesmen such as James Boisi of Morgan Guaranty, to gain the support of officials in New York City and State. The state legislature in 1978 passed legislation aimed at reducing the state and city tax consequence of certain domestically booked international banking transactions. All that remained was for the Federal Reserve Board to permit such transactions free of reserve and interest rate restrictions.

As before, the major concern of the Federal Reserve was over the possible adverse consequences such a change would have on monetary policy. The New York Clearing House argued,

> We continue to believe that simply applying to IBFs the powers that are already granted to foreign branches will not create monetary or other policy difficulties for the Federal Reserve.[55]

The increasing body of evidence to support the contention that the external market was an alternative channel of credit rather than a creator of such credit was also cited.

In the end, the Federal Reserve Board came to the realization that the IBF mechanism would not threaten monetary policy, but would merely alter the manner in which certain transactions were recorded and the location to which those transactions would be attributed. Accordingly, on 18 June 1981, the Federal Reserve announced its decision to permit International Banking Facilities.[56]

In order to protect the US money supply from "leakages" of funds from IBF deposits, the Federal Reserve Board has required that these deposits have a minimum maturity of two days. This requirement would not apply to transactions with foreign commercial or central banks, which would be allowed to deposit funds overnight.[57] In order to limit IBF transactions to a wholesale basis, a minimum transaction amount of $100,000 was established as a compromise after an initial $500,000 figure had been

53. Carol Parker, "New Names in New York," *The Banker*, February 1982, p. 97.
54. *A Proposal to Facilitate the Creation of Domestic International Banking Facilities in New York State*, Office of the Governor, 9 March 1978, p. 3.
55. Memo of the New York Clearing House Association to the Federal Reserve Board, 15 March 1979, p. 1.
56. *Press Release*, Federal Reserve Board, 18 June 1981. An IBF is defined in Section 204.8 of Regulation D.
57. *World Financial Markets*, November 1981, p. 8.

proposed. The one exception to the $100,000 minimum would be in the case of withdrawals of interest from IBF accounts. The balance of an IBF account would also be allowed to drop below $100,000 either in the case where exchange rates depreciated a foreign currency deposit balance or where a $100,000 withdrawal reduced the remaining balance to less than $100,000. However, the account would have to be closed in the case of any further withdrawal.[58]

United States resident corporations are not allowed to loan funds to foreign subsidiaries for redeposit with an IBF, nor are IBF deposits loanable in the US. It is permissible, however, for an IBF to issue a letter of credit to a US beneficiary, if such payment is to support an export. Persons transacting business with an IBF are required to sign a statement certifying the "foreign" character of the transaction and banks are under obligation to transfer to the domestic books any loan which is not used to support foreign operations.[59] The decision to require a written statement was highly controversial and even the staff of the Federal Reserve Board recommended against it.[60] That it was included in the final draft of regulations proves the seriousness with which the FRB views possible disruptions of monetary policy.

To establish an IBF, the establishing bank, after notifying the Federal Reserve of its intention, can transfer funds for two weeks, free of the eurocurrency reserve requirement. Thereafter the IBF is limited to transactions with other IBFs or transactions which are foreign in nature. Funds raised by an IBF and subsequently lent to the establishing bank would then be subject to the eurocurrency reserve requirement.[61] A recent article in *The Banker*[62] erroneously stated that the Edge Act subsidiaries of an establishing bank can conduct transactions with the IBF of the same bank. Edge Act corporations differ from an IBF in two important respects. Edge Act corporations are 1) separately established domestic subsidiaries that are, and 2) subject to reserve requirements.[63] An Edge subsidiary would be prohibited from transacting business with an IBF, although the Edge Act subsidiary could establish its own IBF, which would then be allowed to conduct business with the IBF of the establishing bank.[64]

The instrumental role played by the New York legislature in winning

58. Federal Reserve Board circular number 9174, 27 October 1981, p. 8.
59. *Ibid.*, p. 8.
60. Federal Reserve Board staff correspondence, 3 June 1981.
61. *Press Release*, Federal Reserve Board, 18 June 1981 and circular 9174.
62. Julian Walmsley, "International Banking Facilities — we have lift off," *The Banker*, February 1982, p. 92.
63. George William Trivoli, "International Banking Facilities — threat or opportunity?" *The Bankers Magazine*, September-October 1981, pp. 14-15.
64. Federal Reserve Board circular number 9197, 27 November 1981.

approval for the IBF concept has already been described. The presence of that legislation, however, delayed the start-up date for IBFs from 1 October to 3 December 1981; as other states also wished to have the opportunity to pass facilitative legislation prior to the authorization date. The need for such legislation was a function of the local taxation imposed on domestically transacted business. The tax burden in New York was particularly onerous prior to the legislation of 10 May 1978, exempting IBF–eligible transactions from such taxes. Prior to that time such transactions would have been subject to both state and city income taxation in the amounts of 12 and 13.823 percent, respectively. By way of contrast, bank profits in Chicago were subject only to a state income tax of four percent. The effective tax rate for banking operations after the payment of other assessments would have been 7.816 percent in New York City and 1.289 percent in Chicago.[65] Before one jumps to the conclusion that Chicago should have been an ideal location from which to transact international business, it should be remembered that profits in the Cayman Islands would be subject neither to direct local taxation nor to the tax implicit in reserve requirements.

In addition to New York, a number of other states passed similar facilitative legislation in 1981. The list of those states and the particular legislation reads as follows: California (Senate Bill 499), Connecticut (Public Act 81-245), Florida (Senate Bill 477), Georgia (Chapter 41A-33A), Illinois (Public Act 82-661), and Maryland (House Bill 1160). A number of other states which have been mentioned as potentially important centers for domestically booked international transactions have not achieved passage of such legislation. In Massachusetts (House Bill 3155) and New Jersey (Assembly Bill 3759), such legislation died without action being taken. Both Massachusetts and Hawaii have cities which could be significant centers for international banking (Boston and Honolulu). However, in responding to an inquiry for this study the banking authorities in these states responded that their offices had no position on this issue.[66] In addition, there are certain states which possess potentially significant centers for IBF transactions, such as Pennsylvania, Texas, Louisiana and Ohio, which tax banks on the basis of share capital rather than income.[67] As an IBF is not a separate entity with its own capital, facilitative legislation is unnecessary in those states.

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65. Emmanuel N. Roussakis, "The Edges Come to Miami," *The Bankers Magazine*, May-June 1981, p. 91.
66. This section is based on correspondence with the state banking authorities in the states mentioned as well as information provided by the office of the executive director of the Conference of State Bank Supervisors.
67. Memo of the New York Clearing House Association to the Federal Reserve Board, 15 March 1979.

No state has more aggressively sought to position itself to become a center for international banking than Florida. This is the result of the conscious policy of Governor Robert Graham and his banking commissioner, Gerald Lewis. Both of these gentlemen sponsored the International Banking Act of 1977, which, for the first time, allowed foreign banks entry into the state.[68] In addition, Florida Senate Bill 477, which became effective on 1 July 1981, is perhaps the most far reaching IBF facilitative legislation passed by any state. That bill reduces state income taxation on IBF transactions from five to zero percent, and exempts IBFs from payment of the state intangible tax ($1 per $1,000 just valuation) and the documentary stamp tax ($0.15 per $100). In addition, IBFs are exempted from the state liquidity reserve requirement as well as the Florida usury law. Finally that aAct bolsters the laws regarding the confidentiality of IBF accounts.[69] "We are not going to move Wall Street to Miami," stated Commissioner Gerald Lewis, "but we can give New York real competition in certain areas."[70] Yet in spite of the efforts of state authorities, the future of Florida as a banking center is uncertain. Allegations regarding the influx of money from Latin American drug traffic into Florida accounts have cast a shadow over the state.[71] Also, the fact that the largest bank in the state (Southeast) has assets amounting only to about one-eighteenth those of Citicorp raises some questions about the role Florida banks will play should interstate banking be authorized.[72]

The antipathy between New York and regional banks also contributed to the postponement of the start-up date to 3 December 1981. Regional banks charged that they would be at a competitive disadvantage since they did not have direct access to the electronic transactions clearing system (CHIPS) operated by the New York Clearing House Association. Regional banks, it is true, would have access to CHIPS through the establishment of Edge Act subsidiaries in New York City, but these subsidiaries would still be at a disadvantage due to the capital restraints imposed on Edge Act corporations. The Federal Reserve Bank of New York attempted to solve this issue by a proposal to establish a CHIPS account through which regional banks could have direct access.[73] This issue remains unresolved at the present time.

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68. Jenny Ireland, "International Banking Facilities: Miami — benefactor or competitor?" *The Banker*, July 1981, p. 57.
69. Roussakis, "The Edges Come to Miami," p. 91.
70. Gerald Lewis as quoted in "Miami Aiming High," *The Banker*, February 1982, p. 107.
71. Nicholas Asheshov, "Will Hot Money Spoil Miami?" *Institutional Investor*, September 1981, pp. 346-359.
72. Parker, "New Names in New York," p. 108.
73. Federal Reserve Board staff correspondence, 4 June 1981.

The operation of the CHIPS system is demonstrated by the following table:

In spite of the obstacles, International Banking Facilities were authorized effective 3 December 1981. As in any decision reached by compromise, there were a number of additional points which dissatisfied members of the banking community. The chief complaints hinged on the prohibition against the issuance of negotiable instruments. The requirement of a signed statement regarding the use of funds also rankled the banker's instinct, while smaller banks objected to the $100,000 transaction minimum.

A unique complaint was voiced by the American Express International Banking Corporation (AEIBC). AEIBC was established in the State of Connecticut, but transacted all of its banking operations outside of the US. Since AEIBC was not subject to Regulations D and Q, it did not fit the definition of a depository institution and was thus precluded from establishing an IBF. The staff of the Federal Reserve Board recommended a change in that definition which would allow AEIBC to establish an IBF.[74]

The first real obstacle to IBFs once they were in operation was posed by the Federal Deposit Insurance Corporation (FDIC), which interpreted its statutory obligations as requiring it to assess deposit insurance on IBF accounts. It was estimated that this assessment would increase costs by six basis points,[75] or approximately one-sixteenth of 1 percent. Although this is nominally a small amount of money, C.W. Carson, the vice chairman of Chemical Bank, testified that "a significant percentage of foreign branch activity involves interbank deposit taking and placements where spreads range from seven to twenty-five basis points."[76] An additional argument was made that since wholesale accounts are generally exempt from deposit insurance and since foreign banks are not required to assess deposit insurance, such an assessment on US banks would defeat the purpose underlying the establishment of IBFs. Congress showed its agreement with these points by passing the International Banking Facility

	Number of CHIPS member banks	Percentage of transactions
Clearing House members	12	41%
Other New York banks	6	3
Edge subsidiaries	21	22
Foreign banks	61	34

(Table based on Federal Reserve staff correspondence dated 3 June 1981).

74. Federal Reserve Board memo dated 4 June 1981, summarizing public comments regarding IBF proposals.
75. *World Financial Markets*, November 1981, p. 10.
76. C. W. Carson, testimony before the House Subcommittee on Banking, 4 November 1981.

Deposit Insurance Act (HR 4879) which became effective as Public Law 97-110 on 26 December 1981.

The first question that comes to mind in assessing the impact International Banking Facilities will have is: Will the offshore centers be adversely affected by the existence of this new competitor? While it would seem that the answer to this question will emerge only after a long period of adjustment, the clue to the answer would seem to lie in the distinction between those centers which exist in themselves as *bona fide* financial centers and those which are merely the result of regulation. London would be the paramount example of an international financial center. Its status as an international banking center predates not only American banking regulations, but the United States as a nation. Although British banking regulation has become more stringent in recent years, and although London's position is sensitive to such regulation, the principal asset which this banking center possesses is confidence. As Walter Wriston stated, "The Eurodollar market exists in London because people believe that the British government is not about to close it down."[77]

Centers which are strictly categorized as being offshore, such as the Bahamas and the Cayman Islands, are more likely to be adversely affected. The "shell branches" which the Federal Reserve Board authorized in these islands have no economic rationale whatsoever other than the artificial advantages created by escaping regulation. The authorization of International Banking Facilities in essence allows the equivalent of a "shell branch" to be established at the bank's home office at no additional expense or administrative inconvenience.

The future of the Bahamas and the Cayman Islands would seem to depend on two factors: uncertainty about the FRB's degree of commitment to the IBF concept and the degree of remaining regulation. The limitations placed on IBF maturities and transaction amounts will continue to provide some demand for shell operations. The secrecy laws and location outside US jurisdiction will also create an incentive for certain accounts to be placed in these locations. As one American was quoted as saying, "In the Caymans, the banks work for you. In the US, they work for the IRS, your ex-wife, and whoever else wants to know your financial position."[78] Already, some banks in the Bahamas are anticipating a shift in emphasis to trust services which are prohibited by law in the state of their new regional competitor: Florida.[79] Foreign banks will have an incentive to conduct business offshore in order to avoid the federal income taxation

77. Walter Wriston as quoted by Sampson, *The Money Lenders*, p. 113.
78. Richard B. Miller, "The Caymans — Offshore Paradise," *The Bankers Magazine*, January-February 1981, p. 41.
79. Ireland, "International Banking Facilities," p. 60.

that would be levied on business transferred to the US. Finally, US authorities are remembered for the IET, the VCRP and the freezing of Iranian assets, and are therefore viewed with suspicion. As one recent commentary in *Euromoney* pointed out: "It is perhaps too early to assess the degree of commitment of the US authorities for the IBF concept. Abrupt regulatory changes in the United States are not unknown."[80] Banks may keep offshore branches in operation both as a precaution and in order to seek to prevent the Federal Reserve Board from using the "new approach" to control the external market.

A noted commentator on the external market, David F.V. Ashby, predicts that over the next decade International Banking Facilities will increase New York's share of this market from 0 to 18 percent. Much of that increase will come at the expense of the Caribbean centers which Ashby predicts will be reduced from 11 to merely 2 percent of the overall market. Ashby also expressed the opinion that although London will remain the single most important center, its share will fall from 32 to 20 percent.[81] Although such predictions are mere conjecture, factors such as London's time zone advantage and the aforementioned confidence factor do lend credence to his point of view. As the Director of International Operations at Manufacturers Hanover Trust, Donald McCouch, has rightly stated, "A large infrastructure exists in London, which is not apt to shift to New York overnight. Most major banks like to keep things in a number of pockets. . . ."[82]

The effect that IBFs will have on centers such as Hong Kong and Singapore is even more difficult to predict. Although these centers are often listed under the heading "offshore," they are, in fact, important regional centers of ever-increasing importance. They constitute a middle case between London on one hand and the Caribbean centers on the other. It would seem that due to their regional importance and time zone advantages they will adjust fairly well to the new situation. From the standpoint of Singapore and Hong Kong, a greater potential threat exists from Japan than from IBFs.[83]

The IBFs' potential impact on employment is easier to assess. It now is clear that initial claims were wrong. According to a job model created

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80. Stanislas Yassukovoich, "Could the Euromarkets Leave London?" *Euromoney*, October 1981, p. 253.
81. David F. V. Ashby as quoted by Robert A. Bennett, "America's Debut in Offshore Banking," *The New York Times*, 22 November 1981, p. F25.
82. Donald McCouch as quoted by Rosalyn Retkwa, "The Coming New York Offshore Banking Center," *Euromoney*, October 1981, p. 24.
83. *See:* Atsuko Chiba, "Will Tokyo Create an Offshore Banking Center?" *Institutional Investor*, June 1981, pp. 75-86. Also, Nicholas Cumming-Bruce, "If Japan Opened its Markets Could Singapore Compete?" *Euromoney*, December 1981, pp. 151-158.

for the New York Clearing House Association by Morgan Guaranty's James Boisi, it was estimated that establishment of IBFs would create 1,896 new banking jobs. Moreover, 3,792 jobs would be created indirectly in allied industries or induced via increased consumption. Those same projections estimated that the 5,688 new jobs would produce $90,698,500 added payroll in New York City.[84]

These projections were used in the campaign to win approval for the IBF concept and were instrumental in winning the support of state and city officials for the passage of facilitative legislation. The New York Clearing House was unequivocal in its endorsement of these claims. As one of its publications, *International Banking Facilities in the United States*, stated, "Meaningful job gains will probably be realized fairly quickly after the facilities are established."[85]

At this time it seems unlikely that those job gains will be realized. A vice president of the Federal Reserve Bank of New York (who requested anonymity) stated that employment gains would "not be that great." This veiw was endorsed by Shuku Sharooz Hahn, an official at Citibank's New York facility. When asked whether the IBF at Citibank's New York office would live up to the employment projections made for it, at least in the near future, Ms. Hahn replied, "definitely not," adding that any gains would be clerical in nature. As of the end of February, Citibank had not hired a single person at the professional level as a result of the New York facility. When presented with the claims made by the New York Clearing House job model, Tom Casey, the vice president in charge of Citibank's Miami IBF, indicated disbelief. Mr. Casey stated that the Miami IBF had not directly created any banking jobs, but that indirectly demand had been created for certain technical services provided by vendors, particularly in the area of telecommunications.[86] In view of the fact that the "shell branches" of US banks have virtually no staffing it would seem that the potential for job creation is minimal. Transactions booked through shell branches were made by people in the US patents office who already held employment prior to the establishment of IBFs. Most likely these would be the same people to make transactions now that that business is to be booked through an IBF.

Many of the judgments expressed above involve predictions or are based on opinion. The one place where it is definitely possible to identify a beneficiary of the IBF proposal is in its effect on smaller and intermediate size banks. Despite the existence of the low cost shell branch option for

84. New York Clearing House job model, 1978.
85. *International Banking Facilities in the United States.* (New York: New York Clearing House Association, 14 July 1978), p. 4.
86. Based on phone interviews during January and February 1982.

access to offshore operations, international banking, in the words of Sarkis Khoury, was "the domain of giants."[87] The chart below indicates that in spite of the dramatic increase in the number of banks conducting international business and in spite of the rapid increases in foreign branching, size remains a definite factor.

TABLE FOUR
Distribution of U.S. foreign bank branches according to asset size of the parent bank and the percentage of banks in each category possessing a branch

PARENT BANK SIZE (in billions):						
	.1 to .99	1 to 1.999	2 to 2.999	3 to 4.999	5 to 9.999	10-up
Shell Branches	29	49	25	24	14	12
% of Banks in Category	7.5%	41.2%	62.5%	85.7%	100%	85.7%
Regular Branches		4	5	19	66	501
% of Banks in Category		3.4%	12.5%	20.4%	92.3%	100%

Source: Richard K. Abrams.[88]

The difference in the distribution between shell and full-line foreign branches shows that cost has been a very significant bar to entry into international banking. Given the hypothetical situation described in a previous section, in which an offshore branch had competitive advantage of thirty basis points over a regulated bank, and supposing further that it would cost $100,000 to cover all of the expenses for a shell branch, a bank would have needed approximately $33 million in business ($100,000 divided by .003) before it would be a rational strategy to even consider establishing a shell operation. Approximately one-third of all US foreign branch deposits are held by shell branches. This would imply that a bank would have to have about $99 million in foreign branch deposits to reach the point where international banking is an attractive option. Supposing that the banks at this level conduct about 10 percent of their business internationally, a figure of $990 million would be the cutoff point between banks which are potential international actors and those which would find costs to be a barrier to international activity.

With the authorization of IBFs, start-up costs are reduced to the cost of mailing a letter of notification to the Federal Reserve Board. This suggests international banking is *theoretically* a possibility for any bank.

87. Khoury, *Dynamics of International Banking*, p. 128.
88. Richard K. Abrams, "The Role of Regional Banks in International Banking," *The Columbia Journal of World Business*, Volume 16, number 2 (Summer 1981), p. 68.

The Banker estimates that four or five new entrants have established IBFs in New York City.[89] More significant, however, is the fact that banks located outside of money centers have established IBFs. The list of 256 IBFs existing as of 28 January 1982, includes the following eight banks: All American National Bank of Virginia Garden, Florida ($8 million in assets); Bank of New Orleans Trust ($677 million); Laredo National Bank of Laredo, Texas ($446 million); Liberty National Bank and Trust of Louisville, Kentucky ($855 million); National State Bank of Elizabeth, New Jersey ($877 million); and the Union National Bank of Laredo, Texas ($184 million). None of the eight banks had a foreign branch at the time of the establishment of their IBF, although Bank of New Orleans Trust had a branch in Nassau from 1974 to 1976. This branch was closed due to the cost of maintenance.[90]

Two of these banks, the All American National Bank and the National State Bank had zero balances as of 1 March 1982. National State Bank stated that the IBF was established so that it would "be there when (they) need it." An official of the All American National Bank stated that their IBF was established due to the fact that its present owners were from South America. The two IBFs in Laredo, Texas were established due to that city's location on the Mexican border. The experience of these Texas banks is somewhat unusual. Whereas the possible assessment of FDIC insurance nearly priced IBFs out of existence, the Laredo banks stated that the exemption of IBF accounts from deposit insurance had a detrimental effect on their operations. Theresa Aker, of the Union Bank of Laredo, stated that this situation was due to the fact that Mexican depositors were above all concerned with safety. According to Aker, Mexican depositors have seen banks fail in their country and this psychology makes deposit insurance more important than yield. The fact that depositors had to sign a statement that the funds would be reinvested outside of the US was mentioned by Renato Ramirez of the Laredo National Bank as a negative factor. If the funds are required to be reinvested in Mexico, this regulation would run counter to the initial motivation to place funds in the US. As a result, Laredo National Bank disestablished its IBF after the first quarter. However, Union Bank intends to keep its IBF in operation. The experience of these banks is somewhat unusual, and one might even expect that larger Mexican depositors than those who bank in Laredo would not have such an aversion to placing funds with an IBF.

The bank of New Orleans Trust provides perhaps the best example of

89. Walmsley, "International Banking Facilities," p. 92.

90. The information regarding the six banks listed is based on telephone interviews conducted on February 26 and 1 March 1982. Statement of assets is provided either by those interviews or from *Moody's Bank and Financial Manual*.

an intermediate size bank being able to enter international banking. Due to its previous limited experience with a branch in the Bahamas, Bank of New Orleans Trust is situated at that point where marginal costs for such a branch are located just beyond what could be economically justified. Roger Griffiths, an official of that bank, described the IBF as a "poor man's Cayman." Griffiths stated that the bank had booked transactions through its IBF and that it also had operatives in Central and South America to induce deposits. Loan activity, according to Griffiths, was "just a matter of doing business in the area." Although he was of the opinion that IBFs did provide the means for smaller banks to enter this field, he cited the $100,000 transaction limit as too burdensome for a bank the size of his. Claiming that two-thirds of his bank's clientele fell into the below-$100,000 category, he stated that $25,000 would be a better cut-off point. Although he conceded the cost advantage for a small bank in operating through an IBF, Griffiths, who had himself managed a Cayman branch earlier in his career, felt that the largest banks would be ill-advised to close down Cayman Islands branches already in existence. The added features of a Cayman branch, he felt, outweighed the costs of maintaining such a branch, costs which were in any event minimal for a large bank.

CONCLUSION

The future of International Banking Facilities is likely to be evolutionary rather than dramatic. Although it would appear a reasonable certainty that IBFs will win the right to issue negotiable instruments, such a policy change will only likely occur after the Federal Reserve Board is assured that monetary policy will not be adversely affected; in other words, after the Fed has had at least a year to observe the present system in operation.

"The development of the IBF concept," stated a recent article in *The Banker*, "represents a major step forward in international finance; deposits at Eurodollar rates with US sovereign risks."[91] To the extent that this perceived risk is less than in the external market, banks will realize lower costs of funds and thus greater profitability, reversing or at least arresting the narrowing of spreads which has discouraged many banks from international operations. Yet, although the US is recognized as a low political risk, it may be regarded as a significant regulatory risk. The past capital and credit restraint programs and more recently the freezing of Iranian assets held in US banks[92] are examples of such regulatory actions. This

91. Walmsley, "International Banking Facilities," p. 91.
92. Ironically, the majority of the frozen assets were held in London branches of American banks and thus believed to be beyond the extraterritorial reach of U.S. authorities.

history may be the most significant determinant of whether International Banking Facilities are able to attract the degree of the external market that many proponents claimed.

The real significance of the IBF concept does not, however, depend on the amount of business that is transacted through this means. After all, banks were already able to conduct the same type of business offshore. International Banking Facilities must be seen in the context of the reduction of regulatory barriers around the US banking market and thus a greater integration or rather *reintegration* of the financial system based on the dollar.

The establishment of International Banking Facilities in the US seems to fulfill the predictions regarding the future of international banking in the 1980s made by Ian Giddy and D.L. Allen. In an insightful article appearing in the Spring 1979 edition of the *Quarterly Review* of Rome's *Banca Nazionale del Lavoro*, Giddy and Allen stated that during this decade:

1) The distinction between domestic and international banking will disappear;
2) Financial services will be unbundled and relationship banking will fade;
3) Government regulation of banking will fade; and
4) Small banks will rise again.[93]

The authorization of domestic International Banking Facilities is a major step towards confirmation of their claim that "it will not be long before national banking will merge with international banking to form a single, global, wholesale banking market."[94] International Banking Facilities should not be seen as a final stage either in the deregulation of the American market or in the process of integration of the domestic and external markets. Rae Weston described the events of the last several decades as the transition from international to multinational banking.[95] What we are seeing now, and what the IBF represents in part, is a transition from multinational to global banking.

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93. Giddy and Allen, "International Competition in Bank Regulation," pp. 315-321.
94. *Ibid.*, p. 315.
95. Rae Weston, *Domestic and Multinational Banking* (New York: Columbia University Press, 1980.)