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Statement

by

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**Member, Board of Governors
of the Federal Reserve System**

before

**Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives**

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Mr. Chairman, I appreciate the opportunity to appear before this Committee.

As requested in your letter inviting the Federal Reserve to participate in these hearings, I shall discuss the role of U.S. banks in offshore centers and will comment on the types and adequacy of the information the Federal Reserve obtains on bank activities in such locations.

Offshore financial centers, some of which are also tax havens, are nowadays a highly important part of the international financial system. No picture of international financial developments is complete without taking into account the transactions that are made or booked in these centers. It is for this reason that activities in these centers are of interest to the Federal Reserve as a central bank when monitoring international flows of money and credit in relation to domestic monetary conditions. Furthermore, U.S. banks occupy a prominent place in these offshore centers. The Federal Reserve as bank supervisor must therefore be concerned with monitoring the activities of U.S. banks in these centers to assure itself that they are conducting their affairs in a safe and sound manner.

While tax considerations are frequently an important element in the operations of offshore financial centers and the kinds of transactions that take place or are booked in them, they are not prominent in the concerns of the Federal Reserve about these centers. Other authorities exercise oversight on tax aspects of transactions

in these centers and have the specialized expertise to deal with such matters. As I have just indicated, our interests run to the broad economic implications of activities in these centers and to the bank supervisory aspects of these activities. Therefore, in my statement, I shall discuss, first of all, some general characteristics of offshore financial centers and of the operations of U.S. banks in them. I shall then turn to the role of the Federal Reserve in relation to these centers to be followed by a description of the kinds of information obtained by the Federal Reserve in the furtherance of its interests and responsibilities.

Offshore Financial Centers

Offshore financial centers are easier to identify than to characterize. Broadly speaking, however, an offshore financial center is a location where funds are borrowed from nonresidents and lent to other nonresidents through the intermediation of banks and other financial institutions. These activities are recognized to have little effect on the domestic economy of the center or on domestic financial conditions. Some of these centers are fully operational, in the sense of actual dealings being conducted with customers regarding obtaining funds and negotiating credits. Others are merely booking centers where deposits and loans are legally lodged, but where no transactions are physically made. The City of London is the preeminent example of an operational offshore financial center. The Bahamas and the Cayman Islands, on the other hand, are notable examples of booking centers.

What are the essential elements of offshore financial centers and what has spurred their growth? As for the former, tax considerations can of course have an important influence on a country's growth and appeal as an offshore financial center. Likewise very important, however, are factors such as exchange control laws, local reserve requirements, communication facilities, the country's time zone, its commercial laws and its political and social stability. This is illustrated by the fact that London, the largest "offshore center," is located in one of the world's most heavily taxed countries. Secrecy laws are frequently another important consideration, but, like liberal tax laws, they are generally more important to the customers of banks than to the banks themselves.

The growth of offshore financial centers has been prompted mainly by the needs and demands of multinational business. As business has become more and more internationalized, needs for international financial services have expanded and become more diverse. Companies operating in a variety of countries have required funding sources in different currencies, outlets for temporarily idle funds, access to different kinds of credit facilities, and the means for the transfer of monies across international frontiers. Tax laws and foreign exchange restrictions are, of course, among the crucial factors influencing the ways international business is transacted. For multinational companies, therefore, locations where international financial transactions

can be effected free of most tax consequences and of foreign exchange controls have a great attraction. Since bankers traditionally follow their customers and adapt to their needs, banks have been quick to locate in and promote such offshore centers.

U.S. banks in Offshore Centers

U.S. banks have long been located in and played a prominent role in the major financial centers of the world, such as London, where "offshore banking" is an important part of their business. U.S. banks have also played an important part in the development and rapid growth of offshore financial centers outside the major financial markets that has occurred in recent years. As recently as December 1972, for example, member bank branches in six major offshore centers had total claims on third parties of only \$14 billion, or 20 per cent of third-party claims at all their foreign branches. At the end of last year, those claims totaled more than \$95 billion, and represented 46 per cent of third-party claims at all foreign branches of member banks.

The Bahamas and the Cayman Islands are by far the most important of these offshore centers to U.S. banks. At the end of last year, U.S. banks had 139 branches in these two locations with claims on third-parties exceeding \$70 billion. Details of the distribution of business among offshore centers and by types of customer are shown in the accompanying tables. As noted earlier, the Bahamas and the Cayman Islands are booking centers for financial transactions

that have been negotiated elsewhere. Virtually all of the branches of U.S. banks in these centers are consequently "shell" branches-- that is to say, they are a set of ledgers managed and kept by an agent rather than a physical location where business is transacted.

The growth of international banking is the underlying cause for the growth of these centers, but the initial catalyst for the establishment of branches of U.S. banks there was U.S. regulations. The Voluntary Foreign Credit Restraint Program (VFCR) and the Interest Equalization Tax (IET), which were implemented in the mid-1960's to restrict the outflow of capital from the United States, limited the ability of U.S. banks to meet their customers' foreign needs and to otherwise engage in international banking. As a way of doing so, banks began to establish low-cost "shell" branches in these countries to obtain access to the Eurocurrency markets. Since foreign loans booked and funded in these branches did not affect the U.S. balance of payments, they were exempt from the restrictions on foreign credits that applied to domestic banking offices.

Although U.S. Government programs to restrict capital outflows were ended in 1974, U.S. bank activity in the Bahamas and the Cayman Islands has continued to grow. For those banks that do not have full-service foreign branches in, say, London, these locations offer low-cost access to the Eurocurrency markets and notably the ability to raise funds for their international business free of domestic reserve requirements.

For many bank customers, these locations provide advantages as tax havens, while for others secrecy laws are important in their decisions to place funds.

For the banks themselves, operations in the Bahamas and the Cayman Islands also have certain tax advantages. U.S. banks operate abroad mainly through branches, and the earnings of branches are not deferrable but are immediately subject to U.S. income taxes after allowable credits for foreign income taxes paid. Generally, therefore, where a foreign tax rate is higher than the U.S. tax rate, there are advantages to shifting the business from the foreign country to tax-free countries. Another reason for shifting business into a tax haven country is to enable banks to avoid double taxation of foreign branch earnings, as can occur when both foreign and U.S. tax authorities tax the same income. It should be noted that in neither of these cases is there an avoidance of U.S. Federal taxes; in fact, in some instances the shifting of business to tax haven countries results in greater tax revenues accruing to the United States Government. Income earned in these locations, as with other income earned abroad, is not subject to U.S. State and local taxation.

The tables attached to this statement provide a general indication of the types of business booked at branches of U.S. banks in the Bahamas and the Cayman Islands. A large amount of purely interbank activity is booked in these branches, some of which involves the rechanneling of funds within a bank's organization and some of which involves purely market transactions of buying funds from some banks and selling

them to others. Loans booked in these branches are preponderantly to foreign companies, including foreign subsidiaries of U.S. companies, and totaled \$36 billion at the end of last year. Deposits from nonbank sources totaled \$25 billion, and were divided almost equally between foreign customers and U.S. addressees. The latter are primarily U.S. corporations.

Federal Reserve Role

The Federal Reserve is interested in and monitors activities of foreign branches of member banks both in its role as the nation's central bank and its role as a bank supervisor. Our interests differ somewhat according to these roles. In our central banking role, we monitor activities of foreign offices of U.S. banks in offshore centers and elsewhere as part of our general surveillance of international financial markets and international flows of funds. The growth of international lending through the Euromarkets and otherwise has had important repercussions for capital flows throughout the world. Conditions and practices in those markets interact closely with conditions and operations in our domestic monetary and credit markets. In analyzing the condition of the U.S. economy and of its external position, as well as in assessing the consequences of various policy alternatives, much effort at the Federal Reserve is nowadays invested in following developments in international banking and financial markets and activities of U.S. banks in those markets.

As a bank supervisor, our interests are directed to the soundness of operations in these offices and to compliance with relevant banking

laws and regulations. Most of our detailed knowledge of the operations of U.S. banks in offshore centers arises from our role as a bank supervisor. Since the branches in the Bahamas and the Cayman Islands are "shell" offices, virtually all of their records are maintained at the head office in the United States and thus are available for inspection at the time the bank is examined. Indeed, because of the special characteristics of these branches, the Board, when it authorized them, conditioned its approval on full records being maintained at the head office. Another condition attached to those authorizations was that these offices not be used to shift deposits and other business from the United States.

The supervisory interest in these operations runs, as I have already indicated, to their safety and soundness and their possible effects on the overall condition of the bank. They are scrutinized by bank examiners in connection with the overall examination of the bank and in the same fashion as other parts of the bank. The emphasis is accordingly on the quality of assets and the ability of borrowers to repay, in accordance with the terms and conditions of the credits. Virtually no attention is paid to the identity of depositors nor to depositor transactions. Thus, customer compliance with the tax laws of their various countries is not a consideration in the examination process. That compliance is covered by other authorities in this country and abroad. In any event, bank examiners are basically credit analysts and are not equipped to conduct tax audits.

Information on Offshore Center Operations

The Federal Reserve employs several sources of information on the activities of offshore offices that enable it to monitor their compliance with sound banking practices and relevant U.S. regulations and that help in evaluating their impact on international financial flows.



The information from these sources has been adapted to the Federal Reserve needs and interests that I have just discussed and are generally adequate for those purposes.

As I mentioned earlier, our most detailed information about the activities of U.S. banks in offshore centers is obtained from examination reports. These reports are the primary supervisory document. In addition, statistical reports are collected periodically on individual offices that are used mainly in our overall evaluation of banking activities in these centers. On a monthly basis, banks file reports for their major foreign branches showing their assets and liabilities by type of customer. Data compiled from this report (FR 502) are published regularly in the Federal Reserve Bulletin, including a separate section covering the Bahamas and the Cayman Islands. This report is also the source for the data shown in Tables I and II attached.

A second report (FR 502S) is collected quarterly and shows foreign branch assets and liabilities by country. This report is the source of the information shown in Tables III and IV attached.

Besides these reports on foreign branches, U.S. banking organizations also submit financial statements on their foreign subsidiaries on an annual basis. Subsidiaries of U.S. banks in the Bahamas and the Cayman Islands are much less important than their

branch operations. At year-end 1977, total assets of these subsidiaries were only \$3 billion, about one-third of which represented intercorporate transactions. Some of these subsidiaries conduct a wide range of activities similar to those of branches; others serve mostly to channel funds among affiliated offices. While some conduct trust activities, the volume is relatively small and is directed to foreign parties.

Conclusion

In this statement, I have tried to provide some insight into the general workings of offshore centers and into the nature of the Federal Reserve's interest and attention to developments in these centers, both in general and in particular relation to offices of U.S. banks.

Attachments

Table I

Assets of Branches of U.S. Banks in Selected Offshore Centers,
by Type of Customer, December 1978
(Amounts in \$ Billions)

<u>Country</u>	<u>U.S. Parties (Excluding Parent)</u>	<u>Non-U.S. Addressees</u>		<u>Total Claims on Third Parties</u>	<u>Claims on Parent and Affiliates</u>	<u>Total Assets</u>
		<u>Banks</u>	<u>Nonbanks</u>			
Bahamas	2.4	26.0	29.7	58.0	14.6	72.6
Cayman Islands	<u>.9</u>	<u>7.7</u>	<u>5.8</u>	<u>14.4</u>	<u>4.0</u>	<u>18.3</u>
Sub Total	3.3	33.7	35.5	72.4	18.5	90.9
Bahrain	-	2.4	3.9	6.3	3.6	9.9
Hong Kong	-	.6	4.1	4.7	2.0	6.7
Panama	.1	.9	4.4	5.5	2.2	7.7
Singapore	-	3.8	2.5	6.3	5.7	12.0
Total	3.4	41.4	50.4	95.2	32.1	127.1

Totals may not add due to rounding.

Table II

**Liabilities of Branches of U.S. Banks in Selected Offshore Centers,
by Type of Customer, December 1978
(Amounts in \$ Billions)**

<u>Country</u>	<u>U. S. Addresses (Excluding Parent)</u>		<u>Non-U. S. Addressees</u>		<u>Total Liabilities to Third Parties</u>	<u>Liabilities to Affiliates</u>	<u>Total Liabilities</u>
	<u>Banks</u>	<u>Nonbanks</u>	<u>Banks</u>	<u>Nonbanks</u>			
Bahamas	4.8	8.6	17.7	10.3	41.4	31.2	72.6
Cayman Islands	1.5	3.1	5.3	2.7	12.6	5.7	18.3
Sub Total	<u>6.3</u>	<u>11.7</u>	<u>23.0</u>	<u>13.0</u>	<u>54.0</u>	<u>36.9</u>	<u>90.9</u>
Bahrain	.2	.3	2.7	.8	4.0	5.9	9.9
Hong Kong	-	-	1.2	.7	1.8	4.8	6.7
Panama	1.1	.1	1.7	1.1	4.0	3.7	7.7
Singapore	.1	-	4.2	2.8	7.0	5.0	12.0
Total	7.7	12.1	32.8	18.4	70.8	56.3	127.1

Totals may not add due to rounding.

Table III

**Assets of Branches of U.S. Banks in Selected Offshore Centers,
by Location of Obligor, December 1978
(Amounts in \$ Billions)**

<u>Country/Region</u>	<u>Bahamas & Cayman Islands</u>	<u>Bahrain</u>	<u>Hong Kong</u>	<u>Panama</u>	<u>Singapore</u>	<u>Total</u>
Europe (Excluding the U.K.)	14.3	.8	.1	.5	.4	16.1
Latin America	23.9	-	-	4.9	-	28.8
Asia & Middle East	5.5	3.4	2.2	-	4.1	15.2
Other (Excluding U.K. & Off- shore Centers)	<u>9.3</u>	<u>1.8</u>	<u>.9</u>	<u>.3</u>	<u>.3</u>	<u>12.6</u>
Sub Total	53.0	6.0	3.2	5.7	4.8	72.7
United Kingdom	10.5	.8	.3	-	.9	12.5
Offshore Centers	18.4	2.9	3.2	1.5	6.2	32.2
United States	9.0	.2	-	.5	.1	9.8
Parent Banks	5.8	.2	-	.4	.1	6.5
Other Parties	3.3	-	-	.1	-	3.3
Total	90.9	9.9	6.7	7.7	12.0	127.1

Totals may not add due to rounding.

Table IV

Liabilities of Branches of U.S. Banks in Selected Offshore Centers,
by Location of Lender, December 1978
(Amounts in \$ Billions)

<u>Country/Region</u>	<u>Bahamas & Cayman Islands</u>	<u>Bahrain</u>	<u>Kong Kong</u>	<u>Panama</u>	<u>Singapore</u>	<u>Total</u>
Europe (Excluding the U.K.)	6.3	.8	.2	.2	.8	8.3
Latin America	4.8	-	-	.9	-	5.7
Asia & Middle East	5.2	1.7	.1	.1	1.6	8.7
Other (excluding U.S. & Off- shore Centers)	<u>5.2</u>	<u>.4</u>	<u>.2</u>	<u>.6</u>	<u>.3</u>	<u>6.7</u>
Sub Total	21.5	2.9	.5	1.7	2.7	29.3
United Kingdom	14.4	3.1	2.0	1.2	3.5	24.7
Offshore Centers	16.0	2.3	3.6	3.0	4.9	29.8
United States	39.0	1.6	.6	1.8	.9	43.9
Parent Banks	20.8	1.1	.6	.6	.8	23.9
Other Banks	6.3	.2	-	1.1	.1	7.7
Nonbanks	11.7	.3	-	.1	-	12.1
Total	90.9	9.9	6.7	7.7	12.0	127.1

Totals may not add due to rounding.