

Research Department
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From the Caymans

Students, teachers and textbook writers now have another international acronym to worry about—IBF. (It means International Banking Facility.) Like SDR (Special Drawing Rights), BIS (Bank for International Settlement), FAS8 (Financial Accounting Standard #8) and CHIPS (Clearing House Interbank Payments System), IBF is one of those acronyms which international finance specialists deal with every day, but which the man-in-the-street finds fraught with mystery.

Actually, IBFs represent an important innovation in international banking. If implemented, they could have a significant impact on the conduct of international banking in the United States and abroad. Indeed, some observers worry that IBFs could have adverse effects on the conduct of U.S. domestic monetary and banking policy.

Background

Two months ago, the Federal Reserve Board of Governors submitted a proposal for public comment, which would permit U.S. banking institutions to establish International Banking Facilities within the nation's borders for the conduct of international banking activities, i.e., lending to and borrowing from non-U.S. residents. Many U.S. banks actually have been engaged in such activities since the 1960s. However, they have operated either through full-service branches in foreign financial centers (such as London, Frankfurt, Tokyo, Hong Kong, and Singapore) or through so-called "shell branches." The latter are little more than name plates at offshore islands (such as the Bahamas and Cayman Islands), with business conducted in the U.S. but assigned to "shell branch" books maintained at head offices.

With IBFs, activities of this type would be brought back to U.S. soil. Like a "shell branch," an IBF would not be a full-service branch; it would need no separate office space, polished marble columns, carpeted

floors, attentive tellers, nor other paraphernalia usually associated with banking offices. Indeed, it could be just a set of accounts segregated on the books of a depository institution for specifically designated categories of customers and types of transactions.

The idea originated with the New York Clearing House Association, which in 1978 proposed the establishment of IBFs with (a) exemption of IBF income from New York State taxes, and (b) exemption of IBF deposits from Federal Reserve reserve requirements and interest-rate limitations. In June 1978, the state legislature passed legislation incorporating the Clearing House proposal, and the Clearing House subsequently asked the Federal Reserve to make the necessary regulatory changes. In December 1980, the Board of Governors approved a proposal to amend Federal Reserve regulations for the establishment of IBFs, and invited public comments prior to final promulgation.

Proposal provisions

Under the proposal, IBFs could be established by all U.S. depository institutions (including banks and thrift institutions), Edge Corporations (U.S.-chartered corporations authorized to engage in international banking operations), and U.S. branches and agencies of foreign banks. These IBFs could accept time deposits and borrow funds from foreign residents or other IBFs, free of Federal Reserve reserve requirements and interest-rate limitations. They could then use the funds for extending credit to foreign residents, other IBFs, or to the U.S. offices of IBF parent institutions.

With IBFs, banking offices in the U.S. could compete with banks abroad on an equal footing in the international market, which doesn't involve the reserve requirements and interest rate limitations found in the domestic market. Thus, IBFs would be able to offer non-resident customers better terms than are

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available to domestic customers, on both deposits and loans. But to preserve the integrity of domestic banking regulations, IBFs would have to be insulated from the domestic banking market as a means of forestalling "leakages."

To this end, IBFs would be permitted to accept only non-negotiable time deposits from non-U.S. residents (including foreign affiliates of U.S. corporations), other IBFs and IBF parent institutions. These deposits would be subject to a two-day minimum maturity or required notice period prior to withdrawal. In addition, the minimum size of deposits or withdrawals would be set at \$500,000 to keep IBF deposits from being used for transaction purposes. (Under an alternative proposal, the minimum average daily balance would be set at \$500,000 and the minimum size of transaction at \$100,000.) Besides offering time deposits, IBFs could borrow from the interbank market outside this country, from other IBFs inside the country, and also from parent institutions. All such borrowings would be exempt from Federal Reserve reserve requirements.

On the asset side, IBFs would be permitted to extend credit to non-U.S. residents, in the form of loans or investments, for financing operations outside the United States. For instance, a foreign subsidiary of a U.S. corporation could borrow only if the loan proceeds were used to finance the borrower's foreign operations. Advances to U.S. offices of parent institutions would be subject to the same reserve requirements as those currently

imposed on the offices' Eurocurrency borrowings.

Up to now, only New York State has adopted legislation exempting IBF income from state income taxes. To permit time for other states to adopt similar legislation, the Federal Reserve has proposed delaying implementation of the arrangement until October 1 of this year.

Major issues

Public benefits. IBF proponents argue that such facilities, by expanding international-banking activities in this country, would lead to increased employment, higher Federal tax revenues, and greater efficiency of U.S. banks. The magnitude of these benefits would depend upon how much business actually shifted from overseas to this country. In June 1980, claims of U.S. banks' foreign branches on non-U.S. residents amounted to \$221 billion, with Caribbean shell branches accounting for \$94 billion of the total. Because of the many locational factors involved, it would be difficult to estimate precisely how much of this business IBFs would attract to the United States—or to gauge the employment and tax-revenue effects of such shifts. But IBF proponents see another advantage: the measure might induce U.S. branches and agencies of foreign banks to retain their international-banking operations in this country. Under the International Banking Act of 1978 and the Monetary Control Act of 1980, these branches and agencies are subject to the same reserve requirements as U.S. banks. Thus, without IBFs, U.S. branches and agencies of foreign banks might be tempted to shift their international-banking operations away from their U.S. offices.

Competitive impact. To date, no other state outside New York has passed legislation to exempt IBFs from state income taxes. As noted above, the Federal Reserve has proposed postponing the IBF startup until October, to allow time for other states to pass similar legislation. But New York has other factors besides tax considerations in its favor.

For example, it is a focal point for the clearing and settlement of international payments, conducted through the Clearing House of Interbank Payments Systems (CHIPS). Membership in CHIPS is limited to banks located in New York, including Edge Corporations of regional banks. Banks outside New York generally incur higher costs because of their need to clear and settle international payments and receipts through either their Edge Corporations or their New York correspondents. Moreover, Edge Corporations don't enjoy as much international prestige as their parent banks, because of their limited separate capitalization. Hence, the establishment of IBFs could increase New York's advantage in international banking relative to the rest of the country.

Monetary-policy impact

Although the Federal Reserve hopes to insulate IBFs from the domestic banking business, non-resident deposits currently in U.S. banks nonetheless would be free to shift to IBFs. In June 1980, non-resident *demand* deposits (including those of foreign banks and official institutions) amounted to nearly \$21 billion, and non-resident *time* deposits to about \$30 billion. Given the proposed restrictions on time deposits, non-residents are not likely to shift much of the demand deposits used for transactions purposes to IBFs, but they certainly would have an incentive to shift time deposits. A one-time shift of this type would cause little problem for U.S. monetary policy, as the resultant reduction in required reserves could be offset by Federal Reserve open-market operations. Nor would it cause much difficulty for domestic credit availability, because funds shifted to IBFs could be easily redirected back to the U.S. market through the Eurodollar market. Such interbank fund flows are routine and do occur in very large volumes.

Some critics are concerned that the planned separation of IBFs from domestic banking could not be watertight. They argue that U.S. residents, faced with higher interest rates on IBF deposits than on domestic deposits,

would have an incentive to shift funds into IBFs—for instance, through real or bogus foreign subsidiaries or affiliates. In their view, large shifts of this sort would tend to subvert U.S. bank reserve requirements; moreover, any shifts from reservable accounts to non-reservable accounts would tend to stimulate an inflationary monetary expansion.

Defenders of the IBF proposal, on the other hand, point out that IBFs would compete with existing international-banking offices located in foreign financial centers, including "shell branches," and that U.S. residents already possess free access to such facilities. IBFs would alter only the location and not the accessibility of such facilities. Hence, the monetary-policy impact might be relatively small, according to this line of reasoning.

Prospects

If serious objections don't arise during the public-comment period, IBFs might be in operation next October. This development would, for the first time, make it possible for deposit-taking institutions in this country to compete on an equal basis with U.S. and foreign banking offices located abroad, insofar as reserve requirements and interest-rate limitations are concerned.

No one knows whether the establishment of IBFs would lead to a massive shift of international banking business to the United States. But there is no question that such a development would give further impetus to the growth of international banking in this country.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
 (Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 1/28/81	Change from 1/21/81	Change from year ago	
			Dollar	Percent
Loans (gross, adjusted) and investments*	146,951	183	9,801	7.1
Loans (gross, adjusted) — total#	124,417	98	10,008	8.7
Commercial and industrial	37,012	23	3,585	10.7
Real estate	50,764	82	6,625	15.0
Loans to individuals	23,729	— 30	— 704	— 2.9
Securities loans	1,473	12	520	54.6
U.S. Treasury securities*	6,792	— 2	— 407	— 5.7
Other securities*	15,742	87	200	1.3
Demand deposits — total#	40,007	—1,896	— 3,339	— 7.7
Demand deposits — adjusted	28,976	—1,253	— 3,135	— 9.8
Savings deposits — total	28,947	— 201	817	2.9
Time deposits — total#	76,696	1,178	17,596	29.8
Individuals, part. & corp.	67,055	1,176	16,818	33.5
(Large negotiable CD's)	30,290	671	8,967	42.1
Weekly Averages of Daily Figures	Week ended 1/28/81	Week ended 1/21/81	Comparable year-ago period	
Member Bank Reserve Position				
Excess Reserves (+)/Deficiency (—)	n.a.	n.a.	—	10
Borrowings	259	321		336
Net free reserves (+)/Net borrowed(—)	n.a.	n.a.	—	346

* Excludes trading account securities.

Includes items not shown separately.

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