FEDERAL RESERVE BANK OF NEW YORK

[Circular No. 8476
December 20, 1978]

REGULATIONS D AND Q

Proposed Exemption for Designated International Banking Facilities

To All Banking Institutions in the Second Federal Reserve District:

On December 14, the Board of Governors of the Federal Reserve System released for public comment a brief statement of the issues raised by a proposal of the New York Clearing House Association to exempt the deposits of specially designated International Banking Facilities (IBFs) from the reserve requirements and interest rate limitations of the Federal Reserve.

In its announcement, the Board invited comment by March 15, 1979 and explained:

The Clearing House proposal contemplates that an IBF:

— Would be allowed to accept funds only from foreign customers, the IBF's own U.S. head office (a U.S. bank) or from other IBFs;

— Could offer only obligations subject to withdrawal on call (after a specified notice period), or obligations with a fixed maturity and a minimum maturity of one day;

— Would not be authorized to offer deposits subject to immediate withdrawal or to offer negotiable CDs.

The Board's statement noted:

"Establishment of IBFs would be expected to result in the creation of a new dollar deposit in this country competitive with Euro-dollars but subject to U.S. laws and hence not subject to 'foreign country risk' . . . Obligations issued by IBFs probably would carry somewhat higher yields than comparable deposits at domestic offices of member banks because of the absence of reserve requirements. As a result, foreigners might shift funds from other international banking centers and from banking offices in the United States to IBFs [*in major domestic monetary centers*]. Moreover, U.S. corporations . . . might be encouraged by favorable terms to find ways of placing funds with IBFs."

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Under the proposal, IBFs could not advance credit to U.S. customers, except to other IBFs or to their own head offices subject to the same Regulation M reserve requirment that is applicable to member banks' net borrowings from their own foreign branches. This requirement currently is at zero.

The Board's press release also indicated that the statement —

. . . noted the implications of possible deposit shifts to IBFs for measuring the monetary aggregates, the level of required reserves and competitive relationships; implications of IBFs on the availability of credit domestically; the possible effects of IBFs on foreign exchange rates and on the relative positions of banks and of their foreign and domestic customers.

The Board invited comment particularly on the following issues:

— Whether the minimum maturity of accounts at IBFs — should they be established — should be one day, or a longer period, perhaps seven days;

— Whether reserve requirements should be applied to head office borrowings from an IBF, and, if so, at what rate;

— Whether obligations offered by an IBF should be available to foreign subsidiaries of U.S. corporations, and

— What implications IBFs would have for competitive balance among banks.

Printed on the following pages is the text of the Board's statement. Comments on this matter may be sent to my office, and any inquiries may be directed to Thomas C. Sloane, Senior Vice President and Senior Adviser, at this Bank (Tel. No. 212 - 791 - 6086).

PAUL A. VOLCKER,
President.

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

International Banking Facilities

The Board of Governors has been asked to consider a proposal by the New York Clearing House Association that the Board amend Regulations D and Q to provide that deposits of specially designated International Banking Facilities (IFBs) be exempt from reserve requirements and interest rate regulations. These facilities would be operated separately from other offices of the bank. The Clearing House maintains that such an action, coupled with special State and local tax treatment of IBFs, would: enhance the role of major domestic monetary centers as international banking centers by attracting business from abroad; stimulate local economies by providing new jobs and raise local tax revenues; and lower bank costs and improve bank efficiency. The State of New York has enacted a law giving eventual tax-free status to IBFs, but this is contingent on favorable reserve requirement and interest rate action at the Federal level. So far as is known, no other State has taken similar action.

The Clearing House proposal contemplates that an IBF would be allowed to accept funds only from foreign customers, the facility's own U.S. head office, and other IBFs. It could offer only obligations subject to withdrawal on call (after a specified notice period) or fixed-maturity obligations with a minimum maturity of one busines day; IBFs would not be authorized to offer deposits subject to immediate withdrawal or negotiable CDs.

If funds placed with IBFs were regarded as deposits upon which the reserve requirement would be set at 0 percent, they would be subject to the 3 percent statutory minimum average reserve requirement on the sum of a member bank's domestic time deposits. Since the 3 percent minimum could reduce the attractiveness of the proposal for many member banks; as an alternative consideration might be given to exempting obligations of IBFs from deposit treatment, similar to the treatment accorded Federal funds borrowings and certain repurchase agreements.

IBFs could not advance credit to U.S. customers, except to other IBFs or to their own head offices; and advances to own head offices would be subject to the same reserve requirement that is imposed under Regulation M on net borrowings by member banks from their own foreign branches (which is zero at present).

Establishment of IBFs would be expected to result in the creation of a new dollar deposit in this country competitive with Euro-dollars but subject to U.S. laws and hence not subject to the "foreign country risk" generally attached to dollar deposits in banks outside the United States. Obligations issued by IBFs probably would carry somewhat higher yields than comparable deposits at domestic offices of member banks because of the absence of reserve requirements. As a result, foreigners might shift funds from other international banking centers and from banking offices in the United States to IBFs. Moreover, U.S. corporations — particularly those with foreign affiliates — might be encouraged by favorable terms to find ways of placing funds with IBFs.

Implications for Deposit Holdings

Various deposit shifts are likely to occur as a result of creation of an IBF. Foreign-owned Euro-dollar deposits may shift to an IBF. In addition, existing foreign deposits held in U.S. banking offices would also be eligible to move into an IBF. Foreign demand deposits in the United States total $18 billion, while foreign-owned time deposits amount to $12½ billion.

It is difficult to estimate the extent to which foreign deposits might be transferred to IBF facilities. The amount of funds shifted from U.S. offices would depend in part on whether drafts could be written on IBF accounts or whether other means could be employed for using IBF accounts for ordinary transactions purposes. For example, although the proposal states that IBFs would not be allowed to offer deposits subject to immediate withdrawal, IBFs might instead offer accounts on which drafts could be written that are payable the next business day — in much the same way as many Euro-dollar transactions are currently settled.

The volume of funds placed in IBFs would also be affected by whether the facility is available to foreign subsidiaries of U.S. corporations. Domestic companies would not be able to place funds directly with IBFs, but could do so indirectly through a foreign affiliate. Even if IBF accounts were not used directly for transactions purposes, some U.S. depositors — with foreign affiliates — might find short-term IBF obligations to be an attractive cash management instrument and might substitute IBF obligations for other short-term investments—such as RPs—and for demand deposits.

The availability of IBF accounts to various types of depositors has implications for measures of the monetary aggregates; for the level of required reserves; and for competitive relationships among foreign corporations, U.S. corporations with foreign subsidiaries, and other U.S. corporations. Whether foreign subsidiaries of U.S. companies should be permitted to hold funds in an IBF, or whether minimum maturities of funds placed in an IBF should be seven days rather than one day, would affect deposit holdings and competitive relationships. A 7-day minimum maturity would, for example, reduce the difference between

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time accounts in IBFs and minimum maturity time deposits in domestic banks.

Implications for Credit Availability

Currently, credit extended to foreigners by banking offices in the United States (including their own foreign branches) is estimated to exceed deposit and nondeposit liabilities to foreigners by about $20 billion.

However, it cannot be determined *a priori* whether the amount of foreign loans that could be shifted to IBFs from domestic offices would be larger or smaller than the amount of deposit and nondeposit funds that would be shifted, and thus it cannot be determined whether the availability of domestic credit to domestic sectors would be affected.

In the final analysis the impact on the availability of credit to domestic sectors will depend on the degree to which IBFs are linked to domestic markets. If no restrictions are applied to funds channeled from IBFs to domestic U.S. offices of the parent bank as would be the case with a zero reserve requirement on head office borrowings from the IBF, there would be no, or little, impact on the availability of domestic bank credit from creation of an IBF. Any difference between the volume of domestic deposits shifted to IBFs and the volume of foreign loans shifted from domestic offices could be reflected in transactions by IBFs with their domestic offices.

Alternatively, should reserve requirements apply to funds channeled from IBFs to domestic U.S. offices of the parent bank, there would be greater scope for a spread to develop between the rates at which IBFs would lend to head offices or other IBFs and the Federal funds rate.[1] The larger the reserve requirement the less closely would IBFs tend to be linked to domestic money markets, and the more likely that variations in flows of funds from domestic deposits to IBFs would be reflected in variations in their foreign lending.

Implications for Foreign Exchange Rates

The same general considerations would affect the extent to which shifts of funds from U.S. offices to IBFs would have an impact on the exchange rate for the dollar. By establishing a zero, or low, reserve requirement on lending by IBFs to domestic U.S. offices of the parent bank, the Board could minimize any possible adverse effect on the exchange rate that might otherwise result from a difference between the volume of deposits in domestic offices shifted to IBFs and the volume of foreign credits in the loan portfolios of those domestic offices that was shifted to IBFs. The Board's policy regarding reserve requirements on lending to domestic offices would thus likely receive increased attention if IBFs were established.

It may be noted that if IBF obligations were regarded as an especially attractive dollar asset, there might be an incentive for some foreign investors to shift funds from money market instruments denominated in foreign currencies to IBFs. As the IBFs advanced these funds to domestic U.S. offices, there would be a tendency for some modest strengthening in the exchange rate for the dollar.

The Effects of Competitive Balance among Banks

IBFs could affect the relative positions of banks, as well as of their foreign and domestic customers. The Board recognizes that if IBFs are to be established on a nationwide basis, adequate time would be needed to permit an opportunity for changes in State laws and regulations. The Board also recognizes that IBFs might also be operated by banks outside New York through Edge Corporations in New York. Various locations and modes of operations may have differeing impacts on banking institutions under current circumstances.

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The Board is considering the proposal and its desirability in light of its impact on monetary conditions, regulatory control, competitive balance and other factors.

Comment is invited from all parties on issues raised by the proposal. The Board would be particularly interested in views on the minimum maturity of accounts that might be held in an IBF, on reserve requirements applicable to head office borrowings from an IBF, on the advisability of making obligations offered by the facility available to foreign subsidiaries of U.S. corporations, on implications for competitive balance among banks, on the length of time that might be required for changes in State laws and regulations and the lead time that member banks would reasonably need in order to establish IBFs. Comment should be sent by March 15, 1979 to the Secretary of the Board, Board of Governors of the Federal Reserve System, Washington, D.C. 20551.

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[1] The Federal funds rate and the rate for loans by one IBF to another would tend to be equal in the absence of restrictions on flows of funds between IBFs and head offices; there would be no differences in country risk on loans in each market as there currently is between interbank Euro-dollar loans and Federal funds loans.

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