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COMMENT

International Banking Facilities

I. Introduction

As an incentive for the expansion of international banking activity in the United States, the Board of Governors of the Federal Reserve System has authorized the establishment of International Banking Facilities[1] by domestic banking institutions. The purpose of these IBFs, which in reality are merely separate sets of asset and liability ledgers, is to encourage the repatriation of international banking business that is now conducted in offshore financial centers as a result of restrictive U.S. banking regulations. These enabling regulations create, in effect, a banker's "free-trade zone" by permitting domestic banks to conduct their international banking business from an office located in the United States free from certain government regulations which heretofore had reduced the profitability of those international operations. IBFs are expected to operate as competitive equals in the international money market with foreign banks[2] and with foreign subsidiaries and branch

[1] International Banking Facilities, 12 C.F.R. §§ 204, 217 (1982) [hereinafter referred to as IBFs]. These IBF enabling regulations were promulgated on June 23, 1981, and became effective on December 3, 1981. *See* 46 Fed. Reg. 32,426 (1981).

[2] Foreign banking has not only been seen as an emerging threat to U.S. banking in the international market, but in the domestic market as well. The new regulatory changes relating to the establishment of IBFs attempt to neutralize the foreign threat to U.S. international banking by reducing the regulatory disadvantages of domestic operation. In 1978, Congress took a significant step toward achieving regulatory parity between domestic and foreign banks operating in the United States by enactment of the International Banking Act of 1978, Pub. L. No. 95-369, 92 Stat. 607 (codified in scattered sections of 12 U.S.C.) [hereinafter cited as IBA], which imposed new regulations affecting the U.S. operations of foreign banks. Until enactment of the IBA, foreign banks operating in the United States enjoyed a number of significant regulatory advantages over their domestic counterparts.

First, § 7 of the IBA subjects foreign bank branches having consolidated (worldwide) assets of $1 billion or more to the same cash reserve requirements imposed by the Federal Reserve on its member banks. Pub. L. No. 95-369, 92 Stat. 620-21 (codified at 12 U.S.C. § 310(a)(2)(B) (Supp. V 1981)). Second, § 7 of the IBA subjects foreign bank branches to the same statutory interest rate limitations and maturity constraints as those imposed by the Congress on U.S. depository institutions. Pub. L. No. 95-369, 92 Stat. 620 (codified at 12 U.S.C. § 3105(a)(1)(A) (Supp. V 1981)). *See infra* notes 5 and 6. Third, § 5(a) of the IBA limits the branching of foreign banks to one "home" state. Pub. L. No. 95-369, 92 Stat. 613 (codified at 12 U.S.C. § 3103(a) (Supp. V 1981)).

Prior to the enactment of the IBA, foreign banks operating in the United States were not subject to reserve requirements and interest rate controls. In addition, while domestic banks were statutorily restricted to operation in one state, 12 U.S.C. §§ 36(c), 321 and 1842(d) (1976 & Supp. V 1981), foreign banks operating in the United States could branch into as many states as

facilities of domestic banks.

II. Purpose of the IBF Regulations

The double burdens of Federal Reserve regulation and domestic taxation have prevented banks located in the United States from competing effectively with so-called "offshore"[3] banks in the growing international banking market.[4] Prior to the creation of IBFs, foreign banks and foreign branches of U.S. banks had an advantage over domestic banks, which were required to fund their international banking transactions with deposits subject to both the reserve requirements of "Regulation D"[5] and the maturity constraints and interest rate limitations of "Regulation Q."[6] Foreign banks, and U.S. banks with foreign subsidiar-

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they desired. The IBA restricts foreign bank operations to one state, just as their domestic counterparts. While foreign banks can still theoretically "branch" into additional states, they are, under § 5 of the IBA, subject to the same restrictions on their acceptance of deposits as those placed on domestic Edge Act corporations. *See infra* note 18. For further discussion of the IBA, *see generally* Skigen & Fitzsimmons, *The Impact of the International Banking Act of 1978 on Foreign Banks and Their Domestic Affiliates*, 35 BUS. LAW. 55 (1979). For an analysis of the effect of the IBA on North Carolina banks see Comment, *The Ramifications of the International Banking Act of 1978 on North Carolina: The Need to Adopt Legislation Enabling Foreign Banks to Establish Federal Agencies and Limited Branches*, 7 N.C.J. INT'L. L. & COM. REG. 67 (1982).

3 As used herein, an "offshore" bank is any company organized under the laws of a foreign country or a territory of the United States which engages in the business of banking outside of the United States, or any subsidiary, affiliate, or branch facility of a banking company organized under the laws of the United States or any state of the United States, which is located outside of the United States. *See generally* Gross, *Offshore Banks: Are They Free From U.S. Court Jurisdiction?*, NAT'L. L.J., Feb. 15, 1982, at 26-27.

4 The emergence of the multinational corporation and the developments of international trade and investment as major forces in an increasingly integrated world economy have created much competition in international banking. Because of the expanding number of U.S. companies operating overseas, U.S. banks have found it increasingly necessary to expand their international operations in order to compete for this business abroad. The worldwide expansion of business enterprises far beyond national borders has greatly encouraged the internationalism of banking. *See* U. STEUBER, INTERNATIONAL BANKING 1-3 (1976).

5 12 C.F.R. §§ 204.1-204.121 (1983). Bank acquisition of earning assets is constrained by these regulations, which require banks to retain a certain proportion of their deposit liabilities in noninterest-earning, nonprofitable cash items known as reserves, as prescribed in 12 C.F.R. § 204.9. Virtually all of a bank's earnings come from the return it receives on its loans and from its security holdings—reserve items do not earn income.

Only member banks of the Federal Reserve System are subject to the reserve requirements of Regulation D. All nationally chartered, and a small percentage of state chartered, commercial banks (including Edge Act corporations, *see infra* note 18) are members of the Federal Reserve. On June 30, 1975, out of 14,332 commercial banks in the United States, 4,732 were national banks and 9,600 were state chartered. Of those that were state chartered 1,064 were members of the Federal Reserve. Thus, approximately 40% of the commercial banking institutions in the United States are member banks. *See* 11 GUENTHER, BANKING IN THE UNITED STATES 6 (1976). As of June 30, 1970, however, national banks total deposits represented 58.7% of all deposits in commercial banks and state member banks' total deposits represented 21.2%, for an aggregate total of 79.9% of all deposits in commercial banks. *Id.*

Although not subject to Regulation 19, nonmember banks are governed by the reserve requirements established by the respective states. The levels of these requirements tend to be at least as high as the level set by the Federal Reserve. As of 1979, only Illinois nonmember banks were subject to no reserve requirements whatsoever. *See* L. THOMAS, MONEY, BANKING, AND ECONOMIC ACTIVITY 156-60 (1979).

6 Section 11(b) of the Banking Act of 1933 prohibits interest payments or demand depos-

ies or branch facilities, could lend money or invest from their offices abroad to the full extent of deposits received, and could fund these loans and investments by attracting deposits at market interest rates without maturity constraints. Domestic banks were required to forego lucrative lending and investing opportunities in order to hold a designated portion of their deposits as nonearning reserve assets.[7] At the same time, domestic banks could not compete effectively for foreign deposit balances because they could not offer equivalent high-yield interest payments, or place funds received in highly liquid accounts.[8] Thus, restrictive U.S. regulations have compelled domestic banks to operate overseas offices, at additional expense, in order to obtain their funds and lend them free from reserve requirements.

To circumvent regulatory restrictions and accomodate foreign depositors, domestic banks relocated their international banking operations offshore.[9] Use of offshore facilities[10] was seen by U.S. banks as essential to meet the growing challenge posed by foreign banks, which form a significant part of the international money market.[11] Many offshore lo-

its, and gives the Federal Reserve the authority to set maximum permissable rates that can be paid on savings and time deposits. Pub. L. No. 73-66, 48 Stat. 181-82 (codified as amended at 12 U.S.C. §§ 371a, 371b (Supp. V 1981)). Regulation Q relating to the payment of interest on deposits, forbids the payment of interest on demand deposits, 12 C.F.R. § 217.2 (1982), and subjects time deposits of less than $100,000 to interest rate limitations as set by schedule, ranging from 5¼ to 7¼%. 12 C.F.R. § 217.7(b) (1982). While time deposits over $100,000 are not subject to any maximum rate of interest, 12 C.F.R. § 217.7(a), all time deposits must remain on deposit for not less than 14 days. 12 C.F.R. § 217.1(c)(1) (1982).

7 12 C.F.R. §§ 204.3, 204.9 (1982).

8 *Id.* §§ 217.1 (1982).

9 Income earned abroad as a percentage of the total income of the 10 largest banks in the United States increased from 17.5% in 1970 to 42.6% in 1979. Guttentag & Herring, *Are International Banks Heading for Trouble?*, 38 BUS. & SOC'Y REV. 4 (1981). In 1965, 13 U.S. banks had $9.1 billion in assets at 211 overseas branches; by 1975, 126 American banks had $145.3 billion in assets at 762 foreign branches. Bellanger, *The Future of Foreign Banking in the United States or How to Get There (The International Banking Act of 1978 and Beyond)*, 1980 U. ILL. L.F. 21, 24. Between 1969 and 1972 in the Bahamas alone, the number of foreign branches of U.S. banks more than trebled from 31 to 94. STEUBER, *supra* note 4, at 12.

10 National banks, pursuant to § 25 of the Federal Reserve Act, 12 U.S.C. § 601 (1976 & Supp. V 1980), and state member banks pursuant to § 9 of the Federal Reserve Act, 12 U.S.C. § 321 (1976 & Supp. V 1981), are authorized to establish offshore branch facilities. Deposits received at and payable from these offshore branch facilities are not subject to Federal Reserve requirements, 12 U.S.C. § 461(b)(6) (Supp. V 1981), and interest rate restrictions. 12 U.S.C. §§ 371a, 371b (1976 & Supp. V 1981). A domestic bank, therefore, can circumvent Federal Reserve regulatory restraints by establishing either an offshore branch facility or an offshore subsidiary banking corporation organized under the laws of that country. U.S. banks must pay federal income tax of 46% on the income of their foreign branches, 26 U.S.C. §§ 11(a)-(b) (1976 & Supp. V 1981), while subsidiary facilities are subject to the income tax rates imposed by the country under whose laws they are organized. Currently, however, U.S. corporations may credit taxes paid to foreign governments against their U.S. income tax liability. *Id.* § 901. Tax considerations will, no doubt, determine whether a domestic bank will conduct its international operations offshore through a subsidiary or branch facility. The Bahamas and the Cayman Islands, for example, do not directly tax bank income. *See* Note, *Legal Prerequisites of International Banking Facilities in the United States*, 13 J. INT'L. L. & ECON. 695, 702 n.52 (1979). *See also* Miller, *Why Bankers Love the Cayman Islands*, 38 BUS. & SOC'Y. REV. 19, 20 (1981).

11 In 1972, seven out of the ten largest banks in the world were headquartered in the United States, while in 1979 only three of the ten largest were U.S. based. Heinz, *Foreign Take-*

cations, most notably those in the Caribbean, are merely "shell" branches which serve as mailing offices where, because of favorable banking laws, taxes and regulations, banks that conduct an international business find it convenient to keep their funds.[12] These "shell" branches usually perform few banking services, and exist mainly as a foreign office to house offshore deposits.[13]

Quite often, "shell" branches are merely licensed offices which are operated on an agency basis by banks or others having substantial facilities in those financial centers. The IBF regulations are, in part, designed to avoid some of the duplicate costs of maintaining these offshore facilities. Elimination, or reduction in the number, of these offshore facilities will repatriate international banking business back to the United States. The Federal Reserve, in order to attract this offshore business back to the United States, has authorized domestic banks to establish competing U.S.-based facilities.

Prior to the authorization of domestic IBFs, banks whose international operations were large enough to justify an office abroad, or at least a "shell" branch at an offshore location, enjoyed an advantage in international banking over those domestic banks too small to maintain such an office. Small banks may now begin to compete for foreign business by establishing an IBF which, under the new regulations, can be run from their home offices.[14] Larger banks which now conduct their interna-

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overs of U.S. Banking — A Real Danger?, 4 J. INST. SOCIOECON. STUD. No. 3, at 1, 2 (1979). From 1974 to 1979, U.S. banks have grown at a much slower rate than their foreign competitors. In dollar denominated amounts, U.S. banks grew 77% compared with 154% for their European counterparts and 151% for Japanese banks. *Id.*

[12] Miller, *supra* note 10, at 20. Favorite offshore locations which have benefitted from migration of the international banking operations include Switzerland, London, the Bahamas, Luxembourg, Panama, the Cayman Islands, Barbados, Bermuda and more recently, Hong King, Singapore and Bahrain. The United Kingdom has capitalized on U.S. regulation by allowing borrowing and lending relatively free from regulatory constraints. London has become the foremost center for international banking transactions. London has over 350 banks, and since 1969, new banks have opened at the rate of approximately one every two weeks. *See* WORLD BUSINESS WEEKLY, July 13, 1981, at 27-34. Switzerland remains the leader in absolute number of offshore bank branches, followed by the Bahamas and Panama. The Bahamas have over 300 foreign banks with a collective portfolio of $85 billion. *Id.* at 27-28. The Cayman Islands rank fourth worldwide. Georgetown, the capitol of Grand Cayman, the largest island in the Cayman group, has more banks per capita than any other city in the world. *See* Miller, *supra* note 10, at 20. *See also* STEUBER, *supra* note 4, at 69.

[13] *See* McCarthy, *Offshore Banking Centers: Benefits and Costs*, FIN. & DEV., Dec., 1979, at 45-48.

[14] Pursuant to 12 U.S.C. § 461(b)(5) (Supp. V 1981), the international banking facilities of nonmember depository institutions are required to maintain reserves to the same extent required by the Federal Reserve of the IBFs of member banks. Thus, small state-chartered nonmember regional banks whose domestic deposits are subject to state reserve requirements can nevertheless take advantage of the IBF reserve requirement exemption authorized by the Federal Reserve. Although Regulation D is only applicable to member banks, the IBF exemption under Regulation D is available to both members and nonmembers. *Id.*

Moreover, it should be noted that where a U.S. bank, or a branch of a foreign bank, maintains a net eurocurrency liability balance, *i.e.*, where there is a net positive inflow of funds into the U.S. office, the eurocurrency liability balance is only subject to a 3 percent reserve requirement. 12 C.F.R. §§ 204.4, 204.8(a) (1981). At least one commentator has noted that it would

tional operations from offshore locations are encouraged to establish a domestic IBF which will enable them to consolidate a large portion of their foreign banking business at a home office, thus reducing costs and increasing efficiency.[15] In addition, the Federal Reserve hopes to increase both the profits and employment opportunities at domestic banking locations through establishment of IBFs.[16]

III. An Overview of the IBF Regulations

All depository institutions located in the United States,[17] Edge Act corporations,[18] and branches and agencies of foreign banks operating in

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be advantageous for a bank without foreign branches to record foreign source deposits as IBF deposit liabilities because these IBF deposit liabilities could then be advanced to the establishing institution, and the establishing institution would only be subject to the 3 percent eurocurrency liability reserve requirement. *See* Note, *International Banking Facilities*, 13 L. & POL'Y. INT'L. BUS. 997, 1027 (1981). While deposits at IBFs are exempt from Federal Reserve requirements, under the IBF enabling regulations funds advanced to a U.S. banking office from its own IBF are subject to eurocurrency reserve requirements in the same manner as funds advanced from a bank's foreign offices to its U.S. offices. 12 C.F.R. § 204.2(h) (1982). This is a substantially more favorable rate than if the foreign source funds were simply recorded in an ordinary transactions account in the first instance. Therefore, it is beneficial for a small bank without any foreign branches to set up and segregate IBF accounts to accomodate these foreign source deposits.

[15] Shortly after the IBF enablign regulations were promulgated, a Chase Manhattan executive stated that the Bank would most likely move "most of its wholesale funding" being conducted in Nassau back to the United States. Wash. Post, June 10, 1981, § D, at 7, col. 4.

[16] *See Offshore Role for New York May Come*, THE BANKER, Apr. 1978, at 90. As many as 4,000 new jobs may be created in New York City alone. Increased activity in banking relating fields such as law and accounting is predicted. *See also* Note, *Legal Prerequisites of International Banking Facilities in the United States*, 13 J. INT'L. & ECON. 695, 710 (1979).

It was once believed that the creation of IBFs would increase federal tax revenues to the extent that U.S. banks had been receiving tax credit for taxes paid to foreign governments. *See supra* note 10. The fact is, however, that many offshore "shell" branches pay no local taxes, and the federal government is already receiving its full corporate tax payment from the income generated at these offshore facilities. Since it is expected that most of the IBF business would come from repatriation of business conducted at these offshore "shell" facilities, the increase in federal revenues will not be significant. *See* Letter from Robert Carswell, Secretary of the Treasury, to G. William Miller, Federal Reserve Board Chairman, reprinted in AM. BANKER, Mar. 12, 1979, at 10, col. 3. *See also* Note, *International Banking Facilities, supra* note 14, at 1006.

[17] For purposes of the IBF enabling regulations, the definition of "depository institution" includes:

— Any insured bank as defined in Section 3 of the Federal Deposit Insurance Act or any bank that is eligible to apply to become an insured bank under Section 5 of that Act;
— Any savings bank or mutual savings bank as defined in Section 3 of the Federal Deposit Insurance Act;
— Any insured credit union as defined in Section 101 of the Federal Credit Union Act or any credit union that is eligible to apply to become an insured credit union under Section 201 of that Act;
— Any member as defined in Section 2 of the Federal Home Loan Bank Act;
— Any insured institution as defined in Section 401 of the National Housing Act or any institution which is eligible to apply to become an insured institution under that Act.

The IBF regulations adopted by the Board of Governors are, therefore, broad enough to permit savings and loan associations and credit unions to establish IBFs to the extent permitted by their charters.

[18] An "Edge Act" corporation is a foreign banking corporation organized under § 25a of

the United States are permitted to establish IBFs.[19] An institution is not required to establish a separate organizational structure for an IBF; rather, it is contemplated that an IBF will be operated mainly as a bookkeeping entity.[20] An institution establishing an IBF, however, is required to maintain segregated accounts for its IBF, report the assets and liabilities of the IBF to the Board of Governors and comply with any other requirements designated by the Board.[21] Application to or approval by the Board is not, however, a prerequisite to the establishment of an IBF.[22]

The IBF regulations seek to achieve competitive parity between U.S. and foreign international banking operations in the international market while maintaining regulatory control over domestic banking activity. An IBF, therefore, may accept deposits only from non-U.S. residents and businesses.[23] An IBF can accept deposits from foreign affiliates of businesses based in the United States; however, these funds must be used to support the customer's operations outside of the United States.[24] An IBF is also permitted to obtain funds from: 1) foreign offices of other U.S. depository institutions; 2) Edge Act corporations; 3) foreign banks; 4) other IBFs; and 5) U.S. and non-U.S. operations of the establishing institution.[25] These IBF deposit liabilities will not be subject to Federal Reserve interest rate limitations and maturity con-

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the Federal Reserve Act. 12 U.S.C. §§ 611-632 (1976 & Supp. V 1981). Edge Act corporations are chartered by the Federal Reserve "for the purpose of engaging in international or foreign banking or other international or foreign operations." 12 U.S.C. § 611 (1976). Edge Act corporations are not bank branches, rather, they are independent, federally chartered domestic banking corporations which may engage in foreign operations. They are often subsidiaries of domestic banks, and while they are authorized to conduct an international banking business, Edge Act corporations are also subject to Federal Reserve constraints. Edge Act banks, in effect, operate as interstate branches of their parents, and enable the parent institution to operate in an office outside of its "home" state.

Section 3 of the IBA, Pub. L. No. 95-369, 92 Stat. 608 (codified at 12 U.S.C. § 611a (Supp. V 1981)), instructed the Federal Reserve to review and revise its existing regulations so as to enable Edge Act corporations to better compete with foreign institutions in international banking, and to encourage regional and small banks to enter international markets. Moreover, § 3(e) of the IBA amended § 25a of the Federal Reserve Act by removing the previously mandated 10% minimum reserve requirement on the domestic deposits of an Edge Act corporation. Pub. L. No. 95-369, 92 Stat. 609 (codified at 12 U.S.C. § 615 (Supp. V 1981)). The amendment provided, however, that the domestic deposits of an Edge Act corporation remain subject to the same reserve requirements as a Federal Reserve member bank. The Federal Reserve has amended its Regulation K, 12 C.F.R. § 211.4(d) (1981), to conform with the removal of the statutory minimum reserve requirement; thus, pursuant to 12 C.F.R. § 204.1(c)(3) (1981), Edge Act corporations are required to comply with the provisions of Regulation D in the same manner and to the same extent as are member banks. Edge corporations, however, are subject to a more restrictive lending limit scheme than are commercial banks despite the fact that they are now subject to the same reserve requirements. *See* 12 C.F.R. § 211.6 (1981).

[19] 12 C.F.R. § 204.8(d) (1982).

[20] *Id.*

[21] *Id.* at § 204.8(f).

[22] 46 Fed. Reg. 32,428.

[23] 12 C.F.R. § 204.8(a)(2)(ii)(B) (1982).

[24] *Id.*

[25] *Id.* at § 204.8(a)(2)(i)(B)(1) to (i)(B)(5).

straints. Furthermore, when reserve requirements are computed for an institution which has established an IBF, the amount of its IBF deposits is not included in the aggregate deposit balance.[26] An IBF can extend credit to: 1) non-bank foreign residents and businesses, for the limited purpose of financing non-U.S. operations; 2) foreign banks; 3) other IBFs; and 4) the U.S. and non-U.S. offices of the establishing institution.[27] An IBF is also permitted to accept deposits and make loans in currencies other than U.S. dollars.[28]

The Federal Reserve Board intended to facilitate the provision of international banking services at the banking offices of domestic banks located in the United States; however, the Fed was concerned about "leakage" of reserve-free IBF accounts into the domestic monetary system. The Fed, accordingly, took steps to prevent IBFs from being used to circumvent domestic reserve requirements and interest rate controls by imposing limitations on the sources and the uses of IBF deposit liabilities.[29]

IBFs have been analogized to a bonded warehouse. Goods imported into the United States can be placed in a bonded warehouse without payment of any customs duties, and if the goods are subsequently shipped to another country without ever entering the U.S. market, duties are never levied. If the goods are sold in the U.S., however, a duty must be paid. By analogy, funds which are deposited in IBFs must come from foreign sources, and they can be lent directly to foreign sources free from reserve requirements and interest rate constraints. As long as the funds do not enter the U.S. money market, the funds remain free from regulation.[30]

An IBF may only obtain funds through time deposit instruments; maturity on such obligations, however, can be on an overnight basis.[31] By redefining time deposits to include those IBF obligations which remain on deposit overnight, the Board of Governors has remained in compliance with federal legislation prohibiting payments of interest on demand deposits.[32] Because IBF deposits are classified as time deposits, interest can be paid on the funds deposited; at the same time, the liquidity advantage of a demand deposit is retained because the funds can be withdrawn the very next day. Moreover, the Board has provided that there is no minimum rate of interest prescribed on any IBF time deposits;[33] therefore, interest can be paid at the competitive market rate.[34]

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[26] *Id.* at §§ 204.8(a), 204.8(c).

[27] *Id.* at §§ 204.8(a)(3)(i)(a) to (3)(vi).

[28] *Id.*

[29] *See* Key & Bellanger, *International Banking Facilities: The Shape of Things to Come*, THE WORLD OF BANKING, March-April, 1982, at 17, 18.

[30] *See* Note, *International Banking Facilities, supra* note 14, at 997-1046.

[31] 12 C.F.R. § 204.8(a)(2)(i)(A) (1982).

[32] 12 U.S.C. § 371(a) (1976 & Supp. V 1981).

[33] 12 C.F.R. § 217.7(a) (1982).

[34] Because the Board of Governors believes that IBFs should be established primarily to

Furthermore, IBFs are prohibited from issuing negotiable instruments,[35] such as negotiable certificates of deposit and banker's acceptances, because such instruments could be transferred by the original holder to U.S. residents or businesses who are not eligible deposit customers of IBFs. IBFs may, however, engage in limited kinds of secondary market transactions as long as they purchase or sell IBF-eligible assets in "arm's length" transactions.[36]

For purposes of illustration, the following extensions of credit are among those permitted to an IBF (it should again be noted that extensions of credit by an IBF are limited to those made to finance the customer's non-U.S. operations):

* An IBF may accept and discount drafts presented by its customers, provided the drafts are held to maturity and that the customer qualifies to borrow from an IBF;
* A U.S. parent of a borrower from an IBF may guarantee a loan made by the IBF to the borrowing foreign subsidiary;
* An IBF may issue a letter of credit even if the beneficiary is a U.S. resident if the account party to the underlying transaction is eligible to borrow from the IBF. Drawdowns under the letter of credit may be made by means of a draft;
* An IBF extension of credit may be secured by a mortgage on property located in the United States, or by shares of a U.S. corporation. If the obligor defaults on the loan, the collateral may be held by the IBF consistent with prudent banking practice.[37]

In order to assure that funds of an international banking facilities are not used for domestic purposes, an IBF must advise its nonbank de-

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conduct "wholesale banking," IBF time deposits of nonbank foreign residents and businesses are subject to a minimum transaction requirement of $100,000 for both deposits and withdrawals. Furthermore, IBF time deposits of nonbank foreign residents and businesses are subject to a minimum fixed maturity, or required notice of withdrawal of at least 2 business days. 12 C.F.R. §§ 201.8(a)(2)(ii)(A)(1) to (ii)(A)(3), (ii)(B), (ii)(C) (1982).

Under Regulation Q, 12 C.F.R. § 217.7(a) (1982), time deposits of $100,000 or more are not subject to any interest rate ceiling, therefore, the new regulations do not effectively remove interest rate limitations on the deposits of nonbank foreign residents and businesses. The new regulations do, however, significantly reduce the maturity requirements on interest-earning deposits of nonbank foreign residents and businesses. *See supra* note 6.

35 12 C.F.R. § 204.8(c) (1982).

36 It should also be noted that an IBF is not intended to enable foreign customers to maintain transaction accounts at domestic banking locations exempt from reserve requirements and interest rate controls. Accordingly, an IBF may not accept transaction accounts. 12 C.F.R. § 204.8(c) (1982). A "transaction account" is an account on which the account holder is permitted to make withdrawals by negotiable instrument, payment order, telephone or electronic transfer or similar device which enables the account holder to make payments or transfers to third parties. *See* 12 C.F.R. § 204.2(e) (1982).

37 Except as specially prohibited by the enabling regulations adopted by the Board of Governors, there is no limitation upon the activities in which an IBF may engage. Consequently, if authorized by the institution's chartering or licensing authority, an IBF may engage in such activities as providing fiduciary services. Conversely, an establishing institution may not engage in any type of activity through its IBF not already permitted under its federal or state charter or license. Therefore, for example, a federal savings and loan association could establish an IBF since it is a depository institution, *see supra* note 17, but it could not make unsecured commercial loans through its IBF because a federal savings and loan association is not permitted to make such loans under federal law. *See* Key & Bellanger, *supra* note 29.

posit and loan customers that the Fed intends IBF funds not to be used to support or finance the domestic operations of a customer.[38] The IBF must obtain an acknowledgment of the receipt of this notice from each of its customers when the customer opens a loan or deposit relationship with the IBF.[39]

Although Federal Reserve authorization of IBFs is expected to reduce the number of U.S. banks operating subsidiaries and branch facilities offshore, these offshore locations remain attractive to domestic bankers because of the significant tax advantages they offer.[40] Currently, the combined weight of federal, state and local taxes on bank income amounts to 62.3 percent in the United States while the percentage of tax on bank income in London, Bahrain and Singapore is significantly more favorable at 52, 20 and 10 percent, respectively.[41] While the regulations permitting domestic banks to establish IBFs will lessen the disparity between domestic and offshore operations, tax reductions at the state and local level are necessary if U.S. banks are to become truly competitive

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[38] All nonbank international banking facility depositors and loan customers must receive notice in writing of the Board of Governors of the Federal Reserve System's policy regarding international banking facility transactions. The following notice is suggested by the Board of Governors of the Federal Reserve System:

> It is the policy of the Board of Governors of the Federal Reserve System that, with respect to nonbank customers, deposits received by international banking facilities may be used only to support the non-U.S. operations of a depositor (or its foreign affiliates) located outside the United States and that extensions of credit by international banking facilities may be used only to finance the non-U.S. operations of a customer (or its foreign affiliates) located outside the U.S.

12 C.F.R. § 204.8(b) (1982).

[39] The international banking facility regulations require acknowledgement of receipt of the notice of the Board of Governors of the Federal Reserve System's policy concerning international banking facility transactions from nonbank customers that are foreign affiliates of United States residents. The form of acknowledgement suggested by the Board of Governors of the Federal Reserve System is as follows:

> ___________, a nonbank entity located outside of the U.S., understands that it is the policy of the Board of Governors of the Federal Reserve System that deposits received by international banking facilities may be used only to support the non-U.S. operations of a depositor (or its foreign affiliates) located outside the United States and that extensions of credit by international banking facilities may be used only to finance the non-U.S. operations of a customer (or its foreign affiliates) located outside the U.S.; or
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> ___________ acknowledges that funds it deposits with the international banking facility of ________ will be used solely in support of its non-U.S. operations, or that of its foreign affiliates, and that the proceeds of its borrowings from the international banking facility will be used solely to finance its operations outside the United States, or that of its foreign affiliates.

12 C.F.R. § 204.8(b) (1982).

[40] *See* Wall St. J., June 11, 1981, at 1, col. 5. Christopher Ball, Inspector of Banks in the Cayman Islands, expects the Federal Reserve's move to reduce the volume of the thriving offshore bank branches there; however, he says that the Caymans (and the Bahamas) still offer important tax advantages, and predicts that some banks will maintain branches both in the U.S. and offshore. From January 1, 1981, when the Federal Reserve plan was already circulating, to June 11, 1981, 36 U.S. and foreign banks had established branches in the Caymans. This brought the total of such offshore branches to 360. *Id. See also* STEUBER, *supra* note 4, at 13. *See* Miller, *supra* note 10, at 10.

[41] *See Offshore Role for New York May Come, supra* note 16, at 91.

with their counterparts abroad.[42] Presumably, banks operating in the offshore centers in which there is no local taxation would be reluctant to repatriate those operations to a jurisdiction where local taxation is substantial.

IV. State Tax Legislation

The North Carolina General Assembly has amended its tax law to provide for favorable treatment of IBFs located within the State.[43] The North Carolina[44] tax amendment is patterned after a New York statute,[45] and allows a deduction of certain IBF income in computing state corporation income tax. The New York statute permits a banking institution to deduct its "adjusted eligible net income"[46] derived from international banking transactions in computing its taxable income. To qualify, the income must originate from foreign sources outside of the United States.[47] As one commentator has noted, the New York tax statute "establishes a complex formula for determining an IBF's 'adjusted

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[42] *Id.* There have been no modifications to federal tax statutes for IBFs; therefore, under federal law, income and expenses of an IBF are not distinguished from those of the establishing institution for tax purposes.

At least one commentator believes that the "low country risk" associated with investments made in the United States may attract banking business to domestic IBFs, notwithstanding the greater tax burden, at least as long as IBFs can offer competitive market rates of return at competitive market maturities without reserve requirements. The United States is recognized as an extremely attractive place to deposit funds because of its "political stability, rule of law, and absence of more powerful and aggressive neighbors." Bellanger, *A European's View of International Banking Facilities*, AM. BANKER, June 26, 1981, at 14, col. 2.

[43] Act of July 7, 1981, ch. 855, 1981 N.C. Sess. Laws 1241 (codified as amended at N.C. Gen. Stat. §§ 105-130.5(b)(13), 105-102.3, 105-122(b) (Supp. 1981)).

[44] Substantially similar legislation has recently been enacted in several other states as well. *See, e.g.*, Cal. Rev. & Tax Code §§ 23044, 25107 (West Supp. 1981); Conn. Gen. Stat. Ann. § 12-217 (West Supp. 1982); Fla. Stat. Ann. §§ 220.62(3), 220.63(5) (Supp. 1981); Ga. Code Ann. §§ 41A-3301 to 3311 (1974 & Supp. 1982); Ill. Ann. Stat. Ch. 120 § 3-304(3)(c)(2) (West Supp. 1982); Md. Ann. Code art. 81, § 128A (Supp. 1982). In some states, special tax relief legislation for IBFs is unnecessary; Texas, for example, does not impose a tax on corporate income.

"Disembodied" IBFs which may be established independently of an otherwise licensed financial institution seem to be permitted only in Georgia under Ga. Code Ann. § 41A-3304 (Supp. 1982); however, such "disembodied" IBFs would appear to be inconsistent with the Fed enabling regulations.

[45] N.Y. Tax Law §§ 1450-1455 (McKinney 1975 & Supp. 1981). The New York banking community, recognizing that its preeminence in the field of international banking had been eroding due to federal regulatory requirements and state and local taxation, originally proposed that domestic banks be permitted to create U.S.-based IBFs. This position was supported by the New York legislature in prospective tax legislation enacted on June 19, 1978. The lawmakers believed that federal regulatory changes would attract the international banking business back to the United States, and that passage of a favorable state tax statute would attract that business back to New York. N.Y. Tax Law § 1450 note on legislative buildings and declarations (McKinney Supp. 1981). In the hope of hastening Federal Reserve action the legislation was passed with the provision that it would become effective contingent upon recognition of IBFs by the Federal Reserve. This provision firmly established that New York based IBFs would be exempt from state and local taxation when and if the Federal Reserve permitted their creation through implementation of the necessary regulatory changes.

[46] N.Y. Tax Law § 1453(b) (McKinney Supp. 1981).

[47] *Id.* The pertinent statutory provisions read as follows:

(f) There shall be allowed as a deduction from entire net income, to the ex-

eligible net income' " which "includes the following basic elements: 1) 'Eligible net income,' 2) the 'ineligible funding amount' and 3) the 'floor amount.' "[48] Some of the other states that have enacted tax relief legislation for IBF operations have instituted a less cumbersome procedure by eliminating the concepts of "ineligible funding" and "the floor amount." In any event, it is noteworthy that the provisions for tax relief differ considerably among those states that have enacted special tax legislation for IBFs, reflecting differences in both the complexity of the underlying tax structures and the amount of the tax relief provided for IBF operations.

Under the North Carolina tax relief statute,[49] "eligible income" of an IBF must also originate from foreign sources outside the United States. To the extent that eligible IBF income is included in determining federal taxable income, it is deductible from federal taxable income for the purpose of determining state net income.[50] Deposits held by an IBF

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tent not deductible in determining federal taxable income, the adjusted eligible net income of an international banking facility determined as follows:

(1) The eligible net income of an international banking facility shall be the amount remaining after subtracting from the eligible gross income the applicable expenses.

(2) Eligible gross income shall be the gross income derived by an international banking facility from:

(A) Making, arranging for, placing or servicing loans to foreign persons, provided, however, that in the case of a foreign person which is an individual, or which is a foreign branch of a domestic corporation (other than a bank), or which is a foreign corporation or foreign partnership which is either eighty per centum or more owned or controlled, either directly or indirectly by one or more domestic corporations (other than banks), domestic partnerships or resident individuals, substantially all of the proceeds of the loan are for use outside of the United States.

(B) Making or placing deposits with foreign persons which are banks or foreign branches of banks (including foreign subsidiaries or foreign branches of the taxpayer) or with other international banking facilities; or

(C) Entering into foreign exchange trading or hedging transactions related to any of the transactions described in this paragraph.

(3) Applicable expenses shall be any expenses or other deductions attributable directly or indirectly, to the eligible gross income described in paragraph two of this subsection.

(8) For purpose of this subsection the term "foreign person" means:

(A) An individual who is not a resident of the United States.

(B) A foreign corporation, a foreign partnership or a foreign trust, as defined in section seventy-seven hundred one of the internal revenue code of nineteen hundred fifty-four, other than a domestic branch thereof.

(C) A foreign branch of a domestic corporation (including the taxpayer).

(D) A foreign government or an international organization of an agency of either, or

(E) An international banking facility.

48 Key & Bellanger, *supra* note 29, at 20.

49 N.C. Gen. Stat. § 105-130.5(b)(13) (Supp. 1981).

50 *Id*. The pertinent statutory provisions read as follows:

(b) The following deductions from federal taxable income shall be made in determining State net income:

(13) The eligible income of an international banking facility to the extent included in determining federal taxable income, determined as follows:

b. The eligible income of an international banking facility for the taxable year shall be an amount obtained by multiplying State taxable income as determined under G.S. 105-130.3 (determined without regard to eligible income of an

located in North Carolina, therefore, will be exempt from state and local income taxes as well as the reserve requirements and interest rate controls of the Federal Reserve. In Florida, special IBF tax relief legislation was enacted to insure that all IBF operations would be exempt from Florida income and other taxation even though foreign source income is generally not subject to Florida state income taxes.[51] There is no exclusion from federal income taxation for the qualified income of an IBF. As a result, income arising from IBF activities is subject to U.S. federal income taxation in the same manner as other income of the domestic office of the establishing institution. Nevertheless, major impediments to the establishment of competitive international banking operations in the United States have been removed by federal regulatory and state legislative action.

As part of the overall scheme to attract offshore banking business back to the State, the North Carolina tax amendment also exempts the assets of IBFs in calculating both state privilege license taxes on banks and the state corporation franchise tax.[52] Under that statute, the assets belonging to a bank operating an IBF upon which the annual privilege tax is levied are reduced by the average amount of all assets of the IBF loaned or invested outside of the United States for the taxable year.[53] Moreover, in determining the state corporation franchise tax, the statute provides that the capital base of an IBF is to be reduced by the excess, at the end of the taxable year, of all assets employed outside of the United

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international banking facility and allocation and apportionment, if applicable, for such year by a fraction, the denominator of which shall be the gross receipts for such year derived by the bank from all sources and the numerator of which shall be the adjusted gross receipts for such year derived by the international banking facility from:

1. Making, arranging for, placing or servicing loans to foreign persons substantially all the proceeds of which are for use outside the United States.

2. Making or placing deposits with foreign persons which are banks or foreign branches of banks (including foreign subsidiaries or foreign branches of the taxpayer) or with other international banking facilities; or

3. Entering into foreign, exchange trading or hedging transactions related to any of the transactions described in this paragraph.

c. The adjusted gross receipts shall be determined by multiplying the gross receipts of the international banking facility by a fraction the numerator of which is the average amount for the taxable year of all assets of the international banking facility which are employed outside the United States and the denominator of which is the average amount for the taxable year of all assets of the international banking facility.

d. For the purposes of this subsection the term "foreign person" means:

1. An individual who is not a resident of the United States.

2. A foreign corporation, a foreign partnership or a foreign trust, as defined in section 7701 of the Internal Revenue Code of 1954, other than a domestic branch thereof.

3. A foreign branch of a domestic corporation (including the taxpayer).

4. A foreign government or an international organization or an agency of either, or

5. An international banking facility.

[51] Key & Bellanger, *supra* note 29, at 20.

[52] N.C. Gen. Stat. §§ 105-102.3, 105-122(b) (Supp. 1981).

[53] *Id.* § 105-102.3.

States over the liabilities owed to foreign persons.[54] Concurrently, local governments are prohibited from levying a license or privilege tax on an IBF under the tax relief statute.[55]

States which have not amended their tax laws to take advantage of the IBF enabling regulations are likely to lose out on the opportunity to gain any significant portion of the returning international banking business. Those operations will inevitably repatriate onshore only in jurisdictions offering the added tax benefits. Moreover, domestic banks not headquartered in states which have enacted favorable tax legislation for IBFs will, no doubt, choose to establish their international operations in a state with accomodating tax laws. Although federal law prohibits banks from establishing branch facilities outside of their home state,[56] domestic banks can establish out-of-state Edge Act subsidiaries for the limited purpose of conducting international banking operations.[57] Under the federal enabling regulations, these Edge Act corporations are permitted to establish IBFs.[58] As a result, a state which chooses not to amend its tax law stands to lose not only returning offshore international operations, but the international operations of smaller, regional banks as well. Instead of establishing a "shell" branch in the Caribbean as was commonplace before the enabling regulations, these smaller domestic banks are now encouraged to establish an IBF as an Edge Act subsidiary corporation in a state providing IBF tax relief.

Thus, it should not be long before more states follow the lead of New York, North Carolina, Florida and the others, and amend their tax laws to facilitate the establishment of local IBFs. Until that time, those more progressive states which have amended their tax laws to provide for favorable treatment of IBFs should claim a disproportionate amount of the increased international banking business generated in the United States by the Federal Reserve enabling regulations.[59]

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[54] *Id.* § 105-122(b).

[55] *Id.* § 105-102.3.

[56] 12 U.S.C. §§ 36(c), 321, 1842(d) (1976 & Supp. V 1981).

[57] *See supra* note 18.

[58] 46 Fed. Reg. 32,426, at 32,429 (to be codified at 12 C.F.R. § 204.8(a)(1)).

[59] As of September 8, 1982, total IBF assets were $152 billion. IBFs in New York accounted for about 78 percent of this total; in California, for about 13 percent; in Illinois, for about 6 percent; and in Florida, for about 2 percent. *See* FED. RES. BULL., Oct., 1982, 565, at 569. As of September 8, 1982, nearly 400 banking institutions in the United States had established IBFs. 176 were established in New York, 70 in California, 60 in Florida, 23 in Illinois and 15 in Texas. The remaining 51 are distributed throughout 12 states, and the District of Columbia, including a few in North Carolina. *Id.*

Of 126 Fed member banks that have established IBFs, 23 have related IBFs in at least one other state established by offices of their subsidiary Edge Act corporations. *Id.* at 577 n.11. It should be noted, however, that of all the IBFs established by September 8, 1982, only 219 (55 percent) had total assets or liabilities of $50 million or more; of these, though, 38 had total assets or total liabilities of $1 billion or more. *Id.* at 569.

V. Establishment of IBFs

A. *Procedures for Establishing an IBF*

Notification of intent to establish an IBF must be given to the Federal Reserve Bank of the district in which the establishing institution is located at least fourteen days prior to the first reserve computation period in which an institution intends to establish an IBF.[60] Various of the states which have adopted IBF legislation require notice of establishment of an IBF and/or submission of an application for permission to do so; however, an institution is not required to submit an application to the Board of Governors of the Federal Reserve System, or to receive approval by the Board of Governors, in order to establish an IBF.[61]

B. *Record Keeping Requirements and Reports*

An institution maintaining an IBF is required to segregate the asset and liability accounts of its IBF and to submit such reports of operations as may be required by the Board of Governors. In addition, the establishing institution must comply with any other requirements that the Fed establishes for IBFs from time to time.[62] Weekly reports will also be required from all IBFs with assets or liabilities exceeding $50 million.

The weekly reports must include information on dollar-denominated assets and liabilities, by types of customers and by maturity. The reports must also include information on an IBF's total nondollar denominated assets and liabilities. A report on assets and liabilities transferred to an IBF within the first four weeks after its operations commence will also be required. Additionally, quarterly reports are required; and, the quarterly reports will be publicly available.[63]

C. *Examination and Supervision Procedures*

IBFs are subject to the same examination and supervisory procedures as apply to other operations of its parent institution. It is the announced intent of the Board of Governors to conduct examinations of IBFs in conjunction with the regular bank examinations of the establishing institution.[64]

Failure to comply with the requirements and restrictions applicable to IBFs or to the establishing institution can result in the imposition of certain penalties. These penalties include the imposition of reserve re-

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[60] 12 C.F.R. § 204.8(e) (1981).

[61] 46 Fed. Reg. 32,426, 32,428 (1981), *See* 12 C.F.R. § 204.8(c) (1982).

[62] 12 C.F.R. § 204.8(f) (1981).

[63] For a series of questions and answers prepared by the staff of the Federal Reserve Bank of New York, in consultation with the staff of the Board of Governors of the Federal Reserve System, regarding the establishment of IBFs, see Federal Reserve Bank of New York, Circular No. 9174, Oct. 27, 1981, and Federal Reserve Bank of New York, Circular No. 9197, Nov. 27, 1981.

[64] 46 Fed. Reg. 32,426, 32,428 (1981), *See* 12 C.F.R. § 204.8(f) (1982).

quirements on the IBF, the subjection of the deposits of the IBF to the interest rate controls of "Regulation Q" and the revocation of the establishing institution's authority to maintain and operate an IBF.[65]

D. *Funding the Initial Operation of an IBF*

Assets may be transferred to a newly established IBF only during the first four reserve computation periods after the founding institution has established the IBF.[66] It appears that assets may be transferred from one banking entity to an IBF established by another bank. Such a transfer may be accomplished by the sale of assets (to be transferred to the IBF) to the establishing institution followed by a transfer of such assets into the IBF during the first four computation periods after the establishment of the IBF.

VI. Conclusion

Prior to the adoption of the Federal Reserve IBF-enabling regulations, foreign banks and U.S. banks with foreign offices had an advantage over U.S. banks operating without overseas facilities. Federal law required domestic banks to fund their international operations with deposits subject to reserve requirements and interest rate and maturity restrictions. Foreign banks and U.S. banks with offshore facilities, on the other hand, could operate from their offices abroad without the burden of reserve requirements, and could fund their investments with deposits of any maturity. Foreign banks attracted these deposits by offering competitive market interest payments. This inequity between foreign and domestic banks helped to drive international operations of U.S. banks offshore.

The Federal Reserve has attempted to repatriate a portion of this foreign business back to the United States by authorizing domestic banks to establish IBFs, which would operate under essentially the same terms as do foreign branches. Although the Federal Reserve has removed the regulatory disparity between domestic and offshore operation, many locations abroad offer significant tax advantages. Tax incentives at the state and local level are considered to be essential if domestic IBFs are to be truly competitive with their international banking counterparts abroad.

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[65] 46 Fed. Reg. 32,426, 32,427 (1981) (to be codified at 12 C.F.R. § 204.8(e)).

[66] Assets acquired by an IBF from a domestic office of the establishing institution are generally considered to be eurocurrency liabilities against which reserves must be maintained. *See supra* note 14. However, if assets are transferred to a newly established IBF by the founding institution during the first four reserve computation periods after the IBF has been established, that transfer can be made without the IBF incurring eurocurrency liabilities against which reserves must be maintained. 12 C.F.R. §§ 204.2(h)(1) n.1, 204.2(h)(2) n.1 (1981).