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Bowman Brown

Gregory J. Willis

BANKING REPORT

BOWMAN BROWN*
GREGORY J. WILLIS**

INTERNATIONAL BANKING FACILITIES—NEW COMPETITION IN EURODOLLAR MARKETS?

I. INTRODUCTION

In a move designed to repatriate some of the international banking business now conducted in offshore financial centers, the Board of Governors of the Federal Reserve System has approved regulations permitting the establishment of international banking facilities (IBFs).[1] The Board of Governors implemented the plan by amending Regulations D[2] and Q[3] of the Federal Reserve to eliminate reserve requirements and interest rate ceilings certain deposits of foreigners in U.S. banks. By easing federal restrictions on domestic banks engaged in wholesale international banking, it is anticipated that an atmosphere of competitive equality will be created between domestic and foreign banks. This article will describe and analyze the IBF regulations and their probable consequences for the U.S. banking industry.

An IBF is simply a domestic office of a U.S. depository institution, branch or agency of a foreign bank, or Edge Act corporation that engages in wholesale international banking activities.[4] The IBF cannot exist independent of these recognized banking institutions but rather is an office or department of one of these banking entities at which its Eurodollar transactions are booked. Operating primarily as a record keeping entity, an IBF will be similar to an offshore shell

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*Mr. Brown is an Adjunct Professor of Law at the University of Miami School of Law and is a partner in the law firm of Shutts & Bowen, Miami, Florida.

**Mr. Willis, former Editor-in-Chief of the *Lawyer of the Americas*, received his J.D. from the University of Miami School of Law in May 1981.

1. 46 Fed. Reg. 32426 (1981).
2. 12 C.F.R. Part 204 (1981) (Reserve Requirements of Depository Institutions).
3. *Id.* Part 217 (1981) (Interest on Deposits).
4. 12 C.F.R. § 204.8(a)(1) (effective December 3, 1981) (published at 46 Fed. Reg. 32429 (1981)) provides the following definition:

> "*International banking facility*" or "*IBF*" means a set of asset and liability accounts segregated on the books and records of a depository institution, United States branch or agency of a foreign bank, or an Edge or Agreement Corporation that includes only international banking facility time deposits and international banking facility extensions of credit.

branch.[5] Thus, the new IBFs will not displace any existing international banking institutions, but, to the contrary, they supplement such entities by allowing them to participate in the Eurodollar market with a minimum of regulation.

To establish an IBF, a bank need only notify the Federal Reserve Bank in its District fourteen days prior to the first reserve computation period during which it intends to begin accepting IBF deposits.[6] This notice must contain a statement of intention to comply with all regulations pertaining to IBF operations.[7] No formal application procedure or prior approval of the Board is required by the regulations. Banking institutions must, however, maintain segregated accounts for IBF transactions,[8] report their IBF assets and liabilities as required by the Board, and comply with other regulations that may be imposed by the Board. The imposition of reserve requirements or the revocation of the IBF's license are potential sanctions for failing to comply with the Board's regulations.[9]

II. The Eurodollar Trading Market

Currently, the wholesale trading of Eurodollars[10] is transacted through international banking centers such as London, the Bahamas,

5. 46 Fed. Reg. 32427 (1981).
6. 12 C.F.R. § 204.8(e) (effective December 3, 1981) (published at 46 Fed. Reg. 32430 (1981)).
7. *Id.*
8. *Id.* § 204.8(f).
9. *Id.* § 204.8(e).
10. Eurodollars are U.S. dollars held abroad. The IBF proposal applies to the trading of all Eurocurrencies and 12 C.F.R. § 204.2(h) (effective December 3, 1981) (published at 46 Fed. Reg. 32428 (1981)) precisely defines Eurocurrency liabilities as follows:

> (1) For a depository institution or an Edge or Agreement Corporation organized under the laws of the United States, the sum, if positive, of the following:
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> (i) Net balances due to its non-United States offices and its international banking facilities ("IBFs") from its United States offices;
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> (ii)(A) For a depository institution organized under the laws of the United States, assets (including participations) acquired from its United States offices and held by its non-United States offices, by its IBF, or by non-United States offices of an affiliated Edge or Agreement Corporation; or
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> (B) For an Edge or Agreement Corporation, assets (including participations) acquired from its United States offices and held by its non-United States offices, by its IBF, by non-United States offices of its U.S. or foreign parent institution, or by non-United States offices of an affiliated Edge or Agreement Corporation; and
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> (iii) Credit outstanding from its non-United States offices to United States residents (other than assets acquired and net balances due from its

Singapore, and the Cayman Islands. These centers are characterized by minimal government regulation and taxation on wholesale loans and deposits. Typically there are no reserve requirements or interest rate restrictions, and they possess overnight deposit and withdrawal capabilities. Some international banking centers are not natural banking centers in the sense that there are no local businesses or industry. These centers attract international banking and finance activities solely by virtue of favorable tax and regulatory treatment. The highly competitive Eurodollar market includes both the interbank transfers and trading of dollars as well as the private trading, deposits, and borrowings of individuals and corporations. It should be noted that foreign branches of U.S. banks already participate in the Eurodollar market;[11] thus, IBFs will be competing with those banks for a portion of the Eurodollar market.

United States offices), except credit extended (A) from its non-United States offices in the aggregate amount of $100,000 or less to any United States resident, (B) by a non-United States office that at no time during the computation period had credit outstanding to United States residents exceeding $1 million, (C) to an international banking facility, or (D) to an institution that will be maintaining reserves on such credit pursuant to this Part. Credit extended from non-United States offices or from IBFs to a foreign branch, office, subsidiary, affiliate of other foreign establishment ("foreign affiliate") controlled by one or more domestic corporations is not regarded as credit extended to a United States resident if the proceeds will be used to finance the operations outside the United States of the borrower or of other foreign affiliates of the controlling domestic corporation(s).
(2) For a United States branch or agency of a foreign bank, the sum, if positive, of the following:

(i) Net balances due to its foreign bank (including offices thereof located outside the United States) and its international banking facility after deducting an amount equal to eight per cent of the following: the United States branch's or agency's total assets less the sum of (A) cash items in process of collection; (B) unposted debits; (C) demand balances due from depository institutions organized under the laws of the United States and from other foreign banks; (D) balances due from foreign central banks; and (E) positive net balances due from its IBF, its foreign bank, and the foreign bank's United States and non-United States offices; and

(ii) Assets (including participations) acquired from the United States branch or agency (other than assets required to be sold by Federal or State supervisory authorities) and held by its foreign bank (including offices thereof located outside the United States), by its parent holding company, by non-United States offices or an IBF of an affiliated Edge or Agreement Corporation, or by its IBFs.

11. 12 C.F.R. § 211.3 (1981) regulates the establishment and operation of foreign branches of banks which are members of the Federal Reserve System.

III. The Structure of the International Banking Facilities Proposal

The New York Clearing House Association (NYCHA) first requested the Board of Governors to amend Regulations D and Q to permit international banking facilities in July 1978. After studying the request, the Board invited public comment on the issues relating to the NYCHA proposal.[12] October 1, 1981 was established as the tentative date for implementation of the plan. However, the regulations as adopted call for an effective date of December 3, 1981.

A. *Depository Capabilities and Restrictions*

According to the regulations, IBFs of all U.S. depository institutions, Edge and Agreement Corporations, and U.S. branches and agencies of foreign banks will be allowed to accept large denomination deposits, free of all reserve requirements, from non-United States residents, including foreign affiliates of U.S. corporations.[13] Additionally, an IBF is permitted to borrow funds from the foreign office of other depository institutions, other IBFs, and the United States office or foreign office of the IBF's depository institution without incurring reserve requirement restrictions.[14] Funds derived by a banking institution from its own IBF would be subject to Eurocurrency reserve requirements.[15]

One significant restriction on the deposit-taking capabilities of an IBF is the requirement that the funds deposited by entities other than banks must be somehow related to the customer's international business. As stated in the amendment to Regulation D: "[F]unds deposited . . . are [to be] used only to support the operations outside the United States of the depositor or of its affiliates outside the United States."[16] In the initial proposal there were no provisions concerning the manner by which the IBF was to police the customer's use of the funds on deposit. The final regulations require the IBF to furnish written notice to all nonbank customers of the use restrictions on deposits. Non-bank

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12. 45 Fed. Reg. 84070 (1980).
13. 12 C.F.R. § 217.1(a) (effective December 3, 1981) (published at 46 Fed. Reg. 32430). This amended regulation exempts IBF time deposits from reserve requirements by excluding IBF deposits from the definition of demand deposit found in Regulation Q.
14. *Id.* § 204.8(a)(2).
15. The reserve ratio presently prescribed by the Board on Eurocurrency liabilities of all depository institutions, Edge and Agreement Corporations, and agencies and branches of foreign banks is three percent. 12 C.F.R. § 204.8 (1981).
16. *Id.* § 204.8(a)(2)(ii)(B).

customers that are foreign affiliates of a U.S. resident must acknowledge the receipt of this notice in writing.[17]

As noted previously, the intent of the IBF regulations is to facilitate the participation of U.S. banks in the *wholesale* international banking arena. To insure that IBFs do not get involved with transaction accounts, the Board of Governors has required that all non-bank deposits have a maturity period of not less than two days,[18] that they be in large denominations,[19] and that they be in neither negotiable nor bearer form.[20] The latter restriction also prevents IBF deposits from coming into the hands of U.S. residents. The two day minimum maturity applies to time deposits and call money. An IBF may, however, borrow funds on an overnight basis from other banking institutions.

With regard to the minimum amount of transactions, the Board initially set forth two alternative proposals for public comment. The first proposal created a $500,000 minimum transaction amount for deposits and withdrawals. The suggested alternative required depositors to maintain a minimum daily average balance of $500,000 with minimum deposits and withdrawals of $100,000.[21] The provision of

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17. A model notice statement proposed by the Board reads as follows:

> It is the policy of the Board of Governors of the Federal Reserve System that, with respect to non-bank customers, deposits received by international banking facilities may be used only to support the non-U.S. operations of a deposit (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.

The model acknowledgments proposed by the Board read as follows:

> _______________, a nonbank entity located outside 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 Sates 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.
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> _______________, acknowledges that funds it deposits with the IBF 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 borrowing from the IBF will be used solely to finance its operations outside the United States, or that of its foreign affiliates.

Both may be found at 46 Fed. Reg. 32427 (1981).

18. 12 C.F.R. § 204.8(a) (effective December 3, 1981). Deposits by banking entities with an IBF have an overnight maturity. *Id.*

19. *Id.* § 217.1(I)(3) ("no deposit or withdrawal of less than $100,000 is permitted, except that a withdrawal of less than $100,000 is permitted if such withdrawal closes an account").

20. *Id.* § 204.8(a)(2).

21. *See* 45 Fed. Reg. 84071 (1980).

additional flexibility and the encouragement to smaller banks to enter the Eurodollar market were the purposes behind the alternative proposal. The Board ulitmately adopted an even more liberal standard of a $100,000 minimum transaction amount with no minimum daily average balance.[22]

The amendment to regulation Q, exempting time deposits with IBFs from the definition of "deposit" and thereby releasing such deposits from applicable interest rate ceilings, will add to the competitive equality of IBFs. At the present time, the interest rates payable on Eurodollar deposits in offshore shell banks are significantly greater than the rates legally payable by a U.S. domestic bank under Regulation Q.[23] This existing interest rate differential presents a serious impediment to domestic banks attempting to attract Eurodollar deposits—an impediment for which the relative stability of U.S. banks does not fully compensate. By releasing U.S. banking institutions both from costly reserve requirements and from non-competitive interest rate ceilings, the Board intends to create a competitive international banking entity.

B. *IBF Credit Extensions*

Funds accumulated by an IBF through its deposit-taking and borrowing activities may be utilized to extend credit to qualified customers. According to the regulations,[24] an IBF may advance funds to:

> (i) Any office located outside the United States of another depository institution organized under the laws of the United States or of an Edge or Agreement Corporation;
> (ii) Any office located outside the United States of a foreign bank;
> (iii) A United States or a non-United States office of the institution establishing the IBF;
> (iv) Another IBF;
> (v) An institution whose time deposits are exempt from interest rate limitations under section 217.3(g) of Regulation Q (12 C.F.R. 217.3(g)); or

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22. *See supra* note 19.

23. There is a gradual trend, though, towards the elimination of interest rate ceilings on deposits at U.S. banking institutions. *See* Depository Institutions Deregulation Act of 1980, 12 U.S.C. §§ 3501-3509 (1980). The stated purpose of this Act is "to provide for the orderly phase-out and elimination of the limitations on the maximum rates of interest and dividends which may be paid on deposits and accounts by depository institutions." *Id.* § 3501(b).

24. 12 C.F.R. § 204.8(a)(3) (effective December 3, 1981) (published at 46 Fed. Reg. 32429 (1981)).

(vi) A non-United States resident or a foreign branch, office, subsidiary, affiliate or other foreign establishment ("foreign affiliate") controlled by one or more domestic corporations provided that the funds are used only to finance the operations outside the United States of the borrower or of its affiliates located outside the United States.

Credit advances of the third type are subject to the reserve requirement on Eurodollar liabilities at the domestic office to the same extent as balances advanced from the foreign branch to its U.S. parent depository institution. Note the similarity between restrictions on the use of the loan proceeds and the restriction imposed on deposits. Loans are also subject to similar written notice and acknowledgment requirements. There are no federal restrictions on the interest rate charged for the placement of loans by an IBF.

C. *Complementary State Legislation*

The IBF proposal is basically an enabling regulation: it allows banks to establish separate departments for the booking of Eurocurrency transactions and permits these transactions to transpire with a minimum of federal intervention. The individual states, however, are free to tax such transactions, enforce usury laws, and regulate the reserve requirements and interest rates applicable to state chartered non-member banks. These powers retained by the state can substantially effect the competitiveness of an IBF. The success or failure of an IBF may, therefore, be determined by its situs within the United States. Florida's approach to this situation will be discussed below, but for now, the reader should bear in mind this problem when reviewing the following analysis.

IV. Commentary: Restraints on the Competitive Viability of IBFs

Ideally, domestic banking institutions will be empowered to enter the lucrative Eurocurrency market on a level of "competitive equality" with offshore shell banks. Competition for funds in this market is keen, so the success of the proposal hinges on achieving the goal of relative equality. United States banks have an inherent advantage in that they exist in a climate of political stability: a situation uncharacteristic of many of the international banking centers of the world. The Board's amendments to Regulations D and Q, however, have left some stumbling blocks on the road to competitive equality.

Most notable are the two day maturity requirement[25] and the restrictions on use of deposits and loan proceeds.[26] Other problems stem not from the proposal itself, but rather from external sources such as inconsistent state legislation and the McFadden Act.[27]

A. The Two Day Maturity Requirement

The two day maturity period on IBF time deposits and call money places U.S. banks at a slight disadvantage because offshore banks offer overnight deposit and withdrawal services. The overnight deposits provide the managers of foreign (non-bank) firms with the cash management flexibility required in the modern international money markets. The restriction prevents IBFs from accepting overnight time deposits, call money requiring an overnight withdrawal notice, call money requiring same day withdrawal notice, and demand deposits.

The product of a phobia that deposit accounts might be utilized as transaction accounts, the regulations fail to reflect the significant differences between overnight time deposits, call money with an overnight notice requirement, and transaction accounts. An overnight time deposit represents a single large block of funds deposited for a short period of time, payable only after a fixed maturity date, that may not be drawn against by check or other similar instrument. Likewise, call money accounts with overnight notice requirements represent large blocks of funds invested for a short period of time that are not payable on demand and cannot be withdrawn by check or similar instrument. In sum, a depositor's flexibility is considerably limited with respect to funds invested in overnight call money or overnight time deposits. On the other hand, a depositor with a transaction account has full flexibility because funds may be withdrawn at any time upon demand, either directly or through payments to third parties. If the IBFs are not permitted to offer overnight time deposits and call money with an overnight notice requirement, the IBFs will only be competitive in the market for longer term deposits and the existing offshore banking institutions will retain at least a portion of the Eurocurrency market.

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25. *Id.* § 204.8(a)(2)(ii).
26. *Id.* § 204.8(a)(2)(ii)(B)(3).
27. 12 U.S.C. § 36 (1976).

B. *Limitations on the sources from which IBFs may obtain deposits or borrow funds*

As noted earlier, deposits of foreign residents and foreign affiliates of U.S. corporations are subject to a test requiring that they be used in "support" of operations outside of the United States. While such a test, although difficult to administer, might be appropriate for the foreign affiliates of U.S. corporations, it is an unnecessary and burdensome restriction on the ability of IBFs to attract non-residents. Offshore banking entities are not burdened by this restriction; thus the goal of competitive equality is less accessible. The test is also discriminatory in that the foreign branches of U.S. banks do not suffer from the same handicap.[28] The "support" test, which reflects a concern about the routing of funds by domestic corporations through foreign affiliates, should only, if at all, be applied to the foreign affiliates of U.S. corporations.

C. *Eligible IBF Credit Customers*

The imposition of a "proceeds" test on extensions of credit by IBFs is another target of criticism. Constraining the use of loan proceeds to the financing of foreign operations of the eligible creditors is a somewhat novel proposition. Attempting to apply a proceeds test to foreign borrowers not controlled by domestic corporations would be impractical and would severely impede the competitive status of IBFs against offshore banks.[29] A foreign resident may resent the intrusion of U.S. authorities into the issue of his use of the loan proceeds; the creditor could easily turn to the offshore market where no such limitation exists. The proceeds test also discriminates between IBFs and foreign branches of U.S. banks, since there is no proceeds test for loans by the latter to non-United States residents.

With respect to the proceeds test on IBF extensions of credit to foreign affiliates of U.S. corporations, note that the language of the test differs from that currently applied to Eurocurrency liabilities for foreign branch banks under Regulation D. Notwithstanding the difficulties of administering the proceeds test currently found in Regulation D, the foreign branches of U.S. banks have learned to cope with its highly judgmental parameters. Creating a new and possibly different test tends to create confusion, and indicates a need to draw

28. 12 C.F.R. Part 204 (1981).

29. Comment of Bankers' Association for Foreign Trade p. 4 (filed with the Board in response to the request for public comment on the original IBF proposal published at 45 Fed. Reg. 84071 (1980)).

distinctions between IBFs and foreign branches of U.S. banks when none should exist. Conforming the IBF proposal to mirror the foreign branch regulations would allow the following to be eligible IBF customers:[30] (1) a non-United States resident; (2) a foreign branch, office, subsidiary, affiliate or other foreign establishment controlled by one or more domestic corporations if the proceeds will be used in its foreign business or that of other foreign affiliates of the controlling corporation; (3) an IBF; and (4) an office of an institution establishing an IBF.

D. *Initial Establishment of an IBF*

Under the regulations as initially proposed, all transfers of assets from the establishing institute to the IBF would have been subject to Eurocurrency reserve requirements. This imposed a high reserve cost on the initial establishment of an IBF. The proposal discriminated in favor of banks with existing offshore shell branches because such banks could establish an IBF by simply extending credit to the new IBF without incurring reserve requirement costs. Therefore, the regulations would have impacted most severely on small banks which have no offshore branches. The initial proposal was rightfully amended to exclude the initial transfer of funds from the establishing bank to the IBF from reserve requirements.[31]

E. *Restraints on Competition among IBFs*

Within the United States there exist numerous factors affecting the competition among IBFs, the most significant variable will be geography. As noted previously, the individual states will have a major impact on whether an IBF within the particular state will be competitive. New York State has already passed the requisite legislation exempting IBF transactions from restrictive taxation.[32]

Aside from state legislation, New York and other east coast banks have an inherent time zone advantage. They are able to participate in the London and Bahamian Eurocurrency markets without substantial deviation from the normal working hours. The vast majority of non-United States resident dollar deposits are corporate, government, and central bank deposits belonging to European and Middle East cus-

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30. Comment of Bank of America p. 16.
31. 12 C.F.R. § 204.8 (effective December 3, 1981) (published at 46 Fed. Reg. 32429 (1981)).
32. 59 N.Y. TAX LAW §§ 1450-1457 (McKinney).

tomers. The most convenient option for these customers is to place deposits and receive credits from IBFs having the maximum time overlap with Europe and the Middle East.

New York State also has the only domestic facilities capable of clearing and settling international banking transactions on a same-day basis. The New York Clearing House Interbank Payments System (CHIPS) offers its clearing and settling system to New York banks, including New York based Edge Act banks.[33]

Obviously there are great benefits to operating an IBF in New York. Some west coast banks attempted to remedy the inequities by supporting two amendments to the IBF proposal. First, they asserted that the IBF proposal should be tied to granting non-New York banks direct access to CHIPS. Secondly, they proposed amending the McFadden Act[34] and the Edge Act[35] so that west coast banks could reap the benefits of operating an IBF in New York.

Non-New York banks wishing to establish IBFs in New York are limited to the use of Edge or Agreement Corporations due to limitations imposed by the McFadden Act on cross-state branching. Unfortunately, the bookings of such an IBF are limited by Regulation K,[36] which requires Edge Act banks to maintain a minimum capital and surplus level of seven percent of "risk assets."[37] Risk assets are defined as all assets excluding cash, amounts due from banking institutions in the United States, United States government securities, and Federal funds sold. Placements by an Edge IBF would be deemed risk assets and therefore limited to 14.3 times the sum of capital and surplus. IBFs of New York based depository institutions, U.S. branches or agencies of foreign banks would not be subject to this limitation since they need not operate in that state in Edge Act bank form.

Suggested solutions to this problem are to either amend the Edge Act to exempt IBF transactions from the risk assets/capital ratio limitations or to amend the McFadden Act to permit the formation of IBFs as special purpose branches of parent banks. Both proposals recognize the unique character of IBF transactions.

Regulation K imposes an additional relevant restriction on the utility of Edge Act banks as vehicles to operate IBFs. The limitation

33. Comment of Bankers' Association for Foreign Trade pp. 10-12.
34. 12 U.S.C. § 36 (1976).
35. 12 U.S.C. §§ 611-632 (1976 & Supp. III).
36. 12 C.F.R. Part 211 (1981).
37. 12 C.F.R. § 211.6(d) (1981).

on loans to individual borrowers of ten percent of the bank's capital prevent the Edge bank from booking large transactions.[38] Edge Act banks typically have substantially smaller capital bases than their parents; so New York based banks once again will compete at a distinct advantage. Amending Regulation K to allow the IBF to lend based on its parent's capital base would alleviate this disadvantage.

V. Florida Legislation

The principal state legislation needed to facilitate the operation of international banking facilities is legislation duplicating the favorable tax climate found offshore for the types of transactions in which international banking facilities engage. New York and Puerto Rico have adopted such legislation. Florida had already adopted legislation which would exempt from the Florida documentary stamp and intangibles tax "international banking transactions."[39] There is also an exemption from Florida franchise tax for "foreign source income."[40] These exemptions provide substantial relief from Florida taxation for international banking facilities' operations. Moreover, Florida recently enacted additional legislation specifically to provide a comprehensive favorable tax climate for international banking facility operations.

A. *Legislation to Exempt the Placement of Funds by International Banking Facilities and Related Foreign Exchange Transactions from the Florida Intangibles and Documentary Stamp Taxes*

Certain "international banking transactions"[41] have already been exempted from the Florida intangibles and documentary stamp taxes to encourage the development of international banking in Florida. To extend these exemptions to the placement of funds by an international banking facility in the manner permitted by the regulations of the Board of Governors of the Federal Reserve System and to extend the exemptions to foreign exchange operations by international banking facilities, section 199.023 of the Florida Statutes was amended to read:

(10) "International banking facility" means a set of asset and liability accounts, segregated on the books and records of a banking

38. *Id.* § 211.6(b).
39. Fla. Stat. § 199.023 (1980 Supp.).
40. *Id.* § 220.63.
41. *Id.* § 199.023(10).

organization, that includes only international banking facility deposits, borrowings, and extensions of credit as those terms are defined pursuant to s. 655.071(2).

(11) "International Banking Transaction" means:

> (a) The financing of the exportation, from or the importation into, the United States or between jurisdictions abroad of tangible personal property or services;
> (b) The financing of the production, preparation, storage, or transportation of tangible personal property or services which are identifiable as being directly and solely for export from, or import into, the United States or between jurisdictions abroad;
> (c) The financing of contracts, projects, or activities to be performed substantially abroad, except those transactions secured by mortgage, deed of trust, or other lien upon real property located in the state;
> (d) The receipt of deposits or borrowings or the extensions of credit by an international banking facility, except the loan or deposit of funds secured by mortgage, deed of trust, or other lien upon real property located in the state; or
> (e) Entering into foreign exchange trading or hedging transactions in connection with the activities described in paragraph (d).

No significant tax revenue should be lost by the State of Florida as a result of the exemptions proposed in subsections (d) and (e) above, because the transactions proposed to be exempted will presumably be principally those which are currently conducted offshore where they are not subject to Florida intangibles and documentary stamp tax.

B. *Legislation to Exempt the Placement of Funds and Foreign Exchange Transactions by International Banking Facilities from the Florida Franchise Tax*

The foreign source income exclusion from the Florida franchise tax would seem to exempt most income generated from international banking facility operations from the Florida franchise tax. However, because certain income generated from loans and deposits between international banking facilities and from foreign exchange transactions by international banking facilities might not be exempt, an exemption from the Florida franchise tax for income generated from these activities was provided by amending in part section 220.63 of the Florida Statutes to read as follows:

> (3) For purposes of this part, the franchise tax base shall be adjusted federal income, as defined in s. 220.13, less the deduction allowed in subsection (5), and less $5,000.

(5) There shall be allowed as a deduction from adjusted federal income, to the extent not deductible in determining federal taxable income or subtracted pursuant to s. 200.13(1)(b)2., the eligible net income of an international banking facility determined as follows:

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

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

1. 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 savings association), or which is a foreign corporation or a foreign partnership which is 80 percent or more owned or controlled, either directly or indirectly, by one or more domestic corporations (other than banks or savings associations), domestic partnerships or resident individuals, substantially all the proceeds of the loan are for use outside of the United States;

2. Making or placing deposits with foreign persons which are banks or savings associations or foreign branches of banks or savings associations, 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 in connection with the activities described in this paragraph.

Provided that eligible gross income shall not include any amount derived by an international banking facility from the making, arranging for, placing or servicing of loans, or making or placing of deposits if the loan or deposit of funds is secured by mortgage, deed of trust, or other lien upon real property located in the state.

(c) Applicable expenses shall be any expenses or other deductions attributable, directly or indirectly, to the eligible gross income described in paragraph (b).

Because both parties to a loan between domestic international banking facilities will be local banking institutions, income derived therefrom will not be foreign source income, exempt pursuant to section 220.13. Similarly, foreign exchange trading by a domestic international banking facility might be deemed to take place in Florida, and the commissions and fees thereon would thus not be considered foreign source income. No significant loss of Florida tax revenue from the exemptions proposed in subsection (5)(b) above should occur, since the transactions exempted will be those which are currently consummated offshore and are currently exempt from Florida franchise tax.

C. *Legislation to Facilitate the Availability of the Board of Governors of the Federal Reserve International Banking Facility Proposal to Florida-Chartered Non-Member Banks*

Florida chartered non-member banks must comply with the reserve requirements imposed by section 658.68 of the Florida Statutes in addition to the reserve requirements of the Board of Governors of the Federal Reserve. It is necessary to provide relief from state liquidity reserve requirements relating to non-member state chartered banks to fully make possible the operation of international banking facilities by state non-member banks. In this connection, an amendment to Florida Statutes section 658.68 was required to modify the current Florida reserve requirements and substitute those adopted by the Board of Governors of the Federal Reserve System in conjunction with the international banking facilities proposal. This amendment may be affected by creating a new subsection 658.68(4), which would read in conjunction with subsection 658.68(1) as follows:

> (1) Every bank shall maintain a liquidity reserve equal to at least 20 percent of its total deposit liability, less those deposits of public funds for which security has been pledged as provided by law. The liquidity reserve shall be maintained as cash on hand; as cash on demand deposit with other banks, including the total amount of any reserves deposited at a Federal Reserve bank; as cash items in the process of collection; as federal funds sold on a daily basis; or as investments in securities which are direct obligations of the United States or which are fully guaranteed as to principal and interest by the United States. Eligible securities must be owned by the bank free of pledge or encumbrance, and their value will represent their liquidity reserve value. For purposes of this section, the value of eligible securities shall be the par value of securities having a maturity of 1 year or less and the market value of securities having a maturity in excess of 1 year. The value of eligible securities which are owned by the bank free of pledge or encumbrance, and that portion of the value of eligible securities which is in excess of the deposit to which pledged, may be utilized in meeting reserve requirements. The total deposit liability for a given banking day for the purpose of computing the required liquidity reserve for that day shall be the total deposit liability at the close of the preceding banking day.
>
> (4) For purposes of subsection (1), international banking facility deposits shall not be included in the total deposit liability of a bank.

Florida chartered non-member banks are not generally subject to the requirements of Regulation Q governing the maximum interest which may be paid upon deposits. Instead, regulations section 329, administered by the Depository Institutions Deregulatory Committee, controls the maximum interest which may be paid upon deposits taken by state non-member banks. It is anticipated that the Depository Institutions Deregulatory Committee will soon propose regulations intended to modify regulations section 329 to provide the relief required to permit state non-member banks to operate international banking facilities.

D. *Legislation to Exempt International Banking Facilities from Usury Limitations*

Lending and borrowing by international banking facilities has been exempted from the usury restrictions of Florida Statutes Chapter 687. This amendment is intended to place Florida on an equal basis with other offshore financial centers with respect to interest rate limitations on major international financing activities. Banks operating in major foreign financial centers are presently subject to little or no interest rate regulation on their international lending and borrowing. In addition, the interest rates in effect in the Eurodollar market often exceed Florida's current twenty-five percent limit on loans to foreign persons and entities. Accordingly, the removal of interest rate limitations on lending and borrowing by International Banking Facilities in Florida will permit these facilities to more effectively compete with banks outside this state and thereby make Florida more attractive as an international financial center.

Existing section 687.13 should be numbered "(1)" and the following paragraph should be added as "(2)":

> (2) The provisions of this chapter shall not apply to any international banking facility deposit, borrowing, or extension of credit, as those terms are defined by the Department of Banking and Finance pursuant to s. 655.071.

VI. CONCLUSION

The regulations of the Board of Governors creating international banking facilities warrant close attention because of both their merits and the inequities which they create within the domestic banking industry. The inequities caused in the banking industry will probably be only partially remedied. Some states have initiated the appropriate legislation so that IBFs located therein may compete with those based in New York. Amendment of either the Edge Act or McFadden Act is not anticipated though. West coast banking wishing to compete with New York based banks will be forced to use Edge Act banks in their present form, despite their shortcomings. Nevertheless, the IBF regulatory scheme promises to be a healthy boost to the U.S. banking industry's efforts to capture a substantial portion of the Eurodollar market.