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Canada as an International Banking Centre

A Report to the Department of Finance
by L. Rasminsky and R.W. Lawson

March 1986

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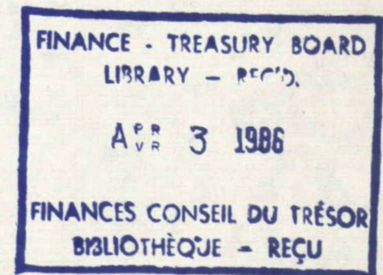

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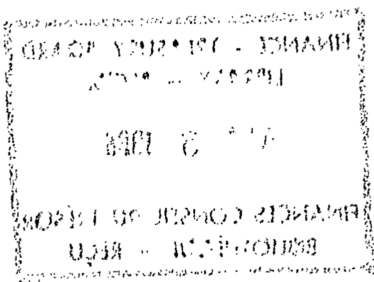

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Cat. No. F 2-73/ 1986

ISBN 0-662-54364-5

This Report is submitted in response to a request by the Department of Finance to enquire into and report on the pros and cons of initiatives to encourage the development of Canada as an international banking centre.

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A. The Nature of International Banking and of International Banking Centres

The world's banks provide many services that cross national boundaries, and in some contexts all of them are considered to be international banking. But as used in the term "international banking centres", international banking has a much narrower meaning which excludes many of the cross-border services provided by banks. It excludes, for example, virtually all the services that are related directly to the individual payments and receipts and foreign-exchange operations arising from the international trade of the country in which the bank is operating. While such services constitute much the greater part of the work of the international departments of banks they are not international banking in the narrower sense.

The international banking done by international banking centres is principally the channelling of flows of capital between countries. It is the intermediation by banks in the world's capital market.

In this role of providing channels for the international flow of capital, the operations of the world's banks have changed dramatically in recent years. Historically those channels were primarily bilateral, capital flowing between the banks of an international financial centre – first London and then increasingly New York – and the banks of other countries. The world system was rather like a wheel with the channels radiating from the financial centre of the world's major international currency. This tended to be the case whether the capital that flowed was generated in the hub-country or elsewhere, and whether the capital flowed through banks or through bond and equity markets.

In the mid-1950s that system began to change, at first slowly but then rapidly. Although the U.S. dollar had become the world's major international currency, the world's banks *found* that the circumstances of the time enabled them to be competitive in doing international business in U.S. dollars from offices outside the United States. By the 1970s, when the international movements of capital were massive and were denominated mainly in U.S. dollars, a very large part of them did not go through the United States. They flowed through channels that had become known as the Euro-dollar market.

The Euro-dollar market provided a new way for the world's banks to intermediate in the flow of capital across national borders. The new way is extra-national, and its activities are not directly subject to national regulation. Through it the world's banks compete for deposit balances in all parts of the world, including countries that are themselves net borrowers on international account, and use the funds to make loans and acquire other assets in all parts of the world, including countries that are themselves net lenders on international account.

A number of factors contributed to the development of the Euro-dollar market. Some early role appears to have been played by the desire of the Soviet authorities during a period of tension to hold their U.S. dollar balances with banks outside the United States and thus outside U.S. control. Another element was that the postwar weakness of sterling limited its use by the highly-sophisticated international financial market that existed in London, and the London market turned to using the U.S. dollar. Banking regulation in the United States (involving the cost of reserve requirements and the restraint of interest-rate ceilings) played a role by making it difficult for banks to compete effectively in the Euro-dollar market if they operated from within the United States. During the 1970s the market's growth was greatly stimulated by the huge imbalances in international payments that were generated by the increases in the price of crude oil; the Euro-dollar market played a major role in recycling the large dollar surpluses of the oil-producing countries, making them available to many oil-importing countries through lending operations.

All the world's larger banks participate in the Euro-dollar market, with U.S. banks operating (until recently) mainly from offices outside the United States. While the market still works very largely (80 per cent) in U.S. dollars, enough use is made of other currencies, mainly the D-mark and the Swiss franc, that it is now usually called the Euro-currency market. The market has now spread from Europe to other regions. A peculiar feature of this activity is that most of it is carried on by banks operating from outside the country whose currency is being used.

It is this Euro-currency activity that we shall have in mind when we refer in this Report to international banking. Though it is in principle quite separate from the other international services that banks provide to their customers it is usually not physically separate. The fact that the world's larger banks use as bases for their Euro-currency activities the facilities that they already had around the world means that it is virtually impossible in practice to distinguish between the facilities that are required for Euro-banking and those that are required for other purposes.

The Euro-currency market is now very large indeed. The usual way of measuring its size is by totalling the foreign currency assets or liabilities recorded in the banking offices in as many countries as possible. The estimates available differ in their coverage, but they indicate that the size of the market is now approaching U.S. $2,500 billion (as compared with about $450 billion 10 years ago and about $110 billion in 1970). Well over half of the current total is inter-bank business because it is the practice of the banks to re-deposit with other banks a considerable proportion of the Euro-currency deposits that they receive. If inter-bank deposits are netted out, the size of the market is not far short of U.S. $1,000 billion. This is well over five times the size of the Canadian-dollar business of the Canadian banking system.

Because of the parlous external-debt situation of a number of countries, the Euro-currency market is unlikely to grow nearly as rapidly in the foreseeable future as it did in the 1970s, but it seems very likely to remain large.

While banks from many countries are active in the Euro-currency market, figures recently released by the Bank for International Settlements indicate that banks from eight countries accounted for about 85 per cent of the market as at the end of 1984. U.S. and Japanese banks together accounted for about 50 per cent, and the banks of France, United Kingdom, Switzerland, Germany, Canada and Italy together accounted for a further 35 per cent. Canadian banks make up about 4 to 5 per cent of the total market.

The business that the Euro-currency market does can be negotiated wherever around the world those involved find it convenient to meet. In practice that is mainly in the world's larger financial centres, notably London and New York, but it is frequently elsewhere. Hong Kong and Singapore are important centres for Asian business. When the business is arranged, the participating banks usually have a fair amount of latitude as to where it is entered on the books of one of their branches or subsidiary companies. Banking considerations will normally point to a suitable place to book (place or domicile) the business, but decisions about where to book are often influenced by non-banking considerations, notably by government regulations and taxation. The result is that, though there are a small number of places in the world where a lot of international banking business is negotiated (and often also booked), there are many more places where a lot of business is booked but little is negotiated. There are few international banking centres but many international booking centres.

The locations of either banking centres or booking centres have virtually nothing to do with the source or use of the capital which flows through them. The centres are places for the negotiation, recording and subsequent administration of the business of a genuinely international market, and the countries in which they are located have, by virtue of that location, no more access to the funds which flow through the Euro-currency markets than they would if the centres were located elsewhere. The benefits to the countries in which such centres are located consist in the employment and income of those who do the centres' work.

Since Euro-currency business is very much a wholesale business, with very large individual transactions, a great deal of it (in money terms) can be done by relatively few people. It involves only a small fraction of the employment that would be involved in a comparable dollar volume of retail banking business. Of those involved, the great majority of the more-skilled people are employed in head offices of the participating banks and in the few banking centres. Employment in international banking in the booking centres is small relative to the magnitude of the portfolios being managed, and is mainly of a routine nature.

B. The Determinants of the Geographical Distribution of the Activity Involved in International Banking

In this section we shall comment on the main forces that contribute to the present distribution around the world of the activity (work) involved in international banking, grouping them under four headings – operating efficiency, customer preferences, regulation, and taxation.

The forces are the same for all banks participating in Euro-currency banking, but their relative importance in explaining the outcome varies from country to country because the regulatory and taxation arrangements in countries differ. We have concentrated on how these forces affect the decisions of Canadian banks rather than those of banks in other countries, but we have enquired into the experience with the International Banking Facilities (IBFs) established in the United States in 1981 and a note on IBFs is attached as Appendix A to this Report.

Operating Efficiency

The Euro-currency markets are highly competitive, and to do well in them a bank must be energetic and efficient. Business must be pursued, and when it is won the client must be well serviced. The objective of the participating banks is to provide good service at the minimum cost.

To compete effectively a bank must be well represented in the main places where international business is done. Only by having a competent presence in the active markets can it keep well informed on developments and make good decisions on what kind of business to seek, and where and how to seek it. International banking goes on around the clock, and a major bank cannot operate efficiently from one time zone; it must at the very least have adequate offices in Europe, in the Western Hemisphere, and in Asia. To service its customers, it may need offices in many other places as well. Effective participation in a world-wide banking system requires offices world-wide.

While the existing distribution of activity in international banking is determined primarily by the views of the participating banks on where the business can be done most efficiently, that distribution is considerably different from what it would be if the banks were not exposed to other influences that affect their decisions. It is the effect of these other influences on the distribution of activity that is the centre of interest in this Report.

It is mainly the distribution of the business of the banks with customers other than banks that is affected by these other influences. We have already noted that the

inter-bank activity of the Euro-currency banks is large, but its nature is such that we believe its distribution to be determined almost entirely by banking considerations. It is done primarily for reasons of liquidity, and it is done at such small margins that it is not an important source of bank profits and is thus little exposed to being influenced by tax considerations.

Customer Preferences

The preferences of customers that are most likely to affect the locations at which their transactions are booked have to do with banking secrecy and country risk.

Sometimes the interest of customers in banking secrecy arises from the fact that they are trying to hide funds that were obtained through illegal activity. Most banks do not like to be used in that way, and they try to know enough about their customers to avoid that role.

There are, however, other reasons why customers may want the privacy of their banking transactions to be as well protected as possible. Customers attaching particular importance to privacy will want their business booked in countries that they think give high priority to such privacy. Banks can do business with such customers only by having regard to where they want the business booked.

Like privacy, country risk is relevant mainly to the location of booking of the liability or deposit side of the banks' business. The claim of a depositor on a bank is exposed to the law and the legal processes of the country in which the deposit is booked, and it is also exposed to possible intervention by the government of that country in a way that might reduce the usefulness of the deposit, as, for example, by the imposition of foreign exchange control. If a depositor is uneasy about a country on any of these scores, he will not want his deposit booked there. Canada's reputation in this regard is an advantage in attracting Euro-currency deposit business to Canada.

Regulation

Government regulations affecting banking, including the reserve requirements of the monetary authorities, have had a major effect on the location of the activity involved in international banking. The regulations of the United States making the deposit liabilities of banks to non-residents (as well as residents) subject to reserve requirements and to interest-rate ceilings were a major factor in the development of the Euro-dollar market. Until the U.S. authorities made arrangements in 1981 for International Banking Facilities, it was very difficult for U.S. banks to be competitive in the Euro-dollar market if they operated from inside the United States. For the same reasons foreign banks could not be competitive if they did such business from their U.S. offices.

By contrast, regulation has not had a major influence on the location of the activity in international banking of the Canadian banks. In their operations in

foreign currencies, the Canadian banks are largely free of specific regulatory restraints, the only exception of consequence being that their foreign currency liabilities to residents booked in Canada attract a reserve requirement of 3 per cent. This requirement was imposed in 1980 in order to make their treatment comparable to that of Canadian dollar deposits.

Another regulatory factor that has had some influence in increasing the external activity of Canadian banks is that the powers of banks with respect to the security market are greater in some other countries than they are in Canada. Some of the business in securities that the Canadian banks do in London, for example, would not be possible in Canada under the provisions of the Bank Act.

The requirements in Canada for reserves on Canadian dollar deposits put the Canadian banks at a competitive disadvantage against foreign banks if they book in Canada international business denominated in Canadian dollars or issue fully-transferable certificates of deposit denominated in Canadian dollars because such transactions attract reserves in Canada.

Taxation

Just as regulation provides a good deal of the explanation of the development of the Euro-currency market, so taxation explains a good deal of the curious distribution of the booking of the business generated by that market. Much of the business is booked in locations that are not large as financial centres in other respects, and their use as booking centres is mainly due to the fact that there is a tax advantage in placing the business there.

It is normal for banks doing Euro-currency business to analyze the difference in taxation that would result from doing it in different ways. In order to be competitive they have to take account of tax factors in deciding what business to do and how to do it.

The tax benefits to be had from the selective placing of international banking business are of various types, and they depend on the interrelationship between the taxation arrangements in the bank's home country and the country in which the business is placed. What may be involved is a lesser rate of (or no) profits tax, a lesser rate of (or no) business, capital or other relevant tax, less exposure to withholding taxes, lower licensing fees or other charges, or a more favourable system of foreign tax credits.

The tax factors that lead the Canadian banks to book international business abroad are discussed in the next section.

C. How Taxation Affects the Location of the Activity of the Canadian Banks in International Banking

The following table presents a broad picture of the places where the foreign currency business of the Canadian banks appears on their books or on those of their subsidiaries. It shows:

1. Of the total inter-bank business (assets plus liabilities), about 45 per cent is booked in Canada, about 10 per cent is booked in what in the table are called offshore centres, and the rest is booked elsewhere, presumably mainly in London and New York. (The countries treated as offshore centres in the table are listed in a footnote to it; they are mainly Caribbean countries, Hong Kong and Singapore.)

2. Of the claims on non-residents other than banks, a little under 10 per cent is booked in Canada, about 35 per cent is booked in the offshore centres, and the rest is booked elsewhere, again presumably mainly London and New York.

3. Of the liabilities to non-residents other than banks, nearly one-half is booked in Canada, about 15 per cent is booked in the offshore centres, and the rest is booked elsewhere.

4. Of the business with residents other than banks, nearly all of the claims are booked in Canada and about 40 per cent of the deposits are. The rest of the deposits are booked largely in New York and London.

All the determinants mentioned in the preceding section contribute to this result. Nearly all of the distribution of the inter-bank business and a good deal of that with non-banks is explained by ordinary banking considerations, and customer preferences and reserve requirements explain some. But a lot of the booking abroad, and particularly that of claims on non-banks (loans and securities) in the so-called offshore centres, has something to do with taxation.

The features of the Canadian tax system that are relevant are quite different if the international business in question is booked abroad in a branch of the bank or in a subsidiary. We shall look first at the case of a branch and then at that of a subsidiary.

Where the booking is in a branch, the rate of corporation profits tax in Canada is not of itself a great inducement to book business abroad. The reason is that all the branches of a bank, foreign and domestic, are consolidated for tax purposes. The Government of Canada applies a tax rate of 46 per cent to that part of a bank's

Place of Booking of Foreign Currency Business of Canadian Banks at June 1984

Place of Booking	Assets			Deposit Liabilities		
	Deposits with Banks[1]	Loans and Securities	Total	To Banks[1]	To Others	Total
	(in billions of U.S. dollars)					
Vis-à-vis Non-Residents						
Canada	17.0	6.0	23.0	24.2	22.7	47.0
Offshore centres[2]	2.7	22.8	25.5	7.6	6.9	14.5
Elsewhere: of which	14.4	36.6	51.0	28.6	17.1	45.8
United States	n/a		20.4	n/a		15.1
United Kingdom			20.8			23.5
Other			9.8			7.2
Total	34.1	65.5	99.6	60.4	46.8	107.2
Vis-à-vis Residents						
Canada	3.0	22.4	25.4	3.1	5.8	8.8
Offshore centres[2]	.1	.1	.3	.5	.7	1.2
Elsewhere: of which	.7	.8	1.5	1.0	8.7	9.7
United States	n/a		.7	n/a		5.9
United Kingdom			.6			3.7
Other			.2			.1
Total	3.8	23.3	27.1	4.6	15.2	19.8
Total						
Canada	20.0	28.3	48.4	27.3	28.5	55.8
Offshore centres[2]	2.8	23.0	25.8	8.1	7.6	15.7
Elsewhere: of which	15.1	37.4	52.5	29.7	25.8	55.5
United States	n/a		21.1	n/a		21.0
United Kingdom			21.4			27.2
Other			10.0			7.3
Total	37.9	88.8	126.7	65.0	61.9	127.0

(1) Includes official monetary institutions.

(2) Countries included are the Bahamas, Bahrain, Barbados, Bermuda, the Cayman Islands, Hong Kong, Lebanon, Liberia, the Netherlands Antilles, Vanuatu (New Hebrides), Panama, Singapore, the Virgin Islands and the West Indies.

Source: Bank of Canada

profits that are deemed to have been earned abroad, and the same rate with a 10 point abatement in favour of the provinces (i.e. a rate of 36 per cent) is applied on profits earned in Canada. In nearly all cases the provincial profits taxes exceed the abatement, and several provinces also impose capital taxes and other relevant taxes. (Information on taxes imposed by the provinces appears in Appendix B to this Report.) To the extent that the burden of the relevant taxes in a province exceeds the relief provided by the federal tax abatement there is a tax inducement to the banks to book business abroad rather than in that province.

For business booked in bank branches, a strong inducement to use branches abroad rather than at home arises from two differences in the way that the federal profits-tax liability is calculated. These differences have to do with foreign tax credits arising from withholding tax and with the distinction made between "business" and "non-business" foreign income.

It is quite common for governments to collect withholding tax on income paid abroad, including interest paid to banks, by private-sector entities. The rate of withholding tax on income flows between pairs of countries is often agreed in tax treaties between them, but many countries, including some who are large borrowers in Euro-currency markets, do not have any tax treaties and determine their withholding tax practices unilaterally. In the treaties that Canada has signed there is typically provision for withholding tax at the rate of 15 per cent on interest paid abroad by private borrowers. Rates of this order or higher are often applied to interest paid to Canadian banks by private-sector borrowers in countries with which Canada has no tax treaty.

A bank making a Euro-currency loan cannot afford to absorb a tax of this magnitude. Profit in banking arises from the spread between what a bank has to pay on the deposits that it attracts and what it can earn by lending the funds, and competition in international banking keeps that difference small on loans to customers who have a good credit rating. At current interest rates a withholding-tax deduction at 15 per cent would normally exceed the pre-tax profit to a bank from an international loan, and no bank would make the loan if it had to absorb any significant part of the tax.

This can be illustrated as follows: Suppose a bank were to lend at 12 per cent per annum $1,000,000 that cost the bank 10 1/2 per cent to borrow, and that interest on the loan were subject to a 15 per cent withholding tax. The annual withholding-tax deduction would be 15 per cent of $120,000, or $18,000, leaving the bank with $102,000 to cover its own interest cost of $105,000. If the bank had to absorb the withholding tax it would lose $3,000 per year plus the non-interest costs of the transaction.

There are nevertheless various circumstances in which a loan normally subject to withholding tax can be profitable to a lending bank. It may be that the bank has a lending office in the country of the borrower, in which case it can lend from that office and avoid the tax. It may be that there is a country outside the borrowing country in which the bank can, by virtue of a tax treaty between that country and the borrowing country, book a loan without attracting withholding tax. In some cases the borrower may agree to pay a sufficiently high rate of interest to offset

the withholding tax, perhaps receiving from his own government a rebate of some or all of the withholding tax that it levies on his loan. But the usual way for the lending banks to escape the incidence of withholding tax is to receive credit for it against profit taxes that they would otherwise have to pay to their home country. The relevant national taxing authorities have arrangements for giving credit for foreign taxes paid as part of their systems for minimizing double taxation.

It is the practice in Canada to give to Canadian corporations operating abroad credit on a country-by-country basis for foreign taxes that they have paid, that is, credit is given for taxes paid to a particular country against taxes otherwise payable in Canada on profits earned in that country. Under this arrangement full credit for withholding tax paid will be available only if there is a suitable fit by country of profits earned and taxes paid. In the case of bank branches abroad, however, all the income of a branch and all the taxes paid (other than to Canada) by the branch are attributed to the country in which the branch is located. This allows an aggregating of profits and foreign taxes paid, and makes it very much easier for a bank to get full credit against Canadian profits tax for withholding taxes paid on loans which are booked abroad than on loans which are booked at home. Full credit can be obtained in a branch abroad if the profits of the branch from all sources generate a Canadian tax liability equal to or greater than the total of its foreign tax credits. One way of ensuring enough profit for that purpose in a particular branch abroad is to book there sufficient loans that do not attract withholding tax, that is, loans to governments.

The other Canadian tax practice that offers banks an inducement to book international business in a branch abroad rather than at home is the distinction made between foreign tax credits in respect of "business" foreign income and those in respect of "non-business" foreign income in accordance with whether the taxes for which credit is being given are related to the income of a business operation carried on abroad (business foreign income) or at home (non-business foreign income). Unused foreign tax credits in respect of business foreign income can be carried forward for seven years or back for three, while those in respect of non-business foreign income are lost if they cannot be used in the year in which they are earned. In their international business the Canadian banks make many loans to borrowers in countries in which the banks do not have business establishments, and if such loans are booked in Canada any foreign tax credits that may arise (e.g. from withholding taxes) are generally treated as being in respect of non-business foreign income. But if such loans are booked in a foreign branch, any foreign tax credits that arise are generally treated as being in respect of business foreign income. There is thus an incentive to the banks to gain flexibility in tax matters by booking abroad any business that would give rise to foreign tax credits on non-business foreign income if it were booked in Canada.

So far in this section we have been looking at the incentives that flow from the tax system for the Canadian banks to book their Euro-currency business at foreign branches rather than at home. The tax system provides quite different incentives to place that business in foreign subsidiaries rather than at home.

It is the Canadian practice not to tax the profits of foreign subsidiaries of Canadian corporations unless and until the profits are brought to Canada. When they are brought to Canada they normally become subject to corporate income tax unless they come from tax-treaty countries. If they come from tax-treaty countries they are not taxed in Canada in accordance with a provision in the tax treaties that Canada has signed that limits the taxation of corporate profits to the country in which they are earned.

These circumstances offer a strong inducement to banks to place international business in subsidiaries in countries where the rate of profits tax is appreciably below that in Canada. Even though the profits are exposed to Canadian taxes if and when they are remitted to Canada, the attraction of a host country with a zero or low rate of profits tax is great because the banks can reasonably expect to have opportunities to use the funds abroad rather than to bring them to Canada, and in any event the payment of the taxes is delayed. In the case of tax-treaty countries there is the additional advantage that the profits after local tax may be brought to Canada without attracting tax in Canada. Canada's tax treaties are mainly with countries that have corporate tax rates broadly similar to those in Canada, but in a few cases, e.g. Singapore and Barbados, there are arrangements that provide a low rate of local tax on profits from international business.

D. International Banking in Canada by Foreign Banks

In this Report we have used the terms international banking centre and Euro-currency centre as virtually synonymous, both meaning those places where the world's banks tend to congregate to do international business. The larger home-banks of a country in which a centre is located can be expected to be important participants in the business done there, but a principal feature of such centres is the large share of the business done in them by foreign banks.

The international banking business done in Canada by foreign banks is that done by their subsidiaries in Canada, the Schedule B banks. The Schedule B banks are, of course, legally Canadian banks but they are foreign owned, and it is foreign-owned banks that we have in mind when we talk about foreign banks in the context of international banking.

The Schedule B banks do international banking in amounts that are significant for them in some cases but that are small relative to amounts done by the Schedule A banks. The parents of a number of the Schedule B banks are among the largest participants in Euro-currency banking, but they make very limited use of their Canadian offices in that regard.

The Canadian regulations governing the operations of foreign banks in Canada are primarily concerned with defining the terms on which such banks can participate in the domestic banking business in Canada. While they do not prevent the Schedule B banks from doing international banking, the fact that the regulations do not permit the foreign parent banks to operate branches in Canada does not encourage it since a branch is the best instrument for competing for Euro-currency deposits.

E. Comments on Some Means of Attracting to Canada More of the Activity Involved in International Banking

By virtue of the relatively large role that the Canadian-owned banks play in international banking, a considerable amount of activity in that business now occurs in Canada. Most of it is in the banks' international departments and in the branches that handle the international business that is booked in Canada.

At the same time, a good deal of the activity of the Canadian-owned banks in international banking occurs outside of Canada, and there is very little international banking activity by foreign banks in Canada.

If the consequences of any initiatives taken to attract to Canada more of the activity involved in international banking were largely limited to more booking here of the Euro-currency business that the Canadian-owned banks do, the benefits in terms of employment would not be large. Even though the amount of business that moved to Canada might look huge in money terms, the amount of additional employment generated here would be small. The reason is that the amount of on-site employment involved in administering even a large portfolio of Euro-currency assets and liabilities is not great. The efficiency of the Canadian banks would be somewhat greater if they could book more of their international business in Canada because they would be able to make better use of their facilities here, and their communications and control would be made easier; as a result the increase in employment in Canada would probably be less than the reduction in employment abroad.

The limited size of the benefits that could flow from booking more international banking business in Canada necessarily puts a limit on the cost that would be warranted to achieve them. It does not, however, preclude all initiatives, and there are some that we think merit consideration.

One important inducement to the Canadian banks to book business abroad has been the difference referred to in the previous section between the treatment of domestic and foreign branches in respect of tax credits arising out of withholding tax and the distinction between business and non-business foreign income.

If this difference were eliminated by extending these aspects of the tax treatment of domestic branches to the foreign branches, the result would be to make it more difficult for the Canadian banks to make international loans that attract withholding tax. Our banks would become less competitive in that type of lending and would do less of it.

If the difference were eliminated by extending these aspects of the tax treatment of foreign branches to the domestic branches, the result would be an increase in international assets booked in Canada.

We understand that the reluctance of the tax authorities to eliminate the difference in the latter way stems from a desire to preserve a country-by-country approach to foreign tax credits and a distinction between business and non-business foreign income for application to non-financial institutions.

If it is desired to preserve these principles for general use, there seems to us to be merit in exploring the feasibility of some special arrangement that would respond to the banking situation by making available offshore tax treatment for international portfolios held onshore. We believe that it would be possible to define and administer an arrangement that would permit the banks to set up in Canada international banking accounts into which they could put eligible international assets and liabilities and which would be treated as foreign branches for the aspects of profits tax that we have been discussing. The business that would be made eligible to be held in such accounts would be Euro-currency business with non-residents.

One problem that would arise in setting up this arrangement would be how to fit it into the provisions for tax sharing between the federal and provincial governments. Should the international banking accounts be regarded as offshore or onshore in that context? Most of the business that would be eligible for them is now booked abroad, and profits arising from it are not taxed by the provinces. On the other hand, a good deal of business now booked in Canada would be eligible to be held by such accounts, and the profits on that business are now taxed by the provinces. There would thus be arguments for and against the extension by the federal government of the 10-point tax abatement to the profits of such accounts.

If the international banking accounts were treated as offshore in the context of tax sharing, i.e. taxed at the 46 per cent rate by the federal authorities and not taxed by the provinces, the result would be that the Canadian tax arrangements would be neutral as between foreign and domestic branches. We believe that the banks would then show, for operating reasons, a preference for booking in Canada rather than in foreign branches, and more international business would be booked here.

If the international accounts were treated as onshore for purposes of tax sharing, i.e. a 10-point abatement extended to the provinces, then the outcome as regards booking would depend essentially on what the provinces did. At one end of the spectrum, if the host provinces did not give them some tax concession there would remain a tax inducement to the banks to leave abroad their business booked in foreign branches because the relief provided by the 10-point abatement would be exceeded by the burden of provincial taxes (see Appendix B). At the other end of the spectrum, if, in addition to the 10-point abatement, the host provinces exempted them from profits and capital taxes, great encouragement would be given to book business in the new international banking accounts in Canada rather than in foreign branches. Thus the assessment by interested provinces of the possible advantages to them of the international banking accounts would be

crucial; without the strong support of some provinces little could be achieved. The April 1985 Budget of the Government of Quebec indicates that that province is disposed to give strong support to measures to attract international financial operations to Quebec.

It would not be realistic to expect that the banks would respond to even a strongly-provincially-supported system of international banking accounts of the kind discussed above by more than a partial shift from the foreign booking of claims on non-banks to the domestic booking of such claims. There are both banking and tax reasons that would lead them to continue to book many such claims abroad. The banking reasons include access to regional economic information, access to their customers, and time-zone considerations. The principal tax reason is the tax advantage that we have already noted from placing international banking business in subsidiary companies in low-tax countries.

There are important legal differences between a foreign branch and a foreign subsidiary but in the context of international banking their similarities have tended to be emphasized. A branch, being an integral part of the bank, automatically engages the full resources of the bank, and this engagement is an essential element in winning and holding the confidence of customers. Even though the legal position may be that a foreign subsidiary stands on its own feet, it is generally assumed that in case of need the foreign subsidiaries of Canadian banks would have the same access to the parent banks' resources as branches, and this has helped them to operate like branches in Euro-currency markets. This assumption has tended to become more explicit in recent years as the risk of losses in international banking has received greater attention. It is not now uncommon for parent banks to enter into formal arrangements, in exchange for a fee, to guarantee or insure their own subsidiaries against loss on their assets.

Up to this point we have been discussing action that might be taken to affect the place of booking of the international assets of the Canadian-owned banks and bring more of this booking to Canada. There remains to be considered the possibility of much stronger action which would have as its objective to make Canada a truly important international banking centre by providing conditions which would encourage foreign banks to carry on a large part of their international banking business from this country. Those who urge this objective appear to believe that if Canada and the provinces were to exempt the profits on international business by banks in Canada from taxation (either wholly or substantially), this would bring to Canada a great deal of international financial activity which would provide employment for many skilled persons and would over time have a major general economic fall-out. (In some cases the proposal is that the tax concessions, and consequently the economic effects, should be restricted to one or two cities. This is essentially a political question on which we do not comment.)

These proposals recognize the vital fact that it is indeed the nature of a real international banking centre that foreign banks should have an important presence there. This is the case in London, in New York, in Hong Kong and in Singapore.

We have already noted that the regulation of the activities of foreign banks in Canada has not so far been designed to encourage them to do international banking here.

There can be no doubt that the exemption of the profits on international banking transactions from taxation would attract more of this business to Canada. The same can be said of tax exemption for any other business. A decision to offer it to international banking would require the support of evidence that the ratio of benefits to costs would be particularly favorable in that field.

It does not seem to us likely that Canada could win more than modest benefits from aggressive tax competition to attract international banking activity, and the extent of these would be uncertain. We recognize that Canada has important advantages as a base for supplying financial services to the world market – political stability, a good legal system, free and well-developed financial markets, large and highly-regarded banks – but several other countries have similar advantages. The competition that Canada would face in developing as an international banking centre would be intense. Canada would be most competitive in the Western Hemisphere time zones, and there we would face the competition of New York and other U.S. cities in our time zones. In Europe, London is well established and is vigorously seeking to maintain its position. Whatever the longer-term prospects of Hong Kong, it remains at present an important financial centre. If the Japanese authorities permit it, Tokyo seems very likely to emerge as the major international banking centre in Asia. Finally, it has to be borne in mind that, while the Euro-currency market will no doubt remain large, it is most unlikely to show the remarkable growth rates of the 1970s in the foreseeable future.

None of the other countries with Canada's advantages has tried to win a competitive edge in international banking through major tax concessions. No one knows how our competitors would react. London and New York did not achieve their predominance in that way, and the rates of profits tax there and in other comparable centres are not greatly different from those in Canada. The positions of London and New York have been buttressed by the increasing freedom that their countries have given to foreign banks to operate in them.

It should not be supposed that such benefits as Canada could obtain from major tax concessions to attract international banking business would be costless on the ground that the tax concessions would apply only to business that is not here now. Any reasonable definition of international banking activity would include a good deal of business that is now done in Canada and that now contributes to the tax base. The potential tax-revenue loss would not be insignificant. Moreover, a large differential between the tax rates on bank profits earned in international business (however defined) and in other business would necessitate a careful, difficult and costly allocation of bank costs and revenues. There would also be the non-measurable but real cost to public policy of major tax discrimination in favour of a particular activity.

The conclusion that we reach is that the benefits to be derived from major tax concessions designed to make Canada a truly important international banking centre would not be worth the cost. Our fear is that these concessions would have as their main result to make us an important international booking centre, with little important economic fall-out.

F. Summary and Concluding Comments

We have enquired into the business of international banking from the point of view of the distribution around the world of the employment involved in it to see if we would find room for initiatives that would be in Canada's interest to change that distribution.

By the business of international banking we mean the handling of the international capital flows that go through the world's Euro-currency markets. Though these channels are relatively new, they are now very large and seem likely to continue to be large. The Canadian banks are major participants in this business, accounting for 4 to 5 per cent of the total.

The principal determinant of the geographical distribution of the activity involved in international banking is the operating needs of the participating banks. The business is highly competitive, and the banks have to be suitably represented wherever in the world they can best do business and best serve their customers. A large proportion of the business is arranged in a few important banking centres, notably London and New York, where the participating banks find it efficient to have establishments for that purpose.

In order to be competitive, the Euro-currency banks have to minimize the costs imposed on them by banking regulations and by taxation, and this frequently obliges them to record their business on the books of their branches or subsidiary companies in countries that they would not otherwise have chosen. Thus a good deal of international business is booked in low-tax countries which are not otherwise financial centres. These are often referred to as booking centres.

Some features of the Canadian tax system provide a strong inducement to the Canadian banks to book their international business outside of Canada. International business booked at branches abroad rather than at home receives more favorable treatment in respect of foreign tax credits arising from withholding tax and in respect of a distinction made by the tax system between business and non-business foreign income. International business placed with foreign subsidiaries receives more favorable treatment than at home in that profits are not taxed by Canada until they are brought to Canada, and if they come from a country with which Canada has a tax treaty they are not taxed then.

We think that it would be reasonable, and advantageous for Canada, to give no less favorable tax treatment to the profits from international business booked in Canada than is now given when it is booked at branches abroad. We have outlined for consideration an arrangement that could help to achieve this result. It involves permitting the Canadian banks to set up international banking accounts in Canada in which they could book international business with non-residents and

have it treated in respect of foreign tax credits and the distinction between business and non-business foreign income as though it were booked in a foreign branch. How much influence this arrangement would have on place-of-booking decisions would depend to a considerable extent on how it was fitted into the system of federal-provincial tax sharing, and how much support the provinces thought that it warranted.

The benefit to Canada of an initiative of this kind would be that some, though by no means all, of the business now booked abroad by the Canadian banks would be booked in Canada. There would remain both banking and other tax reasons for a good deal of international business to continue to be booked abroad. While the amount of business that would move to Canada over time might be large in money terms, the increase in employment in Canada would not be large because the administration of even large Euro-currency portfolios takes relatively little on-site work. Neither the costs nor the benefits of an initiative of this kind would be great.

We have noted that proposals have on occasion been made by others for very strong action to attract activity in international banking to Canada. These have involved the total (or substantial) exemption of such activity from both federal and provincial taxes.

Proponents of major tax concessions foresee substantial economic benefits to Canada from them, in part from the booking and management in Canada of a much larger part of the international business now done by the Canadian-owned banks but mainly from the attraction to Canada of an appreciable part of the Euro-market activity of foreign banks.

We recognize that Canada has some natural advantages as a supplier of financial services to the world, and we also recognize that it is only by attracting a lot of Euro-market activity of foreign banks – by becoming a real and important international banking centre – that there could be more than a modest increase in employment in Canada in the international banking field. We believe, however, that Canadian efforts to develop into an international banking centre would meet intense competition from the existing centres and from other places with a potential as great as ours, and that it would be unwise to force the issue by vigorous tax competition. If the view is taken that rich priority should be given to increasing Canada's role in international financial affairs, it is our opinion that the way to pursue that goal is to take care that the tax arrangements in Canada are no less favorable than they are in the major international banking centres and that foreign banks in Canada are given as much flexibility for their international operations as they are given in those centres.

Appendix A

International Banking Facilities in the United States

The introduction of International Banking Facilities (IBFs) in the United States in 1981 is an interesting example of an initiative taken to change the geographical distribution of international banking activity.

Before the introduction of IBFs it was difficult for banks to compete effectively in the Euro-currency market from offices in the United States. The reasons included both regulatory and tax elements.

From the point of view of banking regulation the situation of the United States was unlike that of other countries in that the currency being used abroad was its domestic currency. U.S. banking regulations imposed reserve requirements (and had earlier imposed interest-rate ceilings) on the liabilities of banks in the United States to non-residents as well as to residents. Since banks operating in other countries were not subject to similar costs and constraints in doing business in U.S. dollars, banks operating in the United States were at a competitive disadvantage. The U.S. banks thus did their Euro-currency business mainly from offices outside the United States.

The tax element was state and local taxes. The federal profits tax was not seen by the banks as an obstacle to onshore banking because the method of calculating the tax, that of consolidating the profits of domestic and foreign branches, meant that the tax was not avoided by going offshore. Moreover, the federal rate of profits tax was not out of line with those in the home countries of the banks with whom the U.S. banks were competing. State and local taxes, however, tended to be high, particularly in New York State and New York City, and these could be avoided by doing international business abroad.

The fact that relatively little international business was booked in New York did not mean that that city was not a very important international banking centre. It is the world's largest financial centre, and much of the international business of both U.S. and foreign banks was arranged there. Much of the business of U.S. banks abroad was directed from there. But the final stage of the international banking transactions, the recording and on-site administration of them, was usually done elsewhere.

The constraint of the regulatory arrangements on the international operations of U.S. banks had long been recognized, but there had been concern that any significant easing of them would erode the effectiveness of monetary control. This concern was reinforced on the occasions in the 1960s and 1970s when the U.S.

authorities felt it necessary to take special measures to strengthen the international payments position of the country. While they lasted, these measures reduced the availability of capital from the United States and thereby stimulated the growth of the Euro-dollar market as an alternative source of U.S. dollar credit. U.S. banks participated actively in the Euro-dollar market but on an offshore basis, attracting the funds that they loaned from outside the United States.

In the late 1970s there was growing interest in the United States in searching for an acceptable way that would allow U.S. banks to participate in the Euro-dollar market from within the country. New York State played a leading role, and offered to exempt international banking transactions from state and local taxes if the other steps necessary to accommodate them onshore were taken. After much discussion the IBFs were agreed upon and introduced. The argument for them was that they would, without eroding monetary control, increase employment and improve banking surveillance and banking efficiency at very little cost in that the reserve and tax concessions involved were already available to the banks through operating offshore. On a more global level it was argued that a U.S. initiative of this kind would be a constructive step towards more intergovernmental cooperation in the management of the international financial system.

The IBFs are systems of separate accounts kept by deposit-accepting institutions for business which is eligible, that being business with non-residents of the United States that is wholly external to the United States. The deposits in IBFs are free from reserve requirements, from interest-rate limitations, and from deposit insurance coverage and assessments. IBFs are available to any U.S. bank and to any foreign bank operating in the United States. IBFs have been given no concessions from U.S. federal income tax, but they have been given major concessions from state and local income taxes in a number of states.

Although the regulations governing the IBFs permit them to be used for many kinds of international business, there are still some constraints imposed for reasons of monetary control. IBFs cannot accept overnight deposits from non-financial sources, they cannot issue instruments in negotiable or bearer form, and they cannot do individual transactions with non-bank customers of less than $100,000. Nor can they do business with residents of the United States (except other IBFs), or with foreign affiliates of U.S. corporations to finance U.S. activities.

As of April 24, 1985, 159 institutions had IBF assets or liabilities of at least $300 million, and 51 of these were U.S. institutions and 108 were U.S. agencies or branches of foreign banks. They reported liabilities other than to their own U.S. offices of $231 billion, $89 billion for U.S. institutions and $142 billion for foreign institutions. Of the 159 institutions, 98 were in the State of New York, with liabilities of $179 billion, and 75 of these were the U.S. agencies or branches of foreign banks, with liabilities of $116 billion. Less current statistics indicate that nearly all the other IBFs were in the states of California, Florida, Illinois and Texas.

The extent of the use of IBFs by foreign banks has been surprising. It appears to reflect in considerable part their use for Western Hemisphere business by Japanese banks, and to a lesser extent Italian banks, these banks having made little use of booking offices in the Caribbean. Several Canadian banks have established IBFs but their use of them does not seem to have been great.

It is still too early to judge what the impact of IBFs on the distribution of international banking activity will eventually be. Some large U.S. banks have moved substantial amounts of business to the United States from their Caribbean offices but others have tended to put only new business into IBFs. The use of IBFs in the State of New York has been constrained by uncertainty about how the new tax regulations of that state will be interpreted. There seems to be a considerable range of opinion among U.S. bankers about the longer-term effects of the limitations on IBFs compared with offshore operations, and there has been disappointment that Euro-dollar depositors have not shown the preference that some bankers expected for deposits booked in IBFs over deposits booked elsewhere.

It has become clear, however, that the IBFs are not going to generate the large increase in employment in New York or elsewhere in the United States that some earlier advocated. Suggestions that they would create, directly or indirectly, 5,000 to 6,000 new jobs have turned out to be substantial overestimates. The experience has been that moving even large amounts of Euro-dollar business from the books of one bank office to another involves very little movement of staff. That is particularly the case when business is moved to the head office, where large and specialized staffs and facilities are available to absorb the extra work.

Appendix B

Some Provincial Tax Rates Relevant for Banks[1]
(as at end 1984)

	Corporation income	Corporation capital
	(per cent)	
British Columbia	16	0.8/2.0[2]
Alberta	11	nil
Saskatchewan	16	0.8
Manitoba	16	1.9
Ontario	15	0.8
Quebec	05.5	0.9
New Brunswick	15	nil
Nova Scotia	15	nil
Prince Edward Island	10	nil
Newfoundland	16	1.5

(1) Other provincial taxes that affect the operating costs of banks are also relevant. In Quebec, for example, a levy on corporations of 3 per cent of payroll for health insurance, and relatively high rates of personal income tax, are relevant. The April 1985 Quebec budget proposes a number of tax reductions in order to attract international financial operations to Quebec.

(2) 0.8 per cent where the amount taxable is $500 million or less, and 2 per cent where it is in excess of $500 million.