Insight

International Capital Requirements and Overseas Corporate Holdings

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Overseas holdings by U.S. multinationals have increasingly drawn attention from policymakers for a variety of reasons. In the early stages of the recovery, these holdings were viewed by some as a potential source of domestic investment, or "stimulus." Since that time, the large (on the order of $2 trillion) holdings have drawn the attention of policymakers for other reasons, either as a source of new tax revenue for federal spending projects or as mere evidence of complex tax avoidance, a sentiment that has only grown as attention increases on so-called tax "inversions."

Tax reform that improves the incentives to return some of these holdings would benefit the U.S. economy. However, it is important to remember that not all of this money will be returned. Some of these holdings will be reinvested abroad so U.S. multinationals can better service foreign markets. More notably, some of this capital is actually held overseas by U.S. banks in order to comply with international banking regulations. Indeed, just a review of the net capital reserves of six of the largest U.S. financial institutions show that these firms have over $231 billion in net capital reserves held overseas.

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The Basel Committee on Banking Supervision, a body consisting of representatives of 27 central banks including the Federal Reserve, establishes common sets of banking regulations. Central banks voluntarily adopt each set of regulations established in the Basel Accords. Any bank incorporated in a member country must comply with that country's implementation of the Basel Accords, even if it is a subsidiary of a foreign company. For example, a subsidiary of U.S.-based Citigroup incorporated in the UK must meet the Bank of England's capital requirements.

In 2004, the Committee released its second set of rules, the Basel II regulations. While the Basel III rules are currently replacing Basel II, the requirements stated below are essentially the same. Pillar 1 of the regulations requires banks to hold a set percentage of their risk-weighted assets in capital; this percentage is 8 percent under both Basel II and III. A bank's regulatory capital acts as a safeguard against a bank's unexpected losses. Banks must hold capital that corresponds to three types of risk: credit, market, and operational risk. In order to further protect themselves from risk, banks typically hold more capital than is required by the Basel regulations.

Pillar 2 of the regulations requires each individual bank and its central bank to review the bank's regulatory compliance. Pillar 3 requires each bank to disclose how much it holds in regulatory capital and how much is required. The data showing each bank's capital reserves and requirements are taken from each bank's pillar 3 disclosures. The data show that banks do, in fact, use much of their overseas profits to safeguard themselves from unexpected losses in accordance with banking regulations.

As policymakers contemplate tax reform or other undertakings that seek to gain access to overseas holdings, it is important to recognize that billions in overseas funds must remain abroad to ensure foreign subsidiaries of U.S. banks are adequately capitalized and in compliance with international regulations.